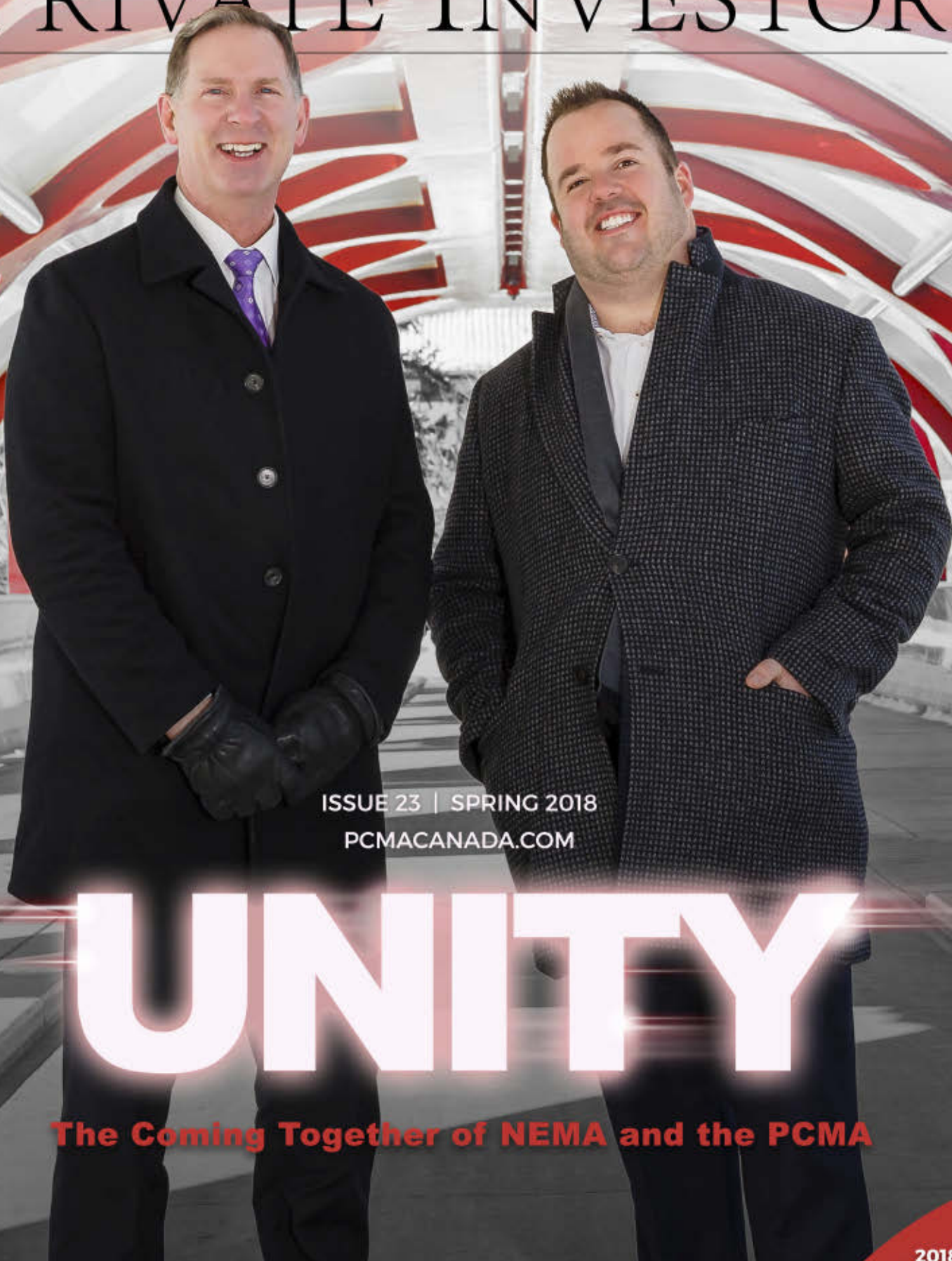


# THE PRIVATE INVESTOR



ISSUE 23 | SPRING 2018  
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THE OFFICIAL PUBLICATION OF THE PRIVATE CAPITAL MARKETS ASSOCIATION OF CANADA

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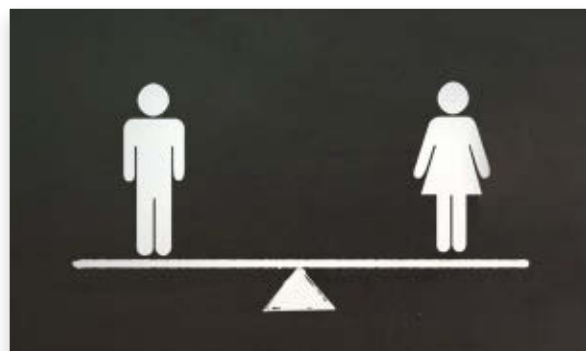
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# THE PRIVATE INVESTOR

## LETTER FROM THE EDITOR

SPRING - ISSUE 23

2018 PCMA  
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### Craig Skauge

Vice-Chair (at-large)

Prior to founding the Western Exempt Market Association (the first name of what came to be known as NEMA) back in 2010, I was made aware of what was known at that time as the Limited Market Dealers Association.

My reputation as somewhat of an agitator to securities regulators out West had spread easterly and caught the attention of the then LMDA. Learning that I had gained somewhat of a following of the would be Western-based EMDs I was asked if I'd be willing to refer my contacts and clients out east to join the LMDA and help support an organization that was theoretically fighting the same fight.

It seemed logical to do so, so I undertook some due diligence on the organization. Ultimately I decided not to refer anyone to them and live by one of the mantras I was raised with "If you want something done right, do it yourself".

While there wasn't necessarily anything wrong with the LMDA, I was raised as many Western Canadians, particularly Albertans are, with a bit of a chip on my shoulder in regards to our Eastern brethren. The fact that the LMDA, at the time, was run predominately by Bay Street lawyers and accountants, didn't help. In addition, the lack of the predominant exemption that my contacts and clients relied on at the time, being the Offering Memorandum exemption, further led me towards doing it myself.

So I did.

While I knew it would be a lot of hard work and may in fact upset some of those working tirelessly at the LMDA at that time, I saw little choice but to start my own association.

Without commitments from anyone, I formed WEMA as an Alberta Society and got to work. First came the raising of the seed money from founders such as Olympia Trust, Pinnacle Wealth Brokers, and Miller Thomson and then came time to develop some marketing



materials and gather members. Needless to say, forming a sustainable non-profit was easier said than done.

Nonetheless, after years of hard work by myself, our directors, and members, we made a meaningful impact in this market place, playing a fundamental role in educating investors and outside advisors about private market securities, advocating for sound regulation, and ultimately our biggest achievement, helping to get the offering memorandum exemption adopted in Ontario.

From WEMA's founding to the ultimate merger with the PCMA, I've learned a lot. Far too many lessons to share here so I'll just keep to the most important one.

While the chip on my shoulder in regards to most regulators, bureaucrats, and politicians remains, my broad brush view of 'the East' was unfounded and just plain wrong. Many of those behind the PCMA aren't fundamentally that different than myself or those who founded WEMA with me. We want the same things.

We want vibrant and healthy capital markets, in particular private markets.

We want good investor protection but not at the cost of efficient capital formation for entrepreneurs.

We want average Joes and Janes to have access to the same kind of investment opportunities enjoyed by large pension funds and the so-called smart money.

We want the private markets to be properly understood, treated with respect, and most importantly to have a voice that never goes unheard. As a unified voice, we're closer than ever to making that a reality.

This first issue of the PCMA Private Investor magazine is a testament to us being better together than apart.



*Craig Skauge was the Founder of the National Exempt Market Association. Mr. Skauge is currently a member of the Alberta Securities Commission Exempt Market Dealer Advisory Committee and a former member of both the Ontario Securities Commission Exempt Market Advisory Committee and Small and Medium Enterprises Committee. Mr. Skauge is the President of Olympia Trust Company. Recognized as a leader and national subject expert on the Canadian Exempt Market. Mr. Skauge has been featured in the Financial Post, Globe & Mail, and Investment Executive and is a regular speaker at industry events.*

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# An Overnight Success Story

## AFTER TWELVE YEARS

By Tiffany Burns

“It’s been 12 years, two recessions, and an \$85 Million cap ex program, but it’s really just the beginning,”

said Anthony Giuffre, CEO of Avenue Living Asset Management. “Now that we’re stabilized, we look more like our larger public peers, except we’re not indexed to a stock price. The final part of our journey is to de-lever.”

Since it was founded in 2006, Avenue Living Asset Management had been on an aggressive arc of multi-residential acquisition. But when the price of oil plunged in 2014, the company stopped asset hunting. After the ink dried on the final deals, Avenue Living’s Real Estate Core Trust portfolio had more than \$850 Million worth of assets under management, totaling 6124 units.

In the face of a regionalized recession with no end in sight, Giuffre decided to double down, focusing on operational stabilization. Avenue Living started a massive capital expenditure program in 2015. An \$85 Million investment in renovations and upgrades across the entire portfolio resulted in 90% occupancy.

“The most difficult thing to achieve when you build a company is to standardize all processes,” said Giuffre. “After focusing on that for the last three years, we are ready to de-lever the balance sheet, which will put us in an optimum place to seize new opportunities.”

### A NATURAL HEDGE

“The benefit of multi-family residential is that we don’t experience large blocks of lease expirations,” said Giuffre. “The continuous flow of tenants coming in and out of our buildings is a natural hedge. Each month we typically see 1.5 to 3% tenant turns. And because we’re in a non rent-controlled environment, we’re also able to keep pace with interest rates.”

For investors interested in real estate exposure, Avenue Living offers a significant scale of multi-residential with geo-demographic diversity. The platform is spread across multiple markets in three provinces: Alberta, Saskatchewan and Manitoba.

### SKIN IN THE GAME

Giuffre is part of a small control group that is the single largest shareholder of the Core Trust — in excess of 50% of the equity.

“Investing alongside your investors creates better management,” said Giuffre. “As a result, we take a long term approach to our investing fundamentals.”

### EQUITY RAISE

To finance an \$85 Million renovation through the worst regional recession in history, Avenue Living had only one option – borrow from non-conventional high cost lenders.

Now past the depths of the downturn, Avenue Living’s Real Estate Core Trust is currently raising an additional \$75 Million to swap this high cost debt for equity. The Core Trust buys into the company’s existing limited partnership and holds an interest pari passu to existing investors. By replacing high interest cost debt with distribution-paying equity, the optimization of the balance sheet is immediately accretive to investors in the platform.

\$75 Million is just the start. Avenue Living has many accretive acquisition opportunities to grow the platform into 2019 and beyond. The company is structured to be an open-ended vehicle.



**Tiffany Burns**

*Calgary-based journalist and TV personality.*

 @Tiffany\_Burns



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By Peter Figura

**D**espite rising interest rates and the expectations that Bank of Canada might move (although that is not really certain at this point) twice to raise the rates again, we are still operating in the historically low levels, and to those investors who are looking for more attractive yield, “conventional markets” are still being offered a very limited opportunities.

For many investors, one of the options is investing in private income driven securities. In that space one of the very interesting opportunities is being offered by Invico Diversified Income Fund (2016 winner of the Fund of the Year award in “Diversified Mature” category).

Jason Brooks – Invico President sees the fund as one that addresses key things investors are looking for in today’s high yield markets: well diversified portfolio, monthly income, protection of capital, and mitigation of risk”. Being a niche player focusing on income driven securities Invico focuses on two types investments: private debt which represents lending strategies, and energy working interest, which represents direct participation in production of oil and gas on a joint venture basis.

Invico Diversified Income Fund was created in 2013 in response to investors demand. After the carnage of 2008-2009 financial crisis there was much moderate demand for high (and risky) returns. Investors were much more willing to settle for single digit returns in exchange for diversified portfolio, income and protection of capital. Invico fund with preferred target return of 8-10%, monthly income, and diversified portfolio was well position to fill the gap in high yield income product.

Allison Taylor, Invico CEO and Portfolio Manager thinks that well diversified fund such as Diversified Income Fund, which offers access to very unique opportunities that investors otherwise would not be able to invest in, shod be a very attractive and solid part of

many investor’s portfolios. Our fund – says Taylor – is very actively managed by well experienced team of Portfolio Managers, lending specialists, investment professionals, due diligence experts, energy technical professionals, accounting and marketing professionals.”

The lending strategies are represented by bridge financing, traditional mortgages, and factoring. “Companies that are approaching Invico, are traditionally private companies, too small for the banks to deal with, and very often need money quickly” explains Taylor.”They are prepared to pay higher interest, as quick access to money will allow them to seize the opportunities for their business”.

Other unique strategy on the lending side is factoring. With big companies paying their smaller contractors within 60-90 days, which very often is too long, Invico has the ability to pay the receivables within 2 weeks. Lending against the good credit rating of the large companies and having access to credit insurance provides protection of capital for the portfolio and ultimately for the investor.

Our very interesting strategy that allows Invico to generate those attractive target returns is our energy working interest- says Jason Brooks who is also Invico Fund Manager. Owing land rights and having a partner on the ground Inico is able to shape the profits created through oil and gas exploration. With oil recovery we think that in 2018 not only Invico will be able to deliver targeted returns, but also will allows investors to participate in the profit sharing – says Brooks.



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# Blockchain Technology Part 1

## “Blockchain Assets” as Collateral

By Adam Armstrong and Marko Trivun

**Bitcoin was conceived in a 2008 white paper entitled *Bitcoin: A Peer-to-Peer Electronic Cash System*, authored by one or more persons using the pseudonym Satoshi Nakamoto. But it wasn't until the launch of Ethereum in 2013 that excitement and appreciation for the true potential around the technology underlying Bitcoin, the blockchain, went mainstream.**

**C**hief among Bitcoin's many accomplishments was an ingenious solution to a problem that arises when one tries to “digitize” an asset. A physical banknote cannot be spent twice: once you hand it over to the payee you no longer possess it and as a result you can't spend it again. The vast majority of money in circulation in a modern economy is digital in that it only exists on a bank's ledgers, but it can't be spent twice because of the settlement and clearing process run by third party intermediaries such as banks and credit card processing companies. However, before blockchain was invented, a true digital asset that does not require a third party intermediary was not possible because it could be copied easily in the same way that you copy a picture every time you send it to another person over text.

In this series on the blockchain, we examine certain legal challenges

to the use of the blockchain for recording asset ownership, including securities laws and privacy laws. We begin our series by examining the challenges a lender would face in trying to take security over a blockchain asset.

### What is a blockchain?

A blockchain is a decentralized network of computers otherwise known as nodes which collectively process, maintain and distribute a digital record of activity. Blockchains operate on a computer protocol that uses ingenious cryptography that replaces the function third party intermediaries would otherwise play in verifying transactions.

Given the potential of the blockchain technology to revolutionize how parties transact with one another, a lot of brainpower is spent



by entrepreneurs around the world to figure out what other problems it can solve and what assets it can hold. For example, a Chinese company called Onchain Blockchain Services has launched the first open-source blockchain protocol in China. This blockchain (called NEO) touts the ambitious goal of digitizing and recording all forms of asset ownership in China. In Sweden, the government is considering using the blockchain to replace the land registry.<sup>1</sup> Bext360 is a startup with the ambition of using blockchain to pay farmers fairly for their coffee beans.<sup>2</sup> IOTA relies on a directed acyclic graph, as opposed to traditional blockchain structure, to allow for feeless transactions, unlimited scalability; it is also positioned to be the infrastructure for data transfer for the “Internet of Things.” Symbiont is working with the State of Delaware to transfer Delaware incorporated companies to a blockchain register.<sup>3</sup> Companies like Augur and Gnosis are using the Ethereum blockchain to create a predictive markets platform which allow users to bet on the outcome of any future event (i.e., a sporting match, an election or the price of oil.) The list of use cases is seemingly endless and is a driving force behind the exponential growth in the value of blockchain assets over the past few years.

### How does a blockchain work?

The challenge with explaining how blockchain technology actually works lies in the way it replaces intermediaries and allows users to transact on a peer-to-peer basis with trust. One way to think about blockchain is to imagine just that, a “chain of blocks.”

The following describes how a blockchain using a proof-of-work consensus algorithm works. When a transaction is submitted to the network (e.g. John sends one Bitcoin to Todd), it sits in a pool with all other pending transactions on the network waiting to be verified by a node (for the purposes of this process, a “miner”). Miners scan the network periodically for pending transactions, then combine one or more transactions into a “block.” The miner races to solve a type of cryptographic puzzle called a hash function to validate such block of transactions. This cryptographic process proves, among other things, that the purported owner of the account sending value does in fact “control” such account (i.e., by verifying that the account number of the sender and the “digital signature” of such transaction, which is derived from a private key linked to the account number as well as certain text from the transaction). This process also verifies that the account sending token of value actually holds the thing it purports to transfer, thus addressing the “double-spend problem” alluded to earlier. To prevent against double-spending, the solution to each cryptographic puzzle (remember, a transaction does not occur until the puzzle is solved) requires some data output (i.e., the hash) from the last block of transactions verified on the chain. So each block links to the previous block in a linear fashion (hence the terminology, “blockchain”).<sup>4</sup> This process also renders it unfeasible for anyone to alter a historic transaction without de facto altering the data in every transaction that has since followed; a key underpinning to the security of blockchain technology.

**With data breach being a subject of increasingly prevalent concern, there is an inherent value proposition in the enhanced security of a decentralized blockchain network.**

Once a node successfully solves the puzzle for a given block, it broadcasts the results to all other nodes on the network which independently verify the solution using simple math. If a consensus is reached by the majority of nodes, the block is placed next in the chain and permanently recorded on the network and time-stamped. The successful miner is rewarded an amount of digital currency to compensate the miner for its costs of verifying the transaction (electricity and hardware). This particular process is referred to as mining or proof-of-work but note that contemporary blockchains are moving towards more efficient processes for validating blocks.<sup>5</sup>

### Why is blockchain technology valuable?

It’s secure. Unlike In a departure from classic conventional computer networks in which a central database exists to which all other nodes in the network connect, a blockchain is a decentralized and distributed network with no central database. Each node in a blockchain hosts its own copy of the master record of all activity occurring on the network thereby eliminating the risk inherent in a classic network containing a single point of failure. And given that data breach is a subject of increasingly prevalent concern to financial institutions, large corporations (and us business lawyers), there is an inherent value proposition in the enhanced security of a decentralized network.

*It cuts out the middle man.* A corollary to decentralization is disintermediation. Theoretically, a blockchain can allow users to transact with one another on a peer-to-peer basis without the need of trust or intermediaries. The cost savings that this technology may realize through the redundancy of escrow agents and other financial intermediaries is significant.

### Legal Issues and Blockchain Assets

There is a lack of consensus on a definition for what blockchain assets are. Fundamentally, blockchain assets exist as a state of information stored within a database.<sup>6</sup> And while information is not generally considered to be a form of property in Canadian law (with the exception of intellectual property), blockchain assets are bits of information that only the owner (i.e. the person with the private key) can exercise exclusive control over, akin to private property. Jurisdictions around the world take differing approaches to classifying these assets. In the Philippines, blockchain assets are remittances; in Japan, legal tender; in the United States, property or commodities.<sup>7</sup> But even if we agreed to classify these assets as a form of intangible property, there would still be a number of legal issues that would need to be addressed before blockchain assets can be fully adopted in current market practices.

For instance, consider the need for financial lenders to be able to perfect security interests over the blockchain assets of borrowers. *The Personal Property and Security Act* (PPSA) establishes a

comprehensive statutory framework to govern the creation, perfection, priority and enforcement of security interests in all types of personal property.<sup>8</sup> “Personal property” is best defined as property that is not land.<sup>9</sup> “Security interest” is defined in the PPSA as an interest in personal property that secures payment or performance of an obligation without regard to the form of the transaction or the location of title to the collateral.<sup>10</sup> There are evident gaps in the rules with respect to blockchain assets, exemplified by the fact that neither the PPSA nor the Securities Transfer Act (STA) contemplate the perfection of security interests over securities that are digitally represented. Currently, there are established rules for certificated and uncertificated securities, but blockchain assets do not seem to fall into these existing legislative frameworks. Absent specific rules governing the perfection of security interests over blockchain assets, it is unlikely that lenders would accept such assets as collateral without having certainty that lenders could legally enforce their rights against such collateral. Before the legislature catches up, the blockchain community might have a technical solution that would significantly disrupt the methods by which financial lenders take collateral over a borrower’s assets. Through the use of “smart contracts” on platforms such as Ethereum, parties could program an autonomous trust agent designed specifically to receive a transfer of digital assets from a borrower as collateral, and either release the assets back to the borrower upon satisfaction and repayment of a loan, or transfer the assets to the lender or some other third party upon an event of default. The smart contract would read and execute the terms and conditions of the underlying loan agreement between the parties. Both the borrower and the lender would have confidence in this process because the underlying code would be transparent, unbiased and incorruptible. It would also have virtually no cost to the parties aside from the nominal electricity costs of operating the nodes.

At the current state of the technology, it is questionable whether the more complex terms and conditions of modern loan agreements are machine-readable. While smart contracts can rely on third-party data provided by ‘oracles’ (trusted sources) to monitor the bank accounts of a borrower to determine whether certain financial covenants are met, smart contracts are unlikely to determine whether a borrower has made reasonable best efforts to cure an event of default, or whether a lender acted in *bad faith*. Many legal standards are inherently subjective, and until the advent of more advanced forms of AI, these standards are likely to require human intellect to be accurately interpreted.

The more overarching concern relates to the fact that transactions on a blockchain are immutable, and therefore final. In the event that a nefarious lender or borrower (or other third party) managed to exploit a bug in the code of a smart contract or blockchain protocol and misappropriate the collateral funds, there is limited recourse that the parties may take to recover the funds. Such a scenario is not outside the realm of possibility; in 2013 an unknown hacker exploited a bug in the Ethereum platform to steal \$150 million

worth of Ether from a fundraiser for a project called the DAO (decentralized autonomous organization). In the case of the DAO hack, the majority of the Ethereum community decided that implications of the hack were significant enough to justify “forking” the blockchain (effectively an agreement between every node on the network to “undo” the record of the hack from the history of transactions). At the time this decision as contentious and resulted in the split between Ethereum and Ethereum Classic, the latter being the minority of nodes that principally did not agree to update their record. As blockchains continue to scale, updating every node’s record of transaction history in order to undo an illegal or otherwise contested transaction becomes increasingly unrealistic and impractical. New blockchain projects such as Tezos attempt to address this issue by incorporating voting rights into the project’s native token, so that token holders can theoretically address any issue (such as whether to undo a transaction or otherwise change the protocol) through an on-chain governance structure. But until the security of smart contracting is proven quantity, lenders may be hesitant to incorporate these new technologies into their business processes.

## Conclusion

Our goal is not to dismiss blockchain technology’s capacity to disrupt, but to simply complicate the issues. In order for blockchain technology to truly replace the *status quo*, among its many other obstacles, it has to be able to fit into the rules and practices of the modern economy. The gaps in the existing blockchain technology will undoubtedly require an evolution in legal thinking if the technology can’t adapt to the law.

*Disclosure: Some of the authors of this article have invested in blockchain startups, including initial coin offerings.*

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# Blockchain Technology Part 2

## Can Canada Unlock its Blockchain Potential?

By Marko Trivun

**In the early days of the Internet, there was much skepticism as to its utility, even while those in the vanguard promoted its revolutionary potential.**

Ultimately, a community of entrepreneurs and programmers, with government funding, and later with private capital, brought the Internet to the world. Blockchain, the technology powering Bitcoin and other “cryptocurrencies,” is generating similar reactions.

Originally driven by “crypto-anarchists,” the open source development movement and technologically savvy investors, blockchain has the power to disrupt entire industries (including financial services) or even create the basis for a new peer-to-peer internet. Further to that, blockchain has the potential to more broadly distribute the economic benefits of a successful technology by rewarding the users of the services, not just the early investors in a venture.

### Canada’s Blockchain Hub

Blockchain also has a hub of talent in Canada – centered in the Toronto-Waterloo Region tech corridor. One notable and promising project, Ethereum, was in large part developed in Canada, and there are blockchain incubators and other hotly anticipated projects based in Toronto.

But despite this local talent, much of the value generated by innovation in the blockchain space is being captured outside Canada. It is a combination of regulatory barriers to cryptocurrency and token issuances and a general air of regulatory uncertainty that is driving developers and entrepreneurs to seek out more predictable jurisdictions like Switzerland and Singapore.

**The greatest risk for Canada is the opportunity cost of not being a global hub for a potentially revolutionary technology.**

These missed opportunities have concrete costs to Canada. Not only are provincial and federal governments foregoing potentially significant sources of tax revenue, but talent that may contribute to the next wave of technological innovation is leaving Canada. Canadian companies focused on blockchain are increasingly establishing offshore operations as the base for their blockchain activities. Examples of this include Kik, a Canadian company that excluded Canadians altogether from its recent token offering due to regulatory uncertainty, and the Ethereum project’s governing foundation, which is located in Switzerland.

Amid this uncertainty, the greatest risk for Canada is the opportunity cost of not being a global hub for a potentially revolutionary technology.

### Regulatory Response to Technology

Regulators’ attitudes toward blockchain technology are understandable: the decentralized, open-source ethos of the blockchain community transcends borders and facilitates transactional pseudonymity. Governmental control has been cited as a basis for bans on cryptocurrency in China and other jurisdictions.

But if Canada is to begin capturing the potential value generated by blockchain technology, a compromise between regulators and the blockchain community needs to be reached. What might that compromise look like? We look at two of the main regulatory challenges: securities law and taxation.

## Securities Law

Canadian securities regulators to date have responded conservatively to the blockchain revolution, with reference to the existing case law and regulatory treatment of “investment contracts.” That approach is generally consistent with the SEC, although in practice, it appears that bona fide blockchain developers see greater opportunities for U.S. token issuances that have demonstrated consumptive utility (that is, they can be used to pay or reward contributors to the particular blockchain technology). Conversely, the token-based ventures that have been accepted by the Canadian securities regulators to date (through exemptive relief, including Impak and Token Funder) have been limited in scope or have been subject to specific restrictions that differ from the prevailing market practice in other jurisdictions.

### Real challenges lie in arriving at a compromise that fulfills the needs of both the government and the blockchain community.

Securities regulators are required to balance investor protection with the support of fair and efficient capital markets. Where novel instruments or structures emerge in the market, typically the regulatory reaction is to “occupy the field” and deal with any perceived immediate investor protection concern. Regulatory innovation or adaptation may follow, but that can be a protracted and ultimately unfulfilling process from the entrepreneurs’ perspective. Consider, for example, the gap between the initial enthusiasm for crowdfunding and subsequent limited uptake after a specific regulatory framework was developed. Canada’s blockchain and broader technology communities will be best served if the securities regulatory response is nimble, timely and competitive with those of other global jurisdictions.

## Emerging Best Practices

On the other side of the equation, blockchain’s increased profile and use has arguably started to drive the development of “best practices” by the blockchain community. Increased transparency and blockchain community assessment of specific projects can help “cull the herd” and mitigate the risk of investor loss due to fraud, or simply unviable projects. Investor and regulatory confidence alike should be strongest where:

- The project team has released a technical white paper that details the technology and does not simply function as a marketing document and, as discussed below, where there has been independent review
- The project has a website detailing the project, including the backgrounds and biographies of the core management and technology teams and its financial or other sponsors
- Potential investors have a meaningful way to contact the project team to ask questions
- The underlying protocol or application of the token is sufficiently advanced in development to demonstrate that the token has meaningful utility
- The code is open source and audited by credible third parties, which may help expose fraudulent or non-viable offerings

- The project and its technology are capable of being assessed online by community members, with engagement from the project team
- The percentage of tokens retained by the foundation and core team is transparent and consistent with market standards

In addition, the cryptocurrency community – traditionally opposed to centralized authority – will need to accept some barriers to entry as a means of filtering fanciful or fraudulent projects so that government’s interest in consumer and investor protection can also be fulfilled.

Presently, the “vetting” of projects is largely performed by reputable community members. This practice often consists of rigorous online reviews of the project and official code audits. In both cases, the results are publicly released so that community members are able to gauge risk and make decisions accordingly.

One option is for the community to accept a formalization of this role – so that regulators and community members can take greater comfort from the credibility of code audits as well. This approach would not be unique. For instance, regulators already rely on reports of the International Standards Organization and the American Institute of Certified Public Accountants. These organizations are not governmental bodies, but they prescribe standards and test compliance.

With these considerations in mind, regulators can develop policy that enables the blockchain community to retain the open-source and collaborative ethos that has allowed it to thrive.

## Taxation

Although regulatory issues are a significant barrier to the success of blockchain technology in Canada, taxation cannot be overlooked. Currently, blockchain companies often structure their affairs so that the entities issuing the tokens are located in low-tax, regulation-light jurisdictions such as Singapore, Switzerland and, more recently, Gibraltar.

Tax expenditures are a valuable policy tool, and a regime of tax credits and other financial incentives for blockchain startups can help Canada remain competitive against low-tax jurisdictions and ensure that value created by Canadians is captured in Canada.

## Conclusion

Real challenges lie in arriving at a compromise that fulfills the needs of both the government and the blockchain community. But the costs of the status quo are too high. Not only is capital escaping to other jurisdictions, but talent—the real engine of innovation and growth—attracted to this technology is escaping as well.



By Marko Trivun  
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## Why Private Capital Markets Need Public Relations

By M. Corey Goldman

**T**he implicit assumption is that a lawyer is schooled in and understands the law and the process behind it, and works toward protecting their clients' interests, providing value for their service.

Public relations is arguably similar: schooled in the world of media and trained in the court of public opinion, public relations professionals provide service and expertise on everything from how to get a message out about a new product or service (think Apple) to how to navigate and fight back when the court of public opinion has already rendered judgement (think United Airlines).

Of course, navigating the legal world and the media world are two very different things. Yet few opt to navigate the legal system without representation. Indeed, explaining why one doesn't step into the courtroom without a lawyer remains much easier to explain to a company or individual than why handling their own public relations isn't necessarily the most prudent course of action.

The financial services world, and the capital markets realm in particular, typically has placed PR pretty far down on the "might consider having" list. And for seemingly good reason: In a world where returns generally speak for themselves and relationships are everything, standing on a soap box touting one's brand, expertise and capabilities is somewhat *de rigueur* – it's simply not how things are done.

### Or is it?

A quick flip through the top fold of the daily newspapers, or a stroll through Toronto's underground PATH network, literally assaults one's senses with ads from various financial services firms. From banks to mutual fund companies to ETF providers and others, smiling, happy, retired couples aided by maps, compasses, lighthouses and other guiding metaphors abound – replete with little asterisks and fine print noting in legalese that, "Past performance does not guarantee future results."



While advertising and marketing still very much have their role and place in grabbing the public's attention, the advent of social media, digital platforms and a potential target audience far beyond newspaper readers or PATH walkers is now the norm. Take a look at the folks walking through the PATH or frankly anywhere around any town: they're likely not reading a newspaper or gazing at a billboard – they're nose-down in their smart phones.

What an advertising or marketing expert will tell you is that you need to get your ads online, which is not entirely untrue. A good ad on the right medium can help elevate your offering, your visibility and your brand. What a PR pro will tell you is that, more importantly, you need to get your true voice out there – your genuine story, viewpoints and perspectives that make people not only see and understand what you do, but also how and why you do it – and why they should join you for the ride.

Communications at its core is story-telling. It goes beyond “who you are” or “what you do” towards how and why you do it. It's about giving life to what you do and establishing the means to build a connection between you and your clients – not just one-way messaging. People aren't likely to remember every figure and percentage point they see on an ad boasting high returns and positive results; they will however, remember a story about a fund manager with a compelling take on the day's market activity, or a great anecdote explaining why a particular investment did well for their investors.

Yet, in a sector that has long relied upon traditional marketing and advertising to bring in clients, not to mention past returns and pictures of compasses and lighthouses, the argument for shifting toward a story-driven public relations and communications campaign still resonates as a “nice to have.”

To be sure, the PR industry has long struggled to highlight to the finance sector in particular its value: even in today's digital, algorithmic world, there is still no foolproof way to draw a line between someone hearing, viewing or clicking on what you said and signing

on the dotted line. With private capital markets in particular, there is even more skepticism – that the typical target investor or client isn't on social media, doesn't want or need to hear views or a “story,” and, as the moniker suggests, is more “private.”

The true value of public relations to financial services and private markets in particular – which for that very reason is understandably overlooked by financial services – lies in the fact that publicity through positive and consistent media presence is the most effective and reliable way of actually establishing visibility, authority, and credibility; factors that are all growing increasingly important to prospective clients who in today's world know the difference between spoken to, or with.

Think of it this way: The next time you're presenting to a board or group, consider that at least one of those individuals, either before, after or even during your spiel, has already done a Google, LinkedIn and even Instagram search on you and your firm – looking to not only see whether you have a presence online, but what exactly you say about who you are, what you do, and why you're different.

Of course, there is still a place for advertising and marketing, and there likely always will be. But now more than ever financial services – private capital markets included – need to embrace a broader communications strategy geared toward not just reaching – but resonating and communicating with – their target audience.



**M. Corey Goldman, CEO**

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# IT'S TIME TO CHANGE THE CONVERSATION AROUND OLDER INVESTORS

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We look to achieve our vision of a stronger and more secure financial future for all Ontario seniors through a strategy that is inclusive, social and responsive.

## *It is time to change the conversation around older investors.*

As part of our continued efforts to deliver strong investor protection and responsive regulation, the Ontario Securities Commission (OSC) has developed a strategy and action plan to respond to the needs and priorities of Ontario seniors.

In November 2017, the Government of Ontario published *Aging with Confidence*, its renewed action plan for dealing with some of the broader challenges faced by many Ontario seniors, listing new initiatives that build on its 2013 action plan for seniors.<sup>1</sup> Under the plan, the Government of Ontario establishes a vision to help older individuals remain independent, healthy and active, safe and socially connected, and lays out a framework for supporting that vision through guiding principles that focus on inclusion, diversity, safety, and self determination. The OSC Seniors Strategy reflects this vision and its principles, building on it in a securities regulatory context.

The OSC's vision is a stronger and more secure financial future for all Ontario seniors. We seek to achieve this through a comprehensive approach that recognizes that there are multiple tools in our toolkit, including policy, operational changes, research, education and outreach. The strategy also reflects the fact that we can't do it alone: the way to achieve our vision is dependent in part on engagement and partnerships with stakeholders, including the financial industry, working together to achieve our shared goals.

It is important that the OSC develop a seniors strategy because, as a regulator, we must be responsive to the needs and priorities of older Ontarians and recognize the challenges that investors often face in the financial services market as they age.

The data tells us that Ontarians are living longer than ever, and older Ontarians make up a growing portion of Ontario's population: the Ontario government has projected that one in four Ontarians will be aged 65 or older by 2041.<sup>2</sup> At the same time, the financial lives of individuals aged 65 and older are becoming more complex, with incomes coming from more potentially volatile sources, higher debt levels and a greater share of their assets in less liquid assets, such as real estate, than was the case 20 years ago.<sup>3</sup>

These trends indicate that Ontarians will be called upon to make complex financial judgments later in life, and with higher stakes, than may have been the case for previous generations. But for many people, aging can also be accompanied by health, mobility, or cognitive changes that may affect their ability to make these judgments later in life, as well as their susceptibility to financial exploitation and fraud.

We recognize that these trends give rise to heightened concerns about the ability of older investors to access financial products and services that respond to their needs as they age. That said, it is also important to avoid the ageist tendency of regarding all seniors as "vulnerable" or unable to protect their own interests. While much of this document discusses changes and risks that may become relevant to individuals as they age, it is important to recognize that these factors may affect different individuals at different points in their lives, and to significantly different degrees.

We look to achieve our vision of a stronger and more secure financial future for all Ontario seniors through a strategy that is inclusive, social and responsive. Being inclusive means recognizing that

seniors are not a homogenous group – that policy responses and education and outreach initiatives must take into account, among other things, differences in mobility, vision, hearing, and literacy, including financial literacy. We also need to recognize that financial decisions are social in nature, in that individuals tend to consider the effects of their actions on others and seek others' advice before taking action; this means designing policy and programs in ways that engage these individuals and help them meaningfully participate in conversations about aging and retirement planning. Being responsive means delivering timely and relevant support and resources to investors, as well as the people they work with when making financial decisions, which in turn means paying close attention to emerging trends and changes in circumstances affecting the financial lives of older individuals.

In developing this strategy, we consulted with a number of stakeholders, including the Seniors Expert Advisory Committee (SEAC, an OSC advisory committee composed of experts in financial services, medical sciences, law, seniors advocacy, and other fields), the investment industry, retail investors, and community groups reached through our OSC in the Community program as well as other outreach and engagement initiatives. We also drew significantly from the findings of a roundtable focused on seniors' issues (the Seniors Roundtable) that we held together with our Investor Advisory Panel in 2014,<sup>4</sup> and performed extensive research and consultation with our regulatory counterparts both here in Canada and abroad.

This strategy builds on our existing work to better understand and serve the interests of older investors, including our

establishment of SEAC, our work to strengthen the Ombudsman for Banking Services and Investments (OBSI) as an independent and impartial service for resolving financial consumer complaints, the Canadian Securities Administrators' (CSA) policy project to enhance the obligations that regulated dealers and advisers (often referred to in this document as "registered firms") and their representatives have with their clients so that the interests of clients come first, our diverse education and outreach initiatives that speak directly to investors through a variety of channels, and our ongoing research into the changing needs and priorities of investors.

**Key elements outlined in this strategy include:**

- Developing a flexible and responsive framework to address issues of financial exploitation and cognitive impairment among older investors,

which includes:

- a requirement that registered firms and their representatives make reasonable efforts to obtain the name and contact information for a client's "trusted contact person" that may be reached if there is a concern about a client's behaviour or transactions in a client's account;

- enabling registered firms and their representatives (for example, through a safe harbour) to place a temporary hold on disbursements from a client's account or make a disclosure to a trusted contact person when

they:

- have a reasonable belief that financial exploitation or fraud has occurred, is occurring or will be attempted; or
- have a reasonable belief that a client's judgement may be impaired;

- guidance for registered firms and their representatives when engaging with older

clients, such as collecting sufficient information about a client, supervising client accounts and communicating effectively with clients and supporting their decision-making as they age.

- Addressing registered firms' and their representatives' use of confusing and misleading titles, designations, and market

ing practices, including issues related to older investors.

- Strengthening OBSI and exploring how the dispute resolution process can better respond to the issues of older investors.

- Breaking down silos and working with other regulators and organizations toward a common goal of designing policies and programs that serve the interests of older individuals in areas such as powers of attorney and privacy laws.

- Building capacity among our staff to continually improve the ways in which we work with older investors and undertake various enhancements to our operational activities.

- Further research on the challenges and issues faced by different segments of older investors, which is vital to ensuring that our policy-making, education and outreach activities remain responsive to the circumstances and needs of older Ontarians. This includes working with the Behavioural Insights Team to examine behavioural barriers related to retirement planning and possible intervention tactics to overcome those barriers.

- Enhancing our education and outreach activities to provide tools and resources for older investors, their families and caregivers who support them, as well as their registered firms and representatives, and improving the ways in which we deliver information through written materials, digital publications and in-person engagement. Among other things, this will include:

- developing a series of white label resources (such as forms, discussion guides and educational materials) for firms to adopt and deploy to their representatives and clients;

- creating a "resource hub" to aggregate and organize resources available to older Ontarians in a central online location; and

- implementing an education and outreach strategy for new Canadians that includes a focus on older investors.

We recognize that appropriately addressing the full scope of issues affecting older investors may require work beyond these elements and that there is more that we can learn and do to continually improve the way we respond to the interests of older investors. As such, we see this strategy as a living document: a roadmap for targeted approaches to address older investors' needs. We recognize that, in our efforts to remain flexible and responsive to the changing needs of older individuals, we must be open to adapting our roadmap over time to meet these needs.

We will provide an update on our progress in implementing this strategy in one year and will continue to monitor and assess changes among older demographics through further research and stakeholder consultation. Over this period, we expect that registered firms and their representatives will review and develop ways to improve their own practices with respect to older investors and play a significant role in the broader, ongoing conversation with respect to the needs and priorities of older investors. We look forward to continuing this dialogue with the financial sector as well as investors, community organizations, government, and other stakeholders as we move forward with implementing the various initiatives contemplated by this strategy.

<sup>1</sup> Ontario, Aging with Confidence: Ontario's Action Plan for Seniors (November 2017), <http://bit.ly/2houz5q>

<sup>2</sup> Ontario, Ministry of Finance, Ontario Population Projections Update, 2016–2041 (2017), at p. 4, <http://bit.ly/2CxIQWR>

<sup>3</sup> These trends are reviewed in Section II.B.

<sup>4</sup> Progress Consulting, Seniors Roundtable: Facilitator's Report by D. Scott Ferguson (commissioned by the OSC) (2014), <http://bit.ly/2qIUncQ>



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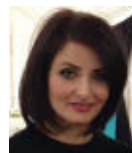
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database allows them to measure all reported private capital/exempt financing since 2016. CPE Media follows angel/private, venture capital, private equity, public market financing, M&As and IPOs. As of September 30, 2017, they tracked 7031 transactions, 4743 of which are exempt financings.

*"This data shows just how significant the Canadian private market is for issuers, investors and dealers alike. The data reveals that exempt market financings are an increasingly key component to capital availability for small and medium-sized businesses in Canada who, all too often, lack the financial resources they need to scale up",* says Ted Liu, President, CPE Media.

Liu has been measuring and monitoring private capital

industry data since 1992. He most recently was Research Director for the Canadian Venture Capital and Private Equity Association.

*"This data is vitally important and will enable PCMA members to compare and contrast their own firms' activity with that of the industry as a whole, in as-close-to-real-time as possible",* says PCMA Chair, Doug Bedard.

CPE Media sources of information include filings from Canadian and US securities regulators such as OCS, BCSC, ASC, AMF, SEC, and various newswires and web sources. Together with the PCMA, CPE Media will be seeking its members' support in submitting their data directly to CPE Media to help complete the compre-

hensive dataset for exempt financing.

*"Ted Liu has a 25-year track record and is without parallel in the private market data aggregation and analysis market in Canada. We look forward to a fruitful collaboration with CPE Media",* said Georgina Blanas, PCMA Executive Director. "This will allow our members to have access to timely, accurate and insightful data about the private capital markets."

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# THE CLOCK IS TICKING

By Robert M. Gignac



**A**fter dinner in a Chinese restaurant this week, I cracked open a fortune cookie which read – “Have you prepared for your worry free retirement with more money than you’ll ever need?” Ok, it didn’t actually say that. It said – “May you live in interesting times!”

When it comes to personal finance we are certainly living in interesting times. Global tariff threats, rising interest rates (or not depending on the day...), global governments stumbling from crisis to crisis and you cannot pick up a daily newspaper without a headline screaming “Impending Market Crash”, “Economic Armageddon” and “Are You Ready For What’s Coming Next?” Don’t panic – the experts don’t know either. The flip side is that the global stock markets have been on a three year run and continue to remain near market highs around the globe. What is really going on?

### Turbulent Times

Turbulent economic times are difficult for investors, but a prime opportunity to re-examine our personal financial plans. Our problem? Many of us spend so much time focused on the rest of our lives that we overlook the very important role of being director of our own finances. Given that we continue to feel some degree of anxiety opening our investment statements, the biggest question we face is best phrased in Latin – “Quo Vadis”. The phrase means “Where are you going?” and it is a good question to ask in times of turmoil.

But it isn’t just personal – it’s also professional. With the merger of the Private Capital Markets Association (PCMA) and the National Exempt Market Association (NEMA) the opportunity for synergy in the private capital and exempt markets will lead to new opportunities for clients across Canada. It isn’t just the clients receiving new opportunities, but there will be new opportunities for financial professionals as well.

Current estimates are that less than 40% of all Boomers (many readers of this article...) currently use a financial advisor? Seriously? Yet many of these same boomers have a personal trainer at the gym, a coach to help them with their golf swing, or see the value in providing tutors for their children. What stops people from seeking guidance with their financial future?

### Emotions Rule

Money is still a very emotional issue for many Canadians – even in 2018. My work in speaking to financial professionals across North America and for their clients confirms this. We all feel that we should be doing better. We all compare ourselves to others which is self-defeating (and always leaves us feeling as though we are lacking somehow...) and many of us feel inadequate about our financial knowledge.

We need to understand that our personal financial future includes much more than just money in terms of bank accounts, mutual funds, RRSPs, RESPs and TFSAs,. Our use of exempt market

opportunities, wise use of credit, the protection of insurance, a will and powers of attorney (personal care and finance), a detailed written financial plan, are part of having a comprehensive financial gameplan for our future and for our families.

### Cost Concerns

Given the potential complexity involved in combining all of these different aspects of personal finance - how is it that close to 60% of Canadian Baby Boomers don’t see the need to consult a financial professional? Often when Canadians are surveyed about their ambivalence to using financial professionals it comes down to cost.

Financial professionals can earn compensation from fees billed to you or from commissions from products sold to you. Some feel there is an advantage to ‘fee only’ because there is no pressure to sell you anything. Fees can range from an hourly rate for work done, a flat fee to create an individual financial plan, or a fee based on the percentage of assets managed. Fee-only planners may not have any direct motivation (i.e.: commissions) to help you implement the plan. Having a plan and not implementing it is equivalent to having no plan at all. Only focusing on cost or commissions, rather than value may lead you to short-change yourself. A more important measure should be how your plan functions and whether or not you are achieving the benefits/results you set out to achieve.

Working with a financial professional can be a scary thought for many people. To build a complete and comprehensive plan, an advisor has to become familiar with your entire financial situation. You have to be comfortable and willing to share personal information with them. They have to understand your dreams and goals. Sharing personal information with a ‘stranger’ can be scary. Don’t be intimidated. Financial professionals aren’t there to pass judgment, and they can help you attain the goals you want for yourself and your family. Keep in mind they don’t do it for you. You are responsible for your part in the planning process; nobody will care more about your money than you will.

Are we living in “interesting times”? Absolutely. Feel free to ignore the headlines, seek the advice you need - your financial future awaits – the clock is ticking.



**Robert M. Gignac**

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# ***GENDER vs MERIT***

By Nancy Bacon

**A**n A number of years ago, I was honored to receive a request from a colleague inviting me to be a member of their board. I respected the reputation of this colleague and was pleased he would think of me. Once the delight of the news died down however, I had to ask myself ‘why did he choose me’? I reviewed the company’s information and being one who always likes to add value, I emailed him asking what in particular of my professional skill set was of interest as a participating board member. His response was that they wanted to add a ‘strong & confident’ woman to their board and that I was their first choice. I politely declined the position. Had he noted that I would provide value via collaboration, or insight into positive growth, I would have leapt at the opportunity.

Before this, I heard of the public consultation held by the Ontario Securities Commission (the OSC) surrounding women sitting on boards by TSX listed issuers. I remembered thinking that it should not be the job of our regulators or our politicians to set ‘quotas’ of any kind within a business’s hiring practice. Such policies could very easily create inequality amongst our up and coming qualified

males. It got me thinking more about the politics behind it, rather than what was published as the desired outcome.

Politicians across the globe are finding ways to strengthen presumed minorities whilst equally creating a divide that inevitably will serve their purpose rather than the good of the ‘community’. Why do they do this you ask? Because by creating a divide or conflict, you draw society away from dealing with it as a community and effectually create reliance on government (or in this case our regulators) to solve the issue.

As the years have passed, I have received a number of similar requests for board positions from companies attempting to take advantage of the moral politics of gender diversity – including from female colleagues, and unfortunately the majority of them respond in a similar fashion when I asked what ‘value’ I would bring.

To be frank, I do not wish to be a token female, rather I would prefer I be chosen to participate on a board due to my diverse skill set rather than from what bathroom I use.

Upon receiving the request to write this article, and knowing it to be a controversial and political subject, I opted to explore further into the OSC's discussion of increasing the number of women sitting on boards. I was surprised at how much information there was. Admittedly, my research was limited given the breadth of material available, but I was a bit dismayed to learn that after extensive consultation, a transcript from the third annual review dated November 3, 2017, noted that based on existing data, "When quotas are in place and the numbers of women have risen quickly at the board level, there actually hasn't been the knock on effect, the cascading effect, into the executive teams that they had hoped for". It discussed that since they issued the policy change, there is has been very little actual change. A commenter suggested that this could be due to a lack of behavioral change in terms of recruitment, but that is merely an argument to create more (and more) discussion. Could it be that entrepreneur-minded women simply do not wish to be chosen at the board level due to politics? Could it also be there is a lower percentage of woman in comparison to men who actually wish for the job?

Ultimately, I agree that this is an incredibly complex issue we are dealing with, however one really must ask, is the time and energy being spent on this worth it and also in line with the regulators mandate? The second portion of the OSC's mandate is to ensure investor protection. Forgive this question, but has the focus, time and energy on being presumably being fair to women taken away from this?

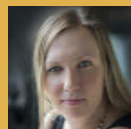
What I mean by this comes from a comment by the current Chair and CEO of the OSC. Maureen Jenson made a surprising statement at a previous OSC Dialogue noting that the OSC admittedly was lacking in enforcement. This comment was received with a few raised eyebrows in that many of us in the room would not expect such a bold statement coming from the Chair. Yet, I agreed with it.

In the private markets, I have had the unfortunate experience to be put in a position where I had to whistleblow on an issuer. It is from such experience that I have to ask, could the loss of some investor dollars have been prevented if more time and energy was spent on enforcement rather than ensuring each board had a token woman sitting at the table?

Sometimes, when attempting to do something that appears positive and innovative, we run the risk of potentially creating more damage. I applaud the regulators willingness to conduct consultations, and also their openness to have direct conversations with market participants, but not so much to exhaust the issue at

the expense of a real issue, simply because the desired results of a political argument were not achieved.

It is very clear from my humble experience, that if a woman is better for the job, she will get the job. Is it possible that perhaps I have missed out on an opportunity given my own sex? Perhaps, but I have not personally seen it, nor will I use the mere possibility of it as an excuse. I will simply work harder and create my own opportunities that again, are not focused on what bathroom I use.



**Nancy Bacon**

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*Nancy Bacon is currently the Managing Director of Chase Alternatives, a boutique independent consulting firm with a focus on private markets within Canada. Ms. Bacon brings over 17 years of professional experience in the Canadian capital markets, the last 12 of which have been devoted entirely to private markets.*

*She is of regular assistance to national industry associations, consults informally with provincial regulators, and has extensive relationships with many leading professionals including dealers, family offices and other service providers devoted to private markets. She is considered a devoted industry expert and advocate.*



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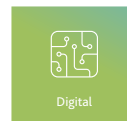


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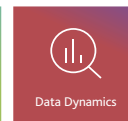
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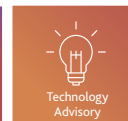
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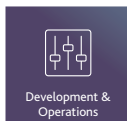
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# MNP Federal Budget Summary 2018

## FEDERAL BUDGET HIGHLIGHTS

On Tuesday, February 27, 2018, the Honourable Bill Morneau, Minister of Finance tabled his third budget: Equality and Growth for a Strong Middle Class.

Despite a relatively strong economy, the government is projecting sizeable deficits stretching to 2023 (and presumably beyond). The deficit for the current year ending March 31, 2018 is projected to be \$19.4 billion.

Given the recent activity around the taxation of private corporations this past year, MNP is pleased to see the government listened to the voices of Canadian business owners. While the tax on split income rules will proceed as drafted, a more practical approach to the passive investment proposals was introduced.

While Budget 2018 states the government will analyze the U.S. tax changes over the next few months, it does not contain any provisions to enhance Canadian tax competitiveness. It will be important for the government to formulate a response in the near term as the U.S. tax changes will have a significant impact on business in Canada.

Below are highlights from Budget 2018.

## A. Corporate Tax Measures

### CORPORATE TAX RATES

As previously announced, the federal small business rate is 10 percent as of January 1, 2018, and will further decline to 9 percent, effective January 1, 2019. The combined federal and provincial corporate tax rates for calendar 2018 are as follows:

	Small Business Rate		General Rate	
	Rate	Threshold	Non-M&P	M&P
Federal	10.00%	\$500,000	15.00%	15.00%
British Columbia	12.00%	\$500,000	27.00%	27.00%
Alberta	12.00%	\$500,000	27.00%	27.00%
Saskatchewan	12.00%	\$600,000	27.00%	25.00%
Manitoba	10.00%	\$450,000	27.00%	27.00%
Ontario	13.50%	\$500,000	26.50%	25.00%
Quebec	18.00%	\$500,000	26.70%	26.70%
New Brunswick	12.62%	\$500,000	29.00%	29.00%
Nova Scotia	13.00%	\$500,000	31.00%	31.00%
Prince Edward Island	14.50%	\$500,000	31.00%	31.00%
Newfoundland and Labrador	13.00%	\$500,000	30.00%	30.00%



## PASSIVE INVESTMENT INCOME

Budget 2018 proposes two measures, applicable to taxation years that begin after 2018, to limit tax deferral advantages on passive investment income earned inside Canadian Controlled Private Corporations (CCPCs).

### 1. Business Limit Reduction

A preferential tax rate applies to CCPCs having active business income up to \$500,000 (the “business limit”). The business limit is shared amongst associated corporations. The business limit is reduced on a straight-line basis for a CCPC and its associated corporations having between \$10 million and \$15 million of total taxable capital employed in Canada.

Budget 2018 proposes to reduce the business limit for CCPCs (and their associated corporations) that have significant income from passive investments.

Under this measure, the business limit will be reduced by \$5 for every \$1 of investment income in excess of \$50,000, such that the business limit will be eliminated at \$150,000 of investment income. As outlined in the table below, a CCPC with \$100,000 of investment income would have its business limit reduced to \$250,000. Provided the reduced business limit remains above the active business income of the CCPC, all of that income would continue to be taxed at the small business tax rate. A CCPC with \$75,000 of business income would have to earn more than \$135,000 in passive income before its business limit is reduced below its business income. This feature of the proposed rules recognizes CCPCs with lower amounts of business income generate less retained earnings that can later be used for reinvestment in the business and may have more difficulty accessing capital. CCPCs with business income above the reduced business limit will be taxed on income above the business limit at the general corporate tax rate.

**Active business income qualifying for the small business tax rate under new business limit:**

Business Income	Investment Income				
	\$50,000	\$75,000	\$100,000	\$125,000	\$150,000
\$50,000	<b>NOT AFFECTED</b>				\$0
\$75,000					\$0
\$100,000					\$0
\$200,000				\$125,000	\$0
\$300,000			\$250,000	\$125,000	\$0
\$400,000		\$375,000	\$250,000	\$125,000	\$0
\$500,000		\$375,000	\$250,000	\$125,000	\$0

*Note: Assumes the corporation has less than \$10 million of taxable capital.  
Table courtesy of Budget 2018 - Tax Measures: Supplementary Information*

The business limit reduction under this measure will include investment income of any other associated corporations. It will also operate alongside the business limit reduction that applies in respect of taxable capital in excess of \$10 million.

## Adjusted Aggregate Investment Income

For the purpose of determining the reduction of the business limit of a CCPC, investment income will be measured by a new concept of adjusted aggregate investment income which will be based on aggregate investment income (a concept that is currently used in computing the amount of refundable taxes in respect of a CCPC’s investment income) with certain adjustments. The adjustments will include the following:

- Taxable capital gains (and losses) will be excluded to the extent they arise from the disposition of:
  - a property that is used principally in an active business carried on primarily in Canada by the CCPC or by a related CCPC; or
  - a share of another CCPC that is connected with the CCPC, where, in general terms, all or substantially all of the fair market value of the assets of the other CCPC is attributable directly or indirectly to assets that are used principally in an active business carried on primarily in Canada, and certain other conditions are met.
- Net capital losses carried over from other taxation years will be excluded;
- Dividends from non-connected corporations will be added; and
- Income from savings in a life insurance policy that is not an exempt policy will be added, to the extent it is not otherwise included in aggregate investment income.

This measure will apply to taxation years that begin after 2018. Certain rules will apply to prevent transactions designed to avoid the measure, such as the creation of a short taxation year in order to defer its application and the transfer of assets by a corporation to a related corporation that is not associated with it.

### 2. Refundability of Taxes on Investment Income

The current tax regime relating to refundable taxes on investment income of private corporations seeks to tax income from passive investments at approximately the top personal income tax rate while that income is retained in the corporation. Some or all of these taxes are added to the corporation’s refundable dividend tax on hand (RDTOH) account and are refundable at a rate of \$38.33 for every \$100 of taxable dividends paid to shareholders.

For income tax purposes, dividends paid by corporations are either eligible or non-eligible. Non-eligible dividends are generally paid from a corporation’s passive income and income taxed at the small business tax rate, while eligible dividends are generally paid from a corporation’s income that has been subject to the general corporate income tax rate.

A corporation receives a refund of taxes paid on investment income (RDTOH) regardless of whether the dividends paid are eligible or non-eligible. When refunds are received as a result of an eligible dividend, this can provide a tax deferral advantage on passive investment income.



To better align the refund of taxes paid on passive income with the payment of dividends sourced from passive income (i.e. non-eligible dividends), Budget 2018 proposes that a refund of RDTOH be available only in cases where a private corporation pays non-eligible dividends. An exception will be provided in respect of RDTOH that arises from eligible portfolio dividends received by a corporation, in which case the corporation will still be able to obtain a refund of that RDTOH upon the payment of eligible dividends.

The different treatment proposed regarding the refund of taxes imposed on eligible portfolio dividend income will necessitate the addition of a new RDTOH account. This new account (eligible RDTOH) will track refundable taxes paid under Part IV of the Income Tax Act on eligible portfolio dividends. Any taxable dividend (i.e., eligible or non-eligible) will entitle the corporation to a refund from its eligible RDTOH account, subject to the ordering rules.

The current RDTOH account (which will now be referred to as non-eligible RDTOH) will track refundable taxes paid under Part I of the Income Tax Act on investment income, as well as under Part IV on non-eligible portfolio dividends (i.e., dividends that are paid by non-connected corporations as non-eligible dividends). Refunds from this account will be obtained only upon the payment of non-eligible dividends.

The proposed rules track refundable balances through connected corporations, adding them to either the eligible or non-eligible RDTOH account depending upon which account the dividend was paid.

Transitional rules will apply to convert the existing RDTOH pool balances to the eligible and non-eligible RDTOH balances.

These measures will apply to taxation years that begin after 2018.

## **AT-RISK RULES FOR TIERED PARTNERSHIPS**

Budget 2018 proposes to clarify the at-risk rules applicable to partnerships in circumstances where a limited partnership is itself a limited partner of a limited partnership (commonly referred to as tiered-partnership structures). These rules restrict the availability of limited partnership losses to a limited partner that is itself a partnership, effectively reversing a recent Federal Court of Appeal decision which was perceived to be inconsistent with the policies underlying the at-risk rules. These rules apply to taxation years that end on or after Budget Day.

## **HEALTH & WELFARE TRUSTS**

There are currently no explicit rules in the Income Tax Act for Health & Welfare Trusts. These trusts are established by employers to provide health and welfare benefits to their employees. Canada Revenue Agency (CRA) has historically published administrative positions relating to health and welfare trusts, such as what arrangements qualify and how their income is computed.

Budget 2018 proposes to legislate income tax rules for health and welfare trusts by extending the current tax rules for employee life and health trusts. Transitional rules will be added to the Income Tax

Act so that existing health and welfare trusts can convert to employee life and health trusts. The government is seeking input from stakeholders on transitional issues, and will subsequently release draft legislation. CRA will no longer apply current administrative positions to existing health and welfare trusts after 2020, or any such new trusts created after Budget Day. Existing health and welfare trusts will be subject to existing trust tax rules if they do not convert to employee life and health trusts.

## **CLEAN ENERGY EQUIPMENT**

Class 43.1 and 43.2 of Schedule II to the Income Tax Regulations provide accelerated capital cost allowance rates (30 percent and 50 percent, respectively on a declining balance) for investments in specified clean energy generation and conservation equipment.

Both classes include eligible equipment that generates or conserves energy by:

- using a renewable energy source;
- using a fuel from waste; or
- making efficient use of fossil fuels.

Class 43.2 was introduced in 2005 and is currently available in respect of property acquired before 2020.

Budget 2018 proposes to extend eligibility for Class 43.2 by five years so that is available in respect of property acquired before 2025.

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## **B. Personal Tax Measures**

### **PERSONAL TAX RATES**

No new personal income tax rate or tax bracket changes were announced in this year's Budget. The government did, however, confirm that it will proceed with the proposed tax on split income measures announced on December 13, 2017.

### **CANADA WORKERS BENEFIT (CWB) (FORMERLY WORKING INCOME TAX BENEFIT)**

Budget 2018 enhances the CWB which is a refundable tax credit paid to low income workers. Currently, the maximum benefit for an individual is \$1,192. The amount is clawed back at a rate of 14 percent of income and is eliminated at approximately \$21,000 of income. The maximum CWB will be increased to \$1,355, with the claw-back rate reduced to 12 percent and is eliminated at approximately \$24,000 of income.

For a family, the maximum benefit will increase from \$2,165 to \$2,335, and is eliminated at approximately \$36,500 of income.

The change is effective for 2019 and subsequent taxation years.

### **MINERAL EXPLORATION TAX CREDIT**

Flow-through shares facilitate resource companies in raising capital. The mineral exploration tax credit, equal to 15 percent of specified mineral exploration expenses incurred in Canada and renounced to investors, will be extended to flow through share agreements entered into on or before March 31, 2019. This credit was set to expire on March 31, 2018.

## REPORTING REQUIREMENTS FOR TRUSTS

To improve the collection of beneficial ownership information of trusts, Budget 2018 proposes new annual reporting requirements for express trusts that are resident in Canada and to non-resident trusts that are currently required to file a T3 return.

Each trust will be required to report the identity of each trustee, beneficiary and settlor, as well as any person who can exert control over trustee decisions.

The proposals will create a T3 filing requirement for many trusts previously not subject to a filing obligation to the extent the trust did not earn income or make distributions in the year.

Exceptions to the additional annual reporting requirements are proposed for the following:

- Mutual fund trusts, segregated funds and master trusts;
- Trusts governed by registered plans;
- Lawyers' general trust accounts
- Graduated rate estates and qualified disability trusts
- Trusts that qualify as non-profit organizations or registered charities; and
- Trusts that have been in existence for less than three months or that hold less than \$50,000 in assets throughout the year (assets must be restricted to deposits, government debt and listed securities).

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## C. International Tax Measures

### CROSS-BORDER SURPLUS STRIPPING

Budget 2018 proposes amendments to the cross-border anti-surplus stripping rules to ensure that such rules are not circumvented by taxpayers through the use of partnerships or trusts. The proposed measures will apply to transactions that occur on or after Budget Day. Budget 2018 further indicates that the Income Tax Act's general anti-avoidance rules may be used to challenge transactions that occurred before Budget Day.

### FOREIGN AFFILIATES

The foreign accrual property income (FAPI) regime prevents Canadian corporations from earning passive income offshore by taxing the income on a current basis. The income is currently taxed if it's earned from an investment business (essentially earning income from property such as dividends, rents, interest and royalties) unless the business employs more than five full time employees. Some structures have been set up to allow the investment business income to meet the threshold by pooling assets and employees. The parties to the arrangement track their returns based on their assets contributed. Budget 2018 proposes that each party's operations be treated as a separate business and therefore will need to satisfy the six-employee test and other conditions of the investment business exemption.

In addition, other structures have been set up such that Canadian taxpayers do not meet the requisite ownership tests to control the foreign corporation and hence are not required to include FAPI in

their income. However, the taxpayers' have used tracking arrangements whereby each taxpayer retains control over its assets and the returns that accrue from those assets. Budget 2018 proposes that a taxpayer is required to include FAPI in their income if the taxpayer's returns are based upon a tracking arrangement. This measure will apply to taxation years of a foreign affiliate that begin on or after Budget Day.

Both of the above proposals appear to apply only in respect of tracking arrangements involving a foreign company that is a foreign affiliate. They therefore do not appear to affect arrangements whereby the Canadian taxpayer's interest in the foreign company is below the 10 percent threshold for foreign affiliate status.

### REASSESSMENT PERIOD

Budget 2018 proposes to extend the reassessment period for an additional three years where the reassessment is made as a consequence of a transaction between a taxpayer and a non-arm's length non-resident.

### FOREIGN AFFILIATE REPORTING

Budget 2018 proposes to shorten the filing deadline for information returns required to be filed by taxpayers with respect to their interest in foreign affiliates to six months after the taxation year (from 15 months). This measure is applicable to taxation years beginning after 2019.

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## D. Indirect Tax Measures

### INVESTMENT LIMITED PARTNERSHIPS

Budget 2018 proposes changes to the September 8, 2017 draft legislation and regulatory proposals relating to the application of the GST / HST to investment limited partnerships. Specifically, Budget 2018 modifies the September 8, 2017 proposal to:

- Ensure the GST / HST applies to management and administrative services rendered by the general partner on or after September 8, 2017 and not to management and administration services rendered by the general partner before September 8, 2017, unless the general partner charged GST / HST in respect of such services before that date;
- Ensure that the GST / HST be generally payable on the fair market value of management and administrative services in the period in which these services are rendered; and
- Allow an investment limited partnership to make an election to advance the application of the special HST rules as of January 1, 2018.

### TOBACCO TAXATION

The Government proposes that tobacco excise duty taxes be indexed annually on April 1. However, for the current year, excise duty rates will be adjusted on February 28 to account for inflationary adjustments since 2014.

### CANNABIS TAXATION

The Government has released an excise duty framework and Budget 2018 contains a new federal excise duty framework for

cannabis products to be introduced in the Excise Tax Act. This will be applicable as of the dates cannabis products became legally available for sale. Cannabis cultivators and manufacturers will be required to get a license from the CRA and remit the excise duty.

The measures include both flat rate duties and additional taxes as the product moves from the manufacturer to the provincially licensed distributor and finally to the consumer. The CRA will be providing excise stamps in order to ensure the package is properly marked before its entry into the applicable market. There will also be an amendment to the GST / HST section on basic groceries in the Excise Tax Act to ensure sales of cannabis products will not be treated as such.

## HOLDING COMPANY RULES

The Government will be releasing for comment and consultation draft proposals with regard to the holding corporation rule. This rule essentially provides that where a parent corporation incurs expenses relating to shares or indebtedness of a related company conducting a commercial operation, the parent is able to obtain input tax credits on its expenditures provided certain conditions are met.

## ABOUT MNP

MNP is a leading national accounting, tax and business consulting firm in Canada. We proudly serve and respond to the needs of our clients in the public, private and not-for-profit sectors. Through partner-led engagements, we provide a collaborative, cost-effective approach to doing business and personalized strategies to help organizations succeed across the country and around the world.

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# Corporate Governance:

How to Protect your  
Investors from Mishaps

By Craig Burrows

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**S**how me any disaster on Wall Street, Bay Street, Fleet Street or Main Street and I'll show you either malfeasance / incompetence in Management and / or lack of oversight from the Board / Trustee level. Our industry is under siege from regulators and lack of confidence from within due to some poor investments into rogue issuers.

When we made the decision to become an EMD back in 2012, we saw the industry had potential as it began to become more regulated. Some people wish for the old days, but I believe that accountable regulation is good for investors and what is good for investors is good for our industry. One thing we demanded from the regulators was the obligation to provide audited financials for OM product. What is the use of having MBAs, CFAs, CPAs if you can't use their financial training to make proper assessments regarding an investment opportunity?

As of the end of 2016, OMs are now mandated to provide audited financials. Some felt that this would be enough to provide us with better information to make investment choices. Although audited financials are useful, please remember what all auditors like to put in the fine print "we're not responsible for the information in the audit as we rely on management to disclose information and that past performance doesn't guarantee future performance". I'm paraphrasing but our thoughts on audited financials is they give us a photo in a time of history but if things go bad, they merely tell you sooner than later that you are screwed. Audited financials are no protection from bad investments as we have seen in major meltdowns like Enron and Nortel.

**“There is the old saying in real estate, the three things you look for are location, location, location. Investing in any business, the three things you look for are management, track record and trends.**

There is the old saying in real estate, the three things you look for are location, location, location. Investing in any business, the three things you look for are management, track record and trends. As we grow as an industry, we're able to review track records of issuers and EMDs for that matter. We can take advantage of growth trends like cannabis, cryptocurrency and AI technologies to measure against tried and true investments that have proven strong management. If you can find an investment opportunity that has proven management, track records and trends; the likelihood of success grows exponentially.

The area that we want our industry to focus on for 2018 and beyond is corporate governance. Proper corporate governance begins with "tone at the top" of any organization that flows through the organiza-

tion. We will be demanding issuers to begin to implement fundamentals like transparency, accountability, conflict of interest and proper oversight to ensure management is executing the business plan that has been disclosed in the OM. We expect independent Board or Trustees to hold management accountable and disclose to shareholders or unitholders when management is in conflict or not putting the interest of investors first.

We have seen too many times where the management are the directors and there is little control or say for investors. When things go bad, unaccountable managers try to cover their mistake rather than try to fix it. Proper oversight provides accountability for investors by asking tough questions, the ability to replace management and sound the warning bells to investors if things are not being addressed. Conflict is good in the boardroom, but a proper board should also provide management with advice, knowledge and a somber second thought before making major decisions. For the issuer, this is not about interfering with day to day operations. Strong board members bring experience and should have the philosophy of "Nose in, hands out".

Fortunately, there are experienced board members across the country that are literally a click away to help. From our dealership perspective, we will encourage our issuers to search out these future directors from the Institute of Corporate Directors (ICD). The ICD provides courses and designations for people that want to learn to be better directors and companies that want better oversight. There are over 12,000 people that have taken the course and they all have unique backgrounds and skills that could benefit our market.

Our future is bright. Private equity and alternative investments are much needed in any well diversified financial portfolio. As we evolve as an industry, we will grow, we will stumble but we will learn to be better. Corporate governance will be a key factor in helping us protect investors from mishaps.

I say to you as a dealing representative in the EMD sector that product today is better than yesterday, and tomorrow's opportunities will be better than today.



**Craig Burrows, ICD.D**  
President & CEO, TriView Capital Ltd.  
✉ [cburrows@triviewcapital.com](mailto:cburrows@triviewcapital.com)

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By Mike White

**T**echnology adoption is accelerating to meet the demand for 400Gbps solutions in both data communication and telecommunication; POET Technologies, Inc. plans to be a disruptor in the market.

The industry is preparing for emerging high bandwidth applications amid the rapid growth of online video streaming, cloud computing, research, gaming and the Internet of Things (IoT). Network traffic increased significantly over the last decade leading to the enormous growth of data centers, such as Amazon, Google, Microsoft, Facebook, Alibaba, Baidu and Tencent. Higher bitrates and capacity are essential but current solutions are costly and consume massive amounts of energy. New technologies are required in the next-generation of data centres to optimally operate at higher bitrates (100G/200G/400G), lower costs, and low power consumption.

POET Technologies Inc. (“POET”) introduced its Optical Interposer Platform in early 2018, which facilitates the co-packaging of electronics and optics in a single Multi-Chip Module (MCM) using conventional complementary metal oxide semiconductor (CMOS) processing. CMOS is a commonly used low-cost semiconductor manufacturing process used in majority of electronic products today. Its Optical Interposer Platform targeting 100G transceiver applications is readily scalable to 200G and 400G transceiver products with minimal incremental cost. Additionally, this technology is projected to offer cost-efficient optical interconnects allowing for a reduction in components and greatly reduced test and assembly steps to decrease manufacturing costs by 2x to 4x, a great cost savings opportunity for POET’s potential customers.

Based on its Dielectric Waveguide technology, POET’s Optical Interposer provides the ability to run electrical and optical interconnections side-by-side on the same interposer chip at a micrometer scale. The importance of the proximity between the electrical and optical component significantly reduces the manufacturing cost and power consumption in the optical engine. The optical interposer represents an integral part of POET’s hybrid integrated optical engines and leverages “flip chip” manufacturing processes and unique capabilities of its dielectric waveguides.

On March 5, 2018, POET entered into a Memorandum of Understanding with Accelink Technologies, Ltd. (“Accelink”) to co-develop its 100G and 400G Optical Interposer transmit and receive devices for the datacom and telecom markets as well as its 10G and 25G devices for telecom applications. This is a major achievement to partner with one of China’s leading multibillion-dollar optoelectronics and subsystem products manufacturer to the datacom, telecom and network access markets. POET will collaborate with Accelink to rapidly test and qualify its advanced multichannel transmit and receive devices to be designed into Accelink’s products towards a goal of commercializing POET’s devices.

POET Technologies is poised to become a disruptor in optical communications by delivering a unique solution to drive down costs and power consumption in the transceiver market. The Optical Interposer Platform will be a disruptive technology targeted to service a wide range of high-growth markets beyond data centres, primary among them being high-performance computing, networking, optical transceivers and transponders, and automotive LIDAR systems. The era of high speed performance at 400G is happening and it will be exciting to see innovative developments in global infrastructure adopt and scale to new network traffic requirements.

### About POET Technologies Inc.

POET Technologies is a developer and manufacturer of optical light source products for the sensing and data communications markets. Integration of optics and electronics is fundamental to increasing functional scaling and lowering the cost of current photonic solutions. POET believes that its approach to both hybrid and monolithic integration of devices, utilizing a novel dielectric platform and proven advanced wafer-level packaging techniques enables substantial improvements in device cost, efficiency and performance. Optical engines based on this integrated approach have applications ranging from data centres to consumer products to military applications. POET is headquartered in Toronto, with operations in Silicon Valley, the United Kingdom, and Singapore.



Authored by IBK Capital Corp.

**Mike White**

President and CEO, IBK Capital Corp.

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*DISCLAIMER: IBK Capital Corp. and its principals own shares and warrants to purchase shares of POET Technologies, Inc. IBK Capital is currently engaged with POET Technologies, Inc. to conduct investment banking services.*



The DMZ at Ryerson University has been ranked the number one university-based incubator in the world by UBI Global. Up from third place in 2015, the DMZ is now the leading incubator program managed by a university out of over 200 programs in its category. A first for any Canadian university.

“Excelling across all impact and performance categories, the DMZ at Ryerson University has once again demonstrated why it is one of the best university-managed incubation programs in the world. A truly impressive accomplishment evident by successful startups such as Sampler, Borrowell and Sensibill, all incubated at the DMZ,” says Ali Amin, co-founder, UBI Global.

UBI Global is a leader in performance analysis of business incubators around the world. The Stockholm-based research organization looks at over 20 key performance indicators including funding raised by startups, jobs created, survival rate of companies, number of coaching hours per company per month and many more.

“At the DMZ, we understand that economic vitality is fueled by growth-driven incubation and acceleration programs that accelerate the success of the next generation of innovative businesses and prepare them for global expansion,” says Abdullah Snobar, execu-

tive director, DMZ. “The UBI ranking is helping us better understand ways to push boundaries in order to create impact not just for our entrepreneurs, but also for our country’s contribution to the global startup ecosystem.”

Since the last UBI ranking in 2015, the DMZ has created an advisory council comprising of the top tech and business minds in North America; opened an office in New York City to support Canadian entrepreneurs; focused on startup scale and growth by launching its flagship sales accelerator program; and developed partnerships with companies like Facebook and large Canadian banks to develop accelerator programs in digital news, fintech and early market validation for women-led founders.

As the DMZ heads into its eighth year in the startup ecosystem, it will focus on its flagship sales accelerator for high-growth companies, with pre-accelerator and incubation programs supporting the full journey of an entrepreneur from ideation to validation to growth.

A startup’s path isn’t linear. And as the leading incubator-accelerator in the world, the DMZ is making an investment in people, not just their ideas.



A photograph of two men standing in front of the Calgary Bow Bridge in winter. The bridge's distinctive red, curved arches are visible in the background, partially covered in snow. The ground is also covered in snow. The man on the left is wearing a dark coat and a light-colored shirt. The man on the right is wearing a dark, textured jacket over a light blue shirt. Both are smiling at the camera.

# UNITY

## The Coming Together of NEMA and the PCMA

By Doug Bedard and Craig Skauge

**I**n regards to regulatory framework, the lack of cooperation and collaboration by provincial securities regulators across Canada has been discussed at great length since the implementation of National Instrument 31-103. And for too long, the advocates for the exempt market, or the private market as we call it more regularly now, weren't much better. While both the National Exempt Market Association and Private Capital Markets Association were collectively extremely effective in helping to both grow and improve the industry at large, having two voices, particularly when one was perceived as West and one East left opportunities for divisiveness, which was ultimately detrimental to our collective stated goal.

**Those days are no longer.**



**The PCMA has worked tirelessly for our members over the last 15 years. During that time we have demonstrated our commitment to our industry through advocacy, professional development and a variety of events including our annual conference and national awards. Our efforts have contributed to the substantial growth of the association. Now, with the merger of our colleagues at NEMA, our association will truly be the one voice of the private capital markets.**

- Doug Bedard



## A SINGLE VOICE

Over the last few years, our respective associations, NEMA and the PCMA, have considered joining forces as one organization but for numerous reasons the timing wasn't right even though it was clear to our members that both associations were working on the same issues and had representatives from our organizations working on many of the same committees with provincial regulators. As our efforts converged and our executives gained more comfort with one another working together on these committees, it made more and more sense to achieve some economies of scale and merge. The finalization of the merger in February was welcome news to members who belonged to both associations as they would gain the benefit of a larger and very capable leadership team with a single annual membership fee. Aside from the obvious economic benefits, the fundamental, biggest benefit to come out of this merger is that there is really only one place for regulators to go now if they want to discuss regulating the retail exempt market - and that's the PCMA. There is no longer any potential to find divisible opinion between the two associations. There is now one voice that represents the industry, so really the PCMA is the first place that regulators should go when they are looking at tweaking or adopting regulations with respect to the sale and distribution of private securities.

## COMING TOGETHER

The first order of business for our newly merged organization is to bring membership together at our annual conference in Toronto this April. In addition, the entire boards of directors of both NEMA and the PCMA have joined, for a total of 45 directors. We plan to reduce the board to 24 members by yearend. The board's numbers will be pared down mainly through attrition, as some directors plan to retire or to step down in order to focus on specific advocacy efforts as members of one of our 10 committees.

## ENLIGHTENING THE PUBLIC

As much as we work to inform stakeholders and the public at large, there remains a knowledge gap of the role of private capital markets play in the Canadian Economy. Last year we highlighted the fact that our members participated in raising over \$8 billion in Ontario alone. Canadian investors overall, invest over 95% in public markets, yet large institutional investors and pension funds are nearly 50/50 in private and public market investments.

Common misperceptions such as risk, lack of liquidity and the exempt category name itself remain many years after adoption of National Instrument 31-103. There is a continuum of risk in alternative investments, however, the current regulations

require a risk acknowledgement that identifies exempt market products as all high risk. Recent discussions with some regulators have been productive in considering how products in this category may be risk rated and fall into a lower risk category.

It is common practice in the market to address liquidity with a redemption mechanism. This offers a fair liquidity opportunity to investors where no secondary market exists for the product.

We have been mindful of the “exempt” description and connotation that invokes. We had carefully considered this when the association became the Private Capital Markets Association and during merger discussions. That’s why we’ve retained that name. It better describes the entire market and was more inclusive for many of our current members.

As a combined organization, we are committed to enlightening the investing public and businesses of the opportunities in exempt offerings.

### **NATIONAL DISTRIBUTIONS**

While IIROC and MFDA members have enjoyed fundamentally the same rules from province to province under the umbrella of their self-regulatory organizations, participants in the largest sector of Canada’s capital markets, the exempt market, have been left with a patchwork of provincial rules, interpretations and inconsistencies. Given both the uncertainty surrounding the creation of that national regulator and the fact that EMDs don’t have a self-regulatory organization, we will continue to advocate for more consistent regulations across the country – particularly for national product distributions, which is currently an overly complex and expensive process.

As the regulatory burden grows in this industry, it is now more important than ever, that the private markets have a stronger and larger association to advocate for our members. With 13 different compliance jurisdictions in Canada today, and the possible implementation of a national regulator, the private market needs effective representation for the “fair and efficient” side of the equation.

### **CONCLUSION**

Negotiating and finalizing a merger isn’t easy. Like in any relationship compromises have to be made to focus on the bigger picture. We’re very proud of the forethought and insight that everyone brought to the table to make this merger happen and the responsibility that rests on the new combined organization is not lost on anyone. We realize that in the end, whether from the East or West, PCMA or NEMA, what our members have always wanted is good advocacy on their behalf. And now as a unified voice, it will be better than ever.

**After years of battling alongside one another, I’m extremely excited about the next chapter in advocacy for our industry with one unified voice. NEMA’s well-known grassroots advocacy efforts and the PCMA’s political efforts and relationship-building, complement each other extremely well, and together position the private capital markets to have the strongest voice possible at a critical time in the capital markets.**

- Craig Skauge





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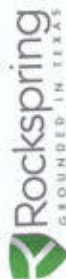






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# The Exempt Market Proficiency Course

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The Exempt Market Proficiency Course is a proficiency requirement for those individuals seeking registration as Exempt Market Dealers – Dealing Representatives and Chief Compliance Officers. The EMP course introduces students to these complex financial instruments and prepares them to operate in the world of private capital markets. Students learn about the capital markets, the exempt market, the all-important know-your-client and know-your-product rules, ethical conduct, the private placement process, how different issuers are structured, compliance requirements and features of common exempt securities.

### Course Highlights

- Clear and concise content
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### Key Topics

- Overview of the capital markets
- Regulatory framework
- Compliance for exempt market dealers
- Dealing with clients
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# MANAGED ACCOUNTS

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**Why managed accounts and cash efficiency may be  
crucial to an investor's long-term survival**

By David Rudd





Following the dotcom fiasco and post 9/11 chaos, many institutional investors piled into hedge funds as they sought investment stability in a sea of equity volatility (remember those days?). It was a unique era of extraordinary demand for alternative investments and hedge funds were in the driver's seat. The terms that hedge funds extracted from investors reflected that great demand. Private Equity/Buyout Funds, Fixed Income Funds, Credit Funds, Mortgage Backed funds, CTAs, Equity Long short, Convertible Arb Funds, and Income funds were just some of the growing number of categories.

Nevertheless, buyer's regret soon set in and questions bubbled to the surface. Liquidity, gating, fees, transparency, exposures and valuations were some of the issues that demanded attention. This lack of control, lack of information, and lack of response from the hedge fund manager was unsettling as investors had granted hedge funds a huge license with a small level of accountability.

Fees were at levels that were not in the experience of endowment and pension fund trustees and they wondered about paying huge sums to rich people that made them richer. The fact that all the risk was born by the investor was galling to some. It didn't seem to be a good deal to the investor.

It was still the early days of "Risk Premia," and investors were trying to attribute those returns to a market subsector or phenomenon. The idea was to see if there was skill, to see if the strategies of the individual managers were correlated and to see if the strategy was sustainable. A high dependence on mean reverting phenomena or some other market phenomena might permit one to have a dialogue to see if the strategy can be replicated for pennies rather than for "2 and 20". Hedge funds were reluctant to share information about their program. In that era, fees were non-negotiable and offering documents typically made provision for extra fees for services that arguably were the investment manager's responsibility such as travel, quote machines, analytical staff and extra charges.

In addition, a few astute investors were concerned about securities pricing protocols, particularly when the trading activity involved illiquid strategies. Suspect year-end valuations drove unrealistic performance payouts and many of the illiquid hedge funds had a highly subjective component to the valuation. In the long-run, performance would normalize, but the desire for the immediate payout of performance fees in the short-term created a conflict that encouraged aggressive valuations. Implicit in these aggressive valuations was an acknowledgement that market forces could at any time destroy a winning thesis or methodology.

### The Astute Investors' View

In this era of the early 2000's, quantitative shops like Sigma were engaged by large investors to decompose hedge fund returns and attempt to understand the drivers and return dependencies. Clients wanted a better understanding of the risks in their investments

(remember Amaranth?) and wanted to know if there was some divergence from the strategy they had signed on for.

Astute investors realized several things very quickly:

- 1 In many cases, there is a market phenomenon (or premia) that accounts for much of a manager's returns.
- 2 One may be able to purchase the market phenomenon in the form of an index.
- 3 One could access a hedge fund manager's returns with a managed account for a very small cash outlay while reducing risk, reducing fees and getting total transparency and liquidity. The cash efficiency available in the managed account is so important it's created a conundrum that institutional investors are still coming to terms with. This opportunity set, combined with risk premia, has encouraged a massive re-thinking of risk and return.

### How Expensive Is It?

Once you have it (managed accounts), you can make more rational investment decisions. You can analyze for beta. If you can own the S&P 500 index or derivative for a cost of 5 basis points or less and zero cash outlay, a much higher bar is set (one would think) before one would allocate to illiquid private equity or engage in stock picking. The use of derivatives is not an academic question. It is the lifeblood of excess returns. You can't reliably make your bogey without it, and in a less than favourable environment, it is the singular savior.

How does one value the availability of cash & credit lines to generate complementary return drivers? Posing this question simply means, "Let's have a reasonable & informed discussion & flesh it out." While many think these discussions are about new investment tools, the reality is these tools are more than a quarter of a century old.

The answer is complex, but "established investment orthodoxy" is grounded in a mythology of skill & probity with measured judgment put forth by sober, wise people with sufficient gravitas and communication skills to silence the evidence that confronts one on a daily basis. If we were facts based, we'd realize stock picking doesn't reliably beat a simple index.

Why invest cash in trying to generate returns from equities when you can invest in equity indices without cash and get the same or better economic effect at lower cost?

That isn't a trivial question. It is the essence of the question every pension plan, endowment, family office and investor should have asked and answered.

Can someone explain to me why these investors are not allocating on a risk basis and using derivatives & indices that reflect the market and cost very little, wherever they can? The compunction to allocate dollars rather than risk is an extraordinary denial of the last 40 years of financial progress. If one allocates dollars, one is

limited to the asset size of the plan and one takes on more risk than needed. If one allocates on a risk basis, one can build a risk seeking, risk complementary portfolio with better returns and lower risk.

Let me give you an example: Bonds and equities may NOT be negatively correlated. Over the last 35 years, as inflation has been reduced they have been highly correlated to the benefit of the investor. There is good evidence of short term negative correlation in times of crisis, but most investors have made money by simply holding both assets as they rose together. Investors have much more risk on their books than they believe. What rises together will generally fall together and investors understand this risk as never before. Asset based investing is inherently much riskier than risk-based investing.

I admit I may not be the smartest person who trod the capital markets path, but with 40 years of experience in the bowels of various parts of the investment industry with derivatives and hedge fund industry & some pension /systems experience, I feel I have a reasonable grasp of the big picture and I am completely perplexed about the prevailing, universally accepted, non-solution path.

In the case of pension funds, if a plan is underfunded, or even if they want to stay fully funded, they MUST look to use cash efficiently. They MUST look to indices, and overlay cashless, complementary risk, and they really should use managed accounts. ANY underfunded plan that buys private equity is consigning themselves to a continued underfunded status as that path chews up cash and leaves little flexibility. ANY plan that doesn't use managed accounts to allocate to a hedge fund is seriously undervaluing the opportunity cost of cash and may be seriously overestimating and overpaying for the unique skill the hedge fund possesses.

Prevailing pension plan investment orthodoxy is to match assets with liabilities.

In an era where the future economic value of asset ownership is available without deployment of the asset, one has to question this traditional orthodoxy of matching assets & liabilities. A risk-based approach looks at the world differently.

Orville Wright said "If we all worked on the assumption that what is accepted as true is really true, there would be little hope of advance." While Orville was talking about flight, he was also saying one should critically examine accepted orthodoxy.

### Moving to a Risk-Based Approach

Historically, investors are used to deciding an investment approach via an asset mix strategy. For instance, 60/40 used to be the standard. This approach was implicitly a recognition that someone is trying to pick a winner between equity and debt rather than using a risk-based approach. It also implicitly denies the massive opportunity available from cash efficiency. This is a deficiency in thinking. The major Canadian pension funds have moved very aggressively to a risk-based approach, rather than an asset alloca-

tion methodology. This means that one should look to deploy return seeking exposures while at the same time look to reduce overall risk.

Many of the pension plans who conserve cash via a risk-based approach are allocating that cash to private equity. Private equity is illiquid, highly correlated to public equity and has a fee structure that is usually higher than most hedge funds. The premise of an illiquidity premium and lower volatility is not for debate here, but the idea that pension plans have all this cash and they should put it somewhere that can't pay it back for a long time requires one to ensure they will be paid a premium for the right to lock up term money and for the granting of a call option on future funds. Is that premium still there? More on that later.

### Conclusion

It has been a great run. Since March of 2009, the S&P 500 has quadrupled. From its pre-crash high in 2007-8, the index has more than doubled. From its low in the early Reagan era, the S&P 500 has increased 25 fold.

Clearly, every plan, endowment and fund with a traditional long-only approach is so dramatically overfunded, pensioners can rest easy. Not true you say? How is that possible in such a benign and favourable environment?

The willingness and even eagerness of central bankers to provide a path to profitability to the financial institutions they govern has been well understood by banks, S&Ls and the like who see the helping hand of the regulator to restore their balance sheets, profitability and to create the conditions to make the institutions whole. The regulators have never been more co-operative over the last 9 years.

The traditional central bank approach is to present their regulated entities (market participants) with a stable and attractive yield curve and (whether expressly or by implication) to essentially guarantee yield curve stability while the institution's trading & prop desks borrow heavily in the short- term market while lending long term to governments and corporates. Add to that the expressed interest of regulators in inflating assets (and equities) and we realize one just had to be there. There was no skill in this; it's the Chauncey Gardner effect.

That ship has now sailed. If you didn't recognize the opportunity embedded in the central banks desire to repair financial institutions' balance sheets, that one-time offer has expired. It is time to think differently.



**David Rudd**

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MaRS Centre, Toronto

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## Founding Partner receives Order of Ontario Distinction

**T**he government of Ontario bestowed Michael Lee-Chin, president and chairman of Portland Holdings and PCMA founding partner, with its highest honour when he became a member of the Order of Ontario.

Raised in Jamaica and now a Burlington-based entrepreneur, Lee-Chin was among 23 people recently appointed to the Order of Ontario, a distinction that honours individuals from different walks of life who have demonstrated excellence and achievement in their field and who have left a lasting legacy in the province. They were officially appointed on February 27 in an investiture ceremony at Queen's Park, Toronto.

An entrepreneur who believes in the power of giving back, Lee-Chin has been known for his generous donations to local hospitals. He is also known for his contribution to the Royal Ontario Museum, which led to the creation of the iconic Michael Lee-Chin Crystal, a Daniel Libeskind-designed structure serving as the entrance to the Museum.

Michael Lee-Chin has donated more than \$60 million to Ontario institutions, including the Royal Ontario Museum, McMaster University and University of Toronto.







# THE ORDER OF ONTARIO



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AND INSPIRE US DAILY.

FROM,  
YOUR DEDICATED TEAM  
AND YOUR FRIENDS AT THE PCMA



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Access to leading regulatory and compliance insights that help you meet your obligations and stay focused.



## EFFECTIVE ADVOCACY

We need a strong private capital market across Canada. The PCMA works with regulators and governments to foster a better understanding of private capital markets and to drive positive changes for the industry.



## PCMA CHAPTERS & COMMITTEES

Passionate teams of industry leaders across Canada, all committed to elevating the private markets and role of EMDs and issuers of prospectus exempt securities.



## EXCLUSIVE INSURANCE

PCMA FIB Bonding insurance for EMDs, and E&O Professional Liability insurance for dealing representatives - take advantage of very competitive group pricing for PCMA members.



## THE PRIVATE INVESTOR MAGAZINE

Free subscription and special rates for advertising for the PCMA national industry magazine - **The Private Investor**. We provide analysis on regulatory changes, compliance challenges and best practices, and leading insights into deal structures, financial reporting, legal, accounting and other issues.



## PCMA PARTNERSHIP OPPORTUNITIES

The PCMA has built an effective national industry voice for the private capital markets. Become a PCMA Partner and reach key decision-makers in the private capital markets industry. We believe helping you succeed in your business is key to the success of both the PCMA and our private markets. We have a number of partnership opportunities available, which enables you to showcase your business, products and your views.



## PCMA EDUCATION SERIES

PCMA Education Series events build the educational infrastructure to help EMDs, dealing representatives and issuers succeed in their business in a rapidly changing regulatory environment.

## PCMA PRIVATE CAPITAL MARKETS AWARDS

The PCMA Awards are the only national industry awards for private capital markets professionals that recognize business leaders who help build a vibrant and successful private capital markets in Canada.

## PCMA ANNUAL CONFERENCE

PCMA Annual Private Capital Markets Conference brings together pragmatic and insightful presentations from top industry leaders. Each year a capacity crowd of professionals gathers to learn about new developments in the private capital markets.

## TUITION DISCOUNTS

Reduced admission prices for PCMA Members for IFSE Institute exams including the Exempt Market Professionals exam - the only prescribed proficiency course focused on the exempt market in Canada. It is designed for individuals seeking registration as Dealing Representatives and Chief Compliance Officers of Exempt Market Dealers.

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PCMA members receive a complimentary consultation and discounted pricing on marketing and building your business brand!

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Learn from others, share your advice or best practices and success stories of the private capital markets on the Private Capital Markets Blog. Only PCMA members can write posts.

## PREFERRED RATES

Exclusive discounts from North Americas hotels to preferred rates on flights with major Canadian airlines.





# Neil Carnell

## MEMBER SPOTLIGHT

Director, Broker Products  
Computershare Trust Company of Canada

**Q:** *Congratulations on your recent Directorship at the PCMA! Tell us a little about your background and what you intend to bring to this new position?*

**Thank you!** As the Director, Broker Products at Computershare, I oversee business development, product strategy, and relationship management of our solutions for the exempt market and independent investment dealers. I have more than 17 years of experience with Computershare and even more in the industry, and recently led the launch of our exempt market product offering. I'm excited to join the PCMA Board of Directors in this ever-changing industry and I hope to bring a different perspective to the PCMA.

**Q:** *Tell us about the recent announcement of Computershare's acquisition of the exempt market securities business of Canadian Western Trust. How did you come about this business opportunity?*

Computershare signed an

agreement to acquire the exempt market securities account administration and trustee business of Canadian Western Trust Company (CWT) last August. The transaction closed shortly after and included a diverse portfolio of self-directed exempt market plan-holder accounts with assets under administration (AUA) of approximately \$1.7 billion CAD.

We are committed to the development of the exempt market industry and were looking for an opportunity to continue our growth across the country. The opportunity with CWT aligned with our long-term vision for supporting issuers, exempt market dealers (EMDs), dealing representatives (DRs) and investors into the future.

**Q:** *Where is Computershare's Private Capital Solutions business going? What's next?*

Computershare is committed to serving our clients first; we are continuing to grow our team to meet current demands

and manage our business growth effectively. We are also focused on presenting Computershare's complete service offering to the market, including transfer agency, corporate trust and communications services, to fully meet record-keeping, account administration and communications needs of EMDs, DRs, issuers and investors. We will continue to improve our technology and adapt to the market, which will enable us to provide complete service solutions to the exempt market.

**Q:** *Describe for us Computershare's client profile when you first entered the private capital market vs. today. What trends have you observed?*

When we first entered the market in 2015, we quickly realized that the solutions available were not meeting the growing demands of the market. As investments and investors became more sophisticated and regulatory restrictions on investors eased, the industry was asking for more options

with cost-effective pricing, robust technology and the capability to deliver service on a national level.

**Q:** *Can you share with us how Computershare has helped its exempt market clients?*

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**Q:** *With the adage, "Membership has its Privileges", please finish this sentence: Joining the Private Capital Markets Association of Canada is imperative because...*

...this industry is evolving rapidly!

Computershare is proud to support the PCMA and intends to support exempt market participants and the industry as they enter this exciting period of growth and change. Thank you to the Private Capital Markets Association of Canada for being the voice of the industry. ■

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Neil Carnell  
Director, Broker Products,  
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# CANADIAN FARMLAND OMEGA RATIOS

By Stephen Johnston and Karim Kadry

How certain can you be that Canadian farmland will hit your return targets? A review of the market over the last 10 and 20 years reveals that a farmland holding would have generated Omega ratios substantially above one for a return threshold of 5%. At a return threshold of 10% Omega ratios were substantially above one in the 10-year period while ranging between 0.3 and 0.55 for the 20-year period. We used three farmland portfolio configurations, average Canadian farmland, average Saskatchewan farmland and average Alberta farmland.

Before I explain the consequence of these results let's start with an overview of the principle of the Omega ratio as different from its more well-known sibling the Sharpe ratio. Mean and variance cannot completely represent the risk and reward in a return distribution, except in the case where those returns are normally distributed. By comparison, all known information about the risk and return of an investment is contained within the Omega ratio as it is the probability weighted ratio of gains over losses for any expected level of return. As such, Omega quantifies the "quality" of the investment relative to the return threshold.

*"The Omega ratio is a risk-return performance measure of an investment asset, portfolio, or strategy. It was devised by Keating & Shadwick in 2002 and is defined as the probability weighted ratio of gains versus losses for some threshold return target. The ratio is an alternative for the widely used Sharpe ratio and is based on information the Sharpe ratio discards. Omega is calculated by creating a partition in the cumulative return distribution to create an area of losses and an area for gains relative to this threshold. The ratio is calculated as:*

$$\Omega(r) = \frac{\int_r^{\infty} (1 - F(x)) dx}{\int_{-\infty}^r F(x) dx},$$

*where F is the cumulative distribution function of the returns and r is the target return threshold defining what is considered a gain versus a loss. A larger ratio indicates that the asset provides more gains relative to losses for some threshold r and so would be preferred by an investor. When r is set to zero the Gain-Loss-Ratio by Bernardo and Ledoit arises as a special case. Comparisons can be made with the commonly used Sharpe ratio which considers the ratio of return versus volatility. The Sharpe ratio considers only the first two moments of the return distribution whereas the Omega ratio, by construction, considers all moments."*  
Source Wikipedia

Our data shows that even with relatively high nominal return requirements farmland in Alberta, Saskatchewan and Canada (based on the last 10 and 20 years) can be reasonably be expected to meet or exceed portfolio expectations – i.e. it is a high-quality investment. Why do you care? You can put farmland into a portfolio and have a high likelihood of achieving portfolio targets and a low likelihood of underperformance.

## Source Data and Analysis:

### 20-yr (1997-2016)

Mean	8.0%	7.8%	8.1%
St. Dev	6.1%	9.0%	3.6%
Sharpe	0.81	0.53	1.42

### 10-yr (2007-2016)

Mean	12.4%	14.5%	10.1%
St. Dev	5.4%	7.7%	3.9%
Sharpe	1.73	1.50	1.79

### 20-yr (1997-2016)

	Canada	SK	AB
Threshold	0%	0%	0%
Omega	31.82	19.24	32.44
Threshold	5%	5%	5%
Omega	4.28	2.35	13.06
Threshold	10%	10%	10%
Omega	0.45	0.55	0.29

### 20-yr (2007-2016)

	Canada	SK	AB
Threshold	0%	0%	0%
Omega	24.76	29.04	20.10
Threshold	5%	5%	5%
Omega	14.76	19.04	10.26
Threshold	10%	10%	10%
Omega	3.31	5.30	1.03

Applying a minimum limit of 5% for  
 $\int_r^{\infty} (1 - F(x)) dx$

Year	Canada	SK	AB
1997	8.0%	5.5%	7.8%
1998	2.7%	0.5%	5.1%
1999	0.2%	-4.8%	5.7%
2000	1.5%	-2.2%	4.3%
2001	1.4%	-1.5%	4.2%
2002	5.3%	3.9%	6.4%
2003	3.8%	3.1%	4.2%
2004	4.6%	1.9%	9.0%
2005	3.1%	1.3%	6.1%
2006	4.7%	2.1%	8.9%
2007	11.6%	11.0%	17.4%
2008	11.7%	14.9%	9.1%
2009	6.6%	6.9%	4.8%
2010	5.2%	5.7%	4.4%
2011	14.8%	22.9%	8.7%
2012	19.5%	19.7%	13.3%
2013	22.1%	28.5%	12.9%
2014	14.3%	18.7%	8.8%
2015	10.1%	9.4%	11.6%
2016	7.9%	7.5%	9.5%



### Stephen Johnston

Stephen earned a Bachelor of Science Degree (1987) and a Bachelor of Laws Degree (1990) from the University of Alberta and a MBA (1994) from the London Business School. Stephen is the author of "Cantillon's Curse" an Austrian economic analysis of a number of key investment trends and a co-author of "Equicapita's Little Book of What Next" a detailed analysis of the SME valuation and sale process from the perspective of private equity investors.



### Karim Kadry

Karim has 20 years of international experience in the investment and financial fields. He lectures in universities and educational institutions while acting as the investment manager of Agcapita farmland funds. Karim has a Bachelor of Engineering Degree from Cairo University, MBA jointly from IESE School of Business and Nile University and holds the CFA designation.

# — ONLY OURSELVES TO BLAME —

The OSC recently announced the members of their 2018 FinTech Advisory committee and no one from the Private Capital Markets Association was included. Should we care? Should we be mad? What does it mean for our industry?

Stephen Preston, VP of Exempt Edge and Chair of the FinTech and Innovation committee for the PCMA breaks it down:

If you are in the financial services industry there's a good chance you've heard the word FinTech being thrown around. For those who aren't familiar with the term, FinTech can be described as the rapid innovation of financial services through technology.

It's a tidal wave of change empowering people globally by giving them more options for everything related to money including: how people invest, borrow, lend and manage their finances. Artificial Intelligence, Crypto Currency and the Blockchain - are all FinTech innovations that WILL impact every Canadian and every professional in our industry - the only question is when and by how much?

According to KPMG, global FinTech investment topped US\$31B for 2017, bringing the total investment over the past three years to US\$122B (1). It's a large industry that's only going to get bigger.

So how is Canada positioned in the global FinTech revolution? You'd think that with such an entrepreneurial and tech savvy population we'd be leading the FinTech charge but in reality we are woefully behind our peers. Countries like the UK, Australia, Singapore, and the USA are years ahead of us and their citizens are benefiting tremendously from the availability of new innovative financial products and services.

So why are we so far behind?

According to a report by Deloitte (2), regulation is one of the most important factors in creating an environment where FinTech companies can prosper. In Canada, we lack a national FinTech strategy and our provincial securities regimes makes operating a FinTech business difficult.

But it's not all bad news. Recent developments show that Canada may be headed in the right direction. A report released in December 2017 by the Competition Bureau of Canada made a host of recommendations to foster an innovative FinTech environment in Canada. John Pecman, the Commissioner of Competition hit the nail on the head when he said:

"The future is now. Let's get it right by providing policy makers with the information they need to nurture a competitive environment that allows Canada's FinTech companies to innovate and grow globally." (3)

Along the same lines, the OSC posted a release on their website on November 22<sup>nd</sup> 2017, requesting applications for a FinTech Advisory Committee, adding that members would be selected based on their experience in the following areas:

- ◆ Digital platforms (e.g. crowdfunding portals, online advisers);
- ◆ Cryptocurrencies or distributed ledger technologies (e.g. blockchain);
- ◆ Venture capital, financial services, securities, legal or accounting, with a focus on the FinTech or technology sector;
- ◆ Data science or AI (artificial intelligence);
- ◆ FinTech or technology entrepreneurship;
- ◆ Compliance or RegTech solutions; or
- ◆ Cryptography or cybersecurity. (4)

Between this initiative, and the OSC Launchpad which "strives to keep regulation in step with digital innovation", the OSC deserves a lot of kudos for doing many of the right things to foster FinTech innovation in Canada and is going in the right direction.

For the PCMA and NEMA (at the time), it was important that someone from our industry was included on the advisory board to ensure that the voice of the Private Capital Markets were part of the conversation. Though three suitable candidates were put forth by the associations, not one was selected.

We felt snubbed, left out and truthfully – a little upset. How could the OSC not include one of our own? Don't they know that billions of capital pours into the Private Capital Markets by tens if not hundreds of thousands of Canadians each year? Is our industry not innovative and at the forefront of investing?

I was immediately compelled to write an article on the subject which, in my mind, was sure to be laced with a little criticism. When I finally sat down to begin the article, however, my tone changed. Having been critical of the state of technology in the Private Capital Markets for some time, how could I write about what we bring to the table in terms of FinTech and Innovation without being a hypocrite?

As an industry, we are only now beginning to see the adoption of very basic tech functionality like digital signatures and paperless transactions – tech that has been commonplace in other industries for close to a decade (for reference, Docusign, one of the largest digital signature solutions has been around since 2003). As an industry of entrepreneurs and innovators, we can and we must do better. Technology has the power to revolutionize the Private Capital Market while opening new doors along the way.

*Ask a millennial to invest in a private equity deal and see how quickly their excitement turns to shock when you outline the paperwork and the process involved in a transaction. You mean I have to print this giant stack of paperwork? Can't I just sign up online like I did with WealthSimple? What do you mean I might receive three different statements for my investment – can't I just login and get my statement and view my holdings online?*

So in closing, should we be upset that the OSC did not include us on their FinTech Advisory Committee? Yes we should, but we should be upset at ourselves for not being at the forefront of financial innovation and we should be upset at ourselves for not giving the OSC a million reasons why we are a vital and indispensable component of the FinTech landscape in Canada.

In 2018, let's strive to make FinTech synonymous with the Private Capital Markets for the benefit of ourselves, our clients and our industry. Let's let our innovating do the talking so that no conversation about FinTech is complete without our voice.



**Stephen Preston**

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🌐 ExemptEdge.com

(1) [https://www.newswire.ca/news-releases/global-FinTech-funding-tops-us\\$1b-for-2017----fueled-by-us\\$7b-in-q4-kpmg-pulse-of-FinTech-report-673903883.html](https://www.newswire.ca/news-releases/global-FinTech-funding-tops-us$1b-for-2017----fueled-by-us$7b-in-q4-kpmg-pulse-of-FinTech-report-673903883.html)

(2) <https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/Innovation/deloitte-uk-connecting-global-FinTech-hub-federation-innovate-finance.pdf>

(3) <http://www.competitionbureau.gc.ca/eic/site/cb-bc.nsf/eng/04319.html>

(4) [http://www.osc.gov.on.ca/en/NewsEvents\\_nr\\_20171122\\_osc-requests-applications-for-fac.htm](http://www.osc.gov.on.ca/en/NewsEvents_nr_20171122_osc-requests-applications-for-fac.htm)





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# OPERATIONAL TURNAROUNDS

## THE ICU OF THE CORPORATE WORLD

(What you should know, and why you should care)

By Milton A. Parissis

When faced with operational or financial challenges, proactive CEOs understand the need for immediate action to reconfigure their business. Early action reduces costs and the need for dramatic changes, while providing more strategic options. It also buys time to fine tune the pivot of a business. More importantly, it doesn't "spook" employees, suppliers, customers or investors.

Under normal economic conditions, approximately 68% of all businesses in Canada face challenges that could lead to serious decline and possible failure at least once within their life span. Additionally, 2 out of every 3 businesses will need to be repositioned and refinanced at some point in time. Other businesses may endure years of stagnation that limit their competitiveness or growth. All businesses are most vulnerable under conditions of rapid growth, expansion to a higher level of performance, diversification, internationalization, mergers or technological shifts that are specific to their industries.

There are times when a business falls off the rails. It can stagnate for a long time, then suddenly take a swift downturn due to specific circumstances that put it into a decline that is both scary or difficult to reverse. Although just about every business will face such crises at least once in their existence, it is surprising that most CEOs, directors, creditors, or investors are completely unaware of the conditions, process and value of an operational turnaround. They often can't recognise the early symptoms of a business requiring a turnaround, visualize the possible outcomes nor calculate the time and costs to right-size it...let alone the costs and diminished options of letting the business continue to decline.

Sadly, many business leaders, creditors and investors (both traditional and non-traditional), wait too long to take action. This limits them to one option: Formal restructuring under Chapter 11 in the

U.S., or CCAA, BIA or CBCA in Canada. This is a restructuring in the zone of insolvency and it is often, too late for a successful turnaround of a business. Based on our experiences, the turnaround of a troubled company under formal proceedings, is successful only under 15% of the time. Formal restructuring often "buys time" for a gradual, or "orderly" windup, or perhaps the divestiture of a business as a "going concern".

By the time a business requires formal restructuring, it's in a state where drastic actions are required. The sharks are circling their prey. By then, the company's suppliers are bolting, the customers have moved on, and the good employees have found alternative, secure employment. The work in this space is performed by insolvency professionals. They are not operational turnaround professionals, and by the time they are called into a business, it's often, really too late to save it. By then, a business is on "life support", and they are, de facto, "palliative care" workers. They will salvage what they can from the business so as to reduce incurred losses of an investment. In all truth, by this time, the focus is on "minimizing the haircut" for those exposed.

So, if you are a lender or investor to businesses (private or institutional), here are insights to keep in mind:

**1** All businesses, irrespective of size or industrial sector, when they begin to decline will go through four distinct stages of decline. They begin with noticeable market pressures and end with the need for court supervised remedies.

**2** The earlier that owners, management, creditors, investors and other stakeholders identify the symptoms of decline and swiftly address them, the better. As operational circumstances deteriorate, the greater the level of pain, cost, effort and time will be required to fix a business. Moreover, the greater the speed of decline



or the more advanced the stage of decline, the fewer options to remedy the situation will exist, and the more dramatic they will be to be to address the issues at hand.

**3** In general, if a company has experienced losses for 2-3 years, has a shrinking order book or is facing significant staff turnover, it is probably in need of a turnaround. Suffice it to say, that every business is unique (even within the same industry), and requires individual assessment. However, depending on the level of decline, there are specific “red flags” to be noted.

**4** In a turnaround situation where a company has been stagnating or declining over a period of time, it is a mistake to assume that ownership, management or the board of directors can fix the business. Why? Because if they could fix the business, they would have done so already...and, they would have done so quickly. Sadly, given human nature, pride, ego or denial often prevails. Moreover, while it is sometimes thought that “those who grew a business can also stop its decline”, the opposite is actually true. Management usually finds it difficult to make hard, objective decisions quickly, and they are not trained to “manage” troubled businesses back into profitability. This is because the critical and urgent nature of leadership and decision making is completely different in declining business circumstances.

**5** Operational turnaround professionals are *not* consultants in the traditional form. They do not go into a business, analyze the situation and write a report. Rather, they take a C-level operational position within a business and work shoulder-to-shoulder with owners, their board of directors and employees. They lead from within. They work on location, and are there daily within the business until all goals are met. More importantly, they become the key contacts with creditors, investors, shareholders and the board. They become full C-level representatives of the business. A typical engagement can be anywhere from 1-3 years in tenure. Their unique expertise is in understanding declining businesses, and on how to pivot them. They work within fixed timelines to provide “options”. Turnaround professionals are the ICU of the corporate world. They don’t control the “state of their patient”, but their goal is to achieve optimal or “best case” outcomes given the unique challenges they face.

Why do operational turnaround professionals have to work for such prolonged time within a business? Well, let’s be frank: Have you ever heard of anyone trying to fix a business via Skype? By parachuting a consultant into a business once a week to make “recommendations” without being accountable for the outcomes? Or succeed by generating a report and handing it over to the same management team who tanked the business and expecting them to effectively implement transformation? Is this viable, even after their employees have lost respect of their leadership? Really? Would such actions possibly address the “root issues” impacting a business?... and if they did, could it happen in a timely fashion before the business took a “deep dive”? Probably not.

The irony of the turnaround space is that the greatest impediment to a successful turnaround is human “denial”. Unfortunately,

business leaders in denial are not facing enough pain at that moment in time to implement meaningful remedies. The sad part, is when they decide they are ready to take action, it could be too late, too costly or even impossible to salvage their business.

In Canada, just over 1 million businesses are privately owned with under 99 employees. These businesses represent over 95% of the market. They consist of what we call the SMEs (Small to Medium Sized Enterprises). These businesses are hungry for capital and for engaged investors. They are a volume market for many traditional investors. In reality, only about 2-3% of the remaining Canadian businesses are public or large private companies with over 100 employees.

In today’s environment, sophisticated investors know how to source and pick winners, and they know how to manage deal flow. They live and breathe EBITDA growth, Purchase Price Multiples, IRRs, ROI and Leverage. They make money on multiples and deal flow and don’t get stuck in the weeds. Imagine now, that an investment has stalled or is underperforming. Suddenly, it requires close attention. Perhaps the business that possesses unique technologies or has been steadily growing and was considered a star, has precipitously “hit a wall”. Now management is telling you that its underperformance is “just a bump”, “one transaction away” or due to “market shifts”. Or perhaps the niche business you’ve invested in is not yielding the multiples, but you are faced with explanations that make you feel as though your concerns are unreasonable or overblown.

Under such circumstances, if your gut tells you that something “is not right”, it might be time to consider bringing in a turnaround professional who can review the operational, financial and managerial issues of your investment. As niche operational professionals in the stagnating, troubled, or declining space of the corporate world, they will be able to assist in providing insights into a business that are unique, prior to you having the need to call an insolvency professional into a file.

A “Looksee” or review under certain business circumstances can provide investors with insights, options and viable solutions. Consequently, an investor or dealmaker who is not an operator can make strategic decisions quickly and with minimal pressure. Given the tendency of human nature to protect personal ego, the power of denial, the gravitational pull of vested interests, careerism and the desire to preserve personal life styles, turnaround expertise is another option for active investors to consider adding to their toolbox.



**Milton A. Parissis**

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# WHAT OF THE 40?

An analysis of Fixed Income in portfolio building and the private market alternatives that are often substituted

By James Price

## EXECUTIVE SUMMARY

- Fixed Income serves two purposes in a portfolio:
  1. To diversify a portfolio from equity exposure; and
  2. To provide a source of return
- The prospects for Part 2 of that equation have diminished substantially given yields in government and investment grade bonds have declined so dramatically over the past 30 years.
- While the diversification function is still alive and well, many investors have been not just finding returns in the traditional way: lowering the credit profile or increasing duration, but also steadily reducing their allocation to traditional fixed income in an attempt to find more returns.
- As a result, we believe many portfolios are exposed to risk that isn't being properly recognized.
- We examine some of the private market alternatives being used to complement or even replace fixed income in portfolio construction. Namely;
- Hedge Funds
  - Private Debt funds
  - Mortgage Investment Corporations
  - Structured Notes

In our examination, we discuss the benefits and risks of each asset class as they relate to common portfolio construction.

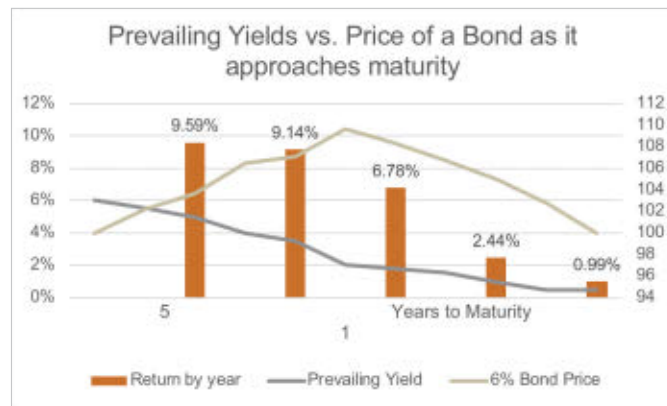
## INTRODUCTION

Once upon a time, the classic portfolio mix was created by taking 100 less your age to determine the equity allocation in your portfolio. The rest went to fixed income. Of course, that rule of thumb was designed in an era where fixed income allocations were both

plain vanilla (more on that later) and offered some fixed real returns. The 60/40 portfolio, referring to 60% equity and 40% fixed income became the standard benchmark, where the fixed income was generally made up of government and investment grade corporate bonds.

Starting in 1981, but particularly since 2008 when central banks around the world began slashing rates, yields, but not so much returns, have diminished on our fixed income portfolios. At first, we didn't mind. Starting yields had been healthy, and with inflation and rates dropping, the capital gains in our bond allocations gave great total returns (as yields drop, the price of bonds rise).

Eventually, however, bonds mature. If a 5 year bond is bought with a yield of 6% and held to maturity, the average return over the 5 years WILL BE 6%, even if yields drop throughout. Returns measured year by year will start out great, but decline quickly such that they average 6%. For fixed income investors, dropping yield feel good along the way, but eventually bonds mature.



When the bonds mature, we must re-invest at prevailing market yields. Since the purchase yield so closely resembles the ultimate return, this spells trouble. The days of declining yields appear to

be over (or at least close to over as we approach the zero bound). A 5 year Canada bond yields about 1% at the moment, so it is a pretty good bet that a portfolio of Canada bonds with maturities near 5 years will average about that return if held to maturity. With inflation running at about 1.6%, the return in real terms is long gone.

This begs the question – if we can't rely on the "40%" fixed income portion of our portfolio to provide any decent return, should we continue to hold it? Fixed Income used to be simple. Bonds had a coupon and a maturity date. That gave them certain reliable characteristics. Over the past decade, government bonds have an average correlation of -0.20 to equities, meaning they will rise in value when equities fall.

Today, what gets classified as fixed income often doesn't pass the classic tests. Coupon rates are not fixed, maturity dates are not guarantees, and pools of debt in a fund often have the ability to use all sorts of instruments including private securities and derivatives in an effort to replicate the fixed income portion of portfolios, while still generating a competitive level of return.

Portfolio construction is not just about return. Government and investment grade bonds tend to do well when equities do not, thus providing some ballast for when equities lag or drop. While we still believe this to be true, we feel seeking actual returns from "the 40" is reasonable, **provided the risks of doing so are understood.**

This paper is our attempt to examine alternatives – many of which are new to the investment landscape - while maintaining diversification and avoiding some of the potential pitfalls that are inherent to seeking returns.

## Bond Markets – How Did We Get to 2017?

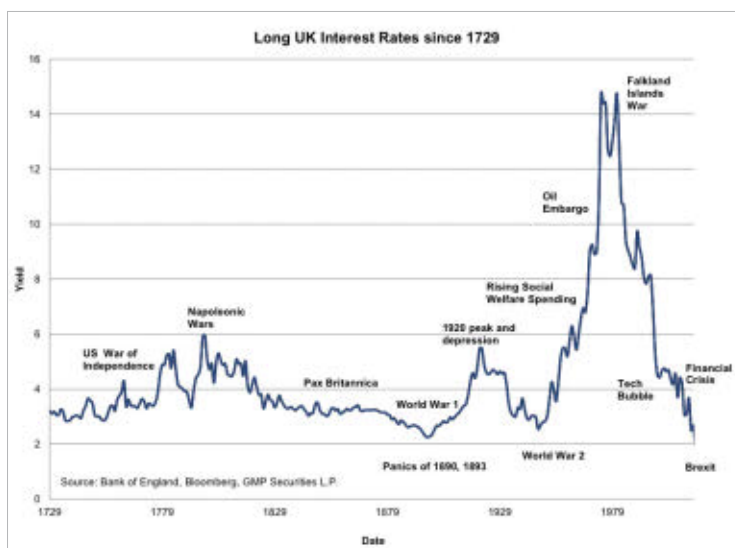
### SUMMARY:

- For centuries, long term rates were range-bound between 2% and 6%. The inflationary 70's caused that upward bound to be shattered, and the deflationary 00-10's have caused the bottom bound to be tested.
- Central Bank actions have been unprecedented
- Current government bond rates provide negative to minimal real returns, challenging investors.

The mid-sixties to the early eighties represented an unprecedented period for bond markets. A confluence of social and military spending, demographics and monetary system changes, among other reasons set the stage for rising inflation. These factors led long term bond yields to definitively break above 6%, a cap that had held not just for decades, but for over two centuries. These centuries were also characterized by a floor on rates of around 2.0%, despite numerous wars and severe business cycles, including the great depression.

Starting in late 1970s, a period of "tight money" was initiated; Higher central bank rates to combat the rampant inflation. Although this sparked a recession, yields finally peaked in 1981, and since

then investors have enjoyed a 35 year run of declining yields. Whereas in the 1890s and 1930s deflationary shocks resulted in severe downturns in industrial production, the monetary tools employed by central banks since 2008 staved off a prolonged decline in GDP. What might have been a severe depression has



instead become a long period of tepid growth, as the unprecedented expansion of the monetary base globally has so far helped markets avoid a deflationary bout as seen in the past.

Cutting interest rates to all-time lows, the use of unconventional policies such as direct bond and asset buying by central banks and experimentation with negative interest rate policy, the bailing out of financial institutions and European sovereigns avoided a crisis, but ensured the continuation of these policies. Finally, last summer global yields plummeted to new lows amidst "Brexit" news and we have broken definitively below that 2% yield floor that had held through the centuries.

For investors, this has translated into a multi-decade run of solid returns from their fixed income portfolios. Canadian long bonds have provided a total return of 8.74% annually from 1960 through 2016, only slightly trailing the 9.49% return on the S&P/TSX Composite Index. Interestingly, since 1980, Canadian long bonds have actually outperformed equity markets, not only over the period, but in each decade since the change in central bank policies in the late 1970s.

The decline in yields has not been simply an inflationary phenomenon. Real yield (the return after inflation) has also fallen. The chart that follows graphs the yield of what was then the benchmark long bond in Canada, the 10.25% due March 15, 2021, in comparison to the Canada Real Return Bond (RRB) 4.25% due December 1, 2021. RRBs pay a rate of return that is adjusted for inflation – as CPI increases year over year, so does the principal, ensuring that inves-



tors maintain their purchasing power regardless of the rate of inflation. In addition, when compared to nominal bonds, they give a good indication of the market's expectation of the average rate of inflation over the remainder of life. In 1990, markets were pricing in over 4% of inflation for the next 30 years; today we are pricing in less than 2%, just below the average of the Bank of Canada's target. In addition, real returns were above 4% in 1990; today short term RRBs have real yields below zero. Real rates are being depressed by central banks, who have kept short term rates below the rate of inflation since the financial crisis.

This leads us to the current dilemma facing fixed income investors. Absolute yields are very low, with longer term yields barely above the rate of inflation and short term yields producing negative real rates of return. When we take into account annual inflation on the nominal return table above, we get the chart that follows. Real returns have recently been dismal for T-Bill investors (2010-2016 has so far provided T-Bill investors with a greater loss in purchasing power than they experienced in the 1970s), and will likely remain dismal. With real yields so low, the current environment is a challenge for bond returns, to say the least.

### THE CLASSIC 60/40 SPLIT

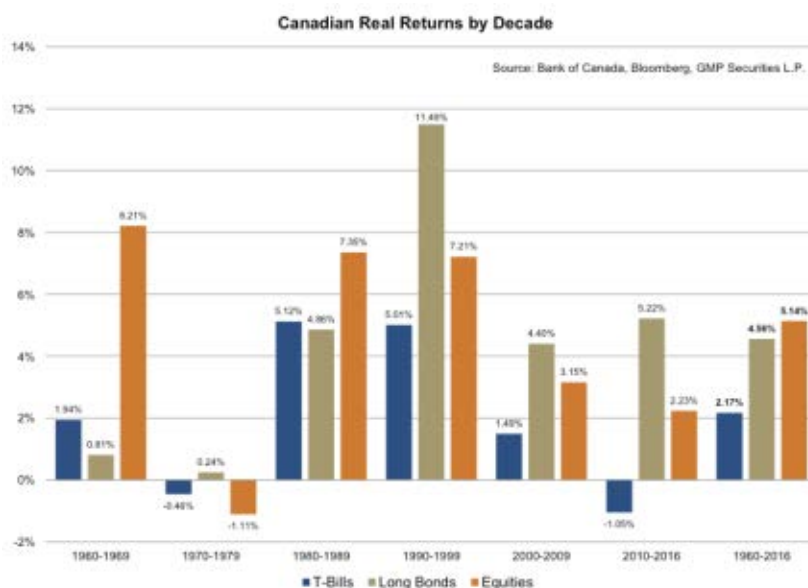
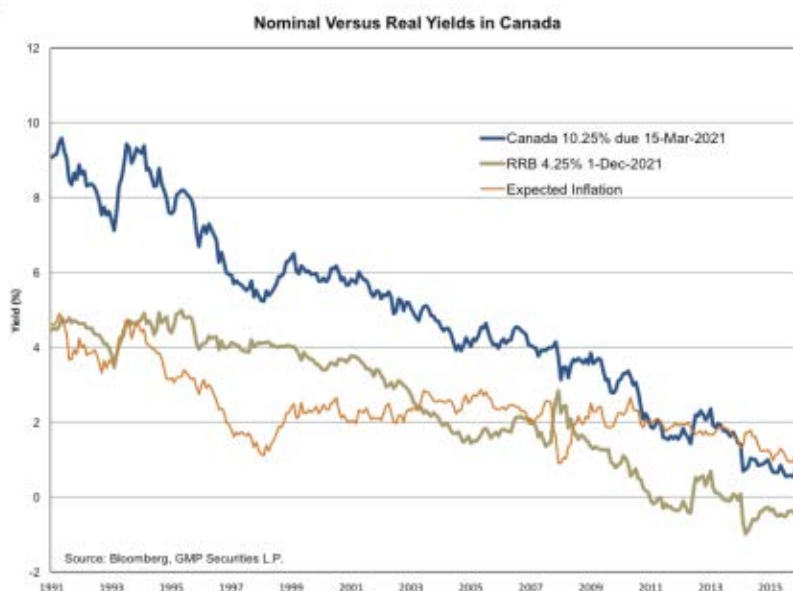
While we're taking a look back at fixed income markets, it's also worth taking a look at the classic 60% equity – 40% fixed income asset allocation split over time. As you can see in the chart that follows, the 60-40 split has served investors well – dampening downdrafts, and until recently providing all the return. However, considering current yields as can be seen by the very recent return, investors may need to reset their expectations going forward as historical returns may be hard to replicate.

### Examining Fixed Income Returns

Let's get technical and dig a little deeper and examine fixed income returns.

Yield is a function of price, coupon rate and term to maturity.

Term structure, also known as the yield curve, reflects market expectations of future interest rates plus the term premium, which



generally rewards investors for investing in longer term instruments. In a normal rate environment, the longer the term to maturity, the higher the yield. Yield can be further broken down into four components.

1. The real yield, which is based on the term structure of interest rates
2. The inflation expectations as yields incorporate both real return and inflation
3. Credit risk as investors demand greater yield in return for a reduced certainty of repayment
4. The liquidity premium as investors demand a greater yield in return for giving up liquidity

There are generally three ways to seek increased returns from fixed income holdings:

1. Increase term to maturity – This is called duration risk. If rates rise the price of bonds will fall. This is the trade off – to the longer the bond the larger price moves in response to changing yields, increasing volatility.
2. Increase credit exposure – The lower the credit quality, the higher the coupon. Investors can increase the return by having more exposure to “credit”. These higher returns come at the cost of increased risk – both of default and of portfolio volatility. The addition of credit risk comes with another hidden cost as it reduces the diversification benefits of bonds. During the 2008 credit crisis, corporate bond spreads increased dramatically and corporate bond portfolios fell in value alongside equities. An investor holding corporate and high yield bonds did not see their fixed income holdings appreciate, reducing the diversification benefits of their portfolio. The lower the credit quality, the higher the correlation with equities.
3. Give up liquidity – The inability to sell usually commands a yield premium over comparable issues of similar credit and term. This liquidity premium can enhance returns, but comes at the cost of reduced diversification as these securities do not increase in value in a falling rate environment (they are, in theory still more valuable though, but that value can’t be realized). The lack of liquidity also prevents your ability to sell and rebalance or to mitigate losses in the case of a negative credit event (like a default).

There are a couple of other ways of attempting to enhance the returns from fixed income holdings. Look abroad to foreign markets where yields may be higher, though this brings volatility in the form of currency exposure. Investors can also get more tactical, trading term and credit premiums.

Given these strategies to increase returns in fixed income, we would remind you – **and this is one of the primary purposes of this study** - it is not just about maximizing returns. **The diversification benefits of traditional fixed income and capital preservation it provides are important considerations.** Portfolio theory aims to

increase return AND lower volatility. Taking on any of the above risks in order to enhance return always comes at the cost of these two other pillars.

Now that we have a better understanding of fixed income returns and the costs and tradeoffs that come with them, let’s examine some alternative fixed income securities, highlighting our three risks: duration, credit and liquidity:

## Credit and Bond Hedge Funds

### SUMMARY:

- Long/Short credit managers have the tools to hedge out certain risks (like rising rates) and have become popular.
- Both spaces can be attractive, but the mainstream narrative for choosing these strategies can be flawed. Picking the right managers is paramount.

### OVERVIEW

2016 saw record fund flows into the High Yield bond market as investors sought higher returns from fixed income. At the same time, many have sought refuge with Long/Short (L/S) credit managers because “rates are going higher”, or in the Private Debt space where there is “no volatility”.

Hedge Funds: L/S credit managers have sought greater returns while also protecting investors from rate sensitivity, volatility, and drawdowns. In theory, the ability to go long and short while applying leverage allows them to achieve those results.

We’ve seen this trend with a growing number of Canadian investors allocating to L/S Credit managers, capital structure arbitrage funds and duration managed products, in attempts to increase returns while minimizing various forms of known and manageable risk.

While all these alternative strategies have provided substantially higher yields versus the fixed income indexes, it is very important to keep in mind that the risks being taken and some key metrics to monitor before allocating to these strategies.

### DURATION

When examining duration, it’s worthwhile to find out how a credit manager is investing your money. Questions you should ask include:

- What is the average duration of the portfolio?
- How is the manager taking out rate sensitivity through the L/S approach?
- How does the manager track rate sensitivity?
- What is the manager’s track record when it comes to execution?

Removing duration has been a very popular strategy as the narrative of ultra-low risk-free rates being anything but risk-free persists. While this narrative came far too early (we have seen many attempts at marketing this since 2009), it looks to be finally working.

## CREDIT RISK

With L/S credit managers, here are some questions to ask:

- How does the manager evaluate good credit vs bad credit?
- What is the manager's experience and track record in this space?
- How many positions does the manager hold and how are they sized? -- This is where they will add value and create alpha. They should be able to identify good credit and isolate rate sensitivity through short positions.

Crucial in the L/S credit manager's process is applying leverage. Understanding how much leverage and where it is applied is essential.

- Does the manager use leverage only on Investment Grade credit?
- How much leverage can they safely use? Leveraging bonds is not the same as leveraging equities. It does, however, magnify the credit risk/reward framework.

## LIQUIDITY

Most L/S credit funds trade very liquid positions and thus, under stress the portfolio could normally be liquidated in a matter of a few days. With these strategies, liquidity should not be the primary concern, **but investors must pay attention to the liquidity provisions of the fund itself.**

We have also begun to pay attention and consider the overall liquidity of the underlying holdings. Regulatory changes since 2009 governing the institutions that make markets in fixed income securities has yet to be tested in tough credit markets. Our concern is that there are less participants making markets to provide liquidity to funds. While there is usually someone willing to take a profit and sell on the way up, history has shown us that buyers can dry up pretty quickly in tough markets.

The up rise of exchange traded funds has created concerns regarding liquidity as large investor pools, who are price-agnostic to the underlying holdings, buy and sell with impunity – potentially making those index heavy issues more susceptible to fund outflows.

### Other Considerations for funds – operational risk:

- How large is the firm?
- What assets do they manage?
- How long have they been active?
- Who are the decision makers?
- Do they segregate operational, compliance and investment duties?
- How are they regulated?
- Who are their service providers?
- How concentrated is their investor base? (i.e. will they have to close shop if their biggest investor leaves).

- Can they provide financial statements to verify that they are profitable?
- Is there any open litigation involving the firm or principals?

## CONCLUSION

- Hedge funds usually try to isolate one form of risk to profit from taking another. They rely on the managers' ability to generate alpha in that particular area of risk-taking.
- All fund types need to be reviewed for operational risk. The departure of a key manager or failure of a service provider could have adverse effects on the fund, with outcomes that could range from deteriorated returns to outright fraud.

## Private Debt

### SUMMARY:

- Private Debt, or Credit as it is sometimes known, has been an asset class quickly on the rise in the institutional endowment and pension fund investing space. More recently, many products are becoming available to retail investors.
- Private debt is lending on bespoke terms to businesses and individuals, funding those loans from investor pools rather than bank balance sheets. The high yields provided are very attractive, but they warrant careful scrutiny as they take extreme amounts of liquidity risk and potentially credit risk which can be very difficult to measure.
- Both spaces can be attractive, but the mainstream narrative for choosing these strategies can be flawed. Picking the right managers is paramount.

*Private Debt:* The argument has been that by giving up some liquidity, investors are able to access high quality private credit and generate better returns with less credit risk than public market equivalents. The shift towards private credit alternatives has been quite popular in the Institutional/Pension/Endowment/Sovereign fund space, with flows increasing exponentially over the past decade. Increased regulatory pressures on banks has opened the door to non-bank lenders finding excess returns in this space, and pension/endowment style funds are perfectly suited pools of capital to provide that, given their need for income and long time horizons.

Mortgage Investment Corporations (MICs), other private real estate lenders, factoring/supply chain financing funds, asset backed lending (ABL)/mezzanine funds or other niche alternative lending strategies all find themselves classified broadly in the private debt space.

With private debt, interest rate sensitivity is low given many loans are of short duration or have floating rate structures. Returns sensitivity is much more related to the type of strategy -- real estate versus ABL or factoring funds as an example. It is still important to ask and understand how rising interest rates may affect investor return, however. As a general rule, the average term of the loans is important to note as lower terms on average reduce interest rate risk. Shorter is typically better, although this can be dependent on fund/style.



For Private debt managers, understanding their underwriting process is important.

- Who is involved, from sourcing to the final decisions, and what risk metrics are in place?
- What is the manager looking for prior to working with a borrower?
- Do they have a competitive advantage and with whom do they compete?
- Do they use additional leverage, if so how?
- What are their Loans to Value, and how is the value measured?
- How do they rate their borrower? (prime vs. near prime vs. subprime)
- How are the loans monitored once issued and how often?
- What covenants are in place to protect the investor?
- What is the ratio of non-performing loans?
- How many loans in the Manager's portfolio, to assess concentration?
- What is the experience and track record of their workout team in dealing with delinquent or defaulted loans.

A private debt manager should have a good credit monitoring team, third party experts to monitor their loans, as well as a proven team and process to resolve issues with non-performing loans. Lastly, it is also very important to note that since private debt managers do not trade their securities on any markets and do not mark to market, volatility is very low. However *volatility is not a valid risk metric* as compared to publically traded equities that mark to market daily.

"Illiquidity premium", is an important driver of returns in private debt. Selling a private loan is a long tedious process (if it can be done at all) since the terms and conditions of each loan is bespoke. Some smaller, shorter duration, nimble private debt strategies can offer monthly liquidity to investors, but many larger established managers will have quarterly or even yearly investor liquidity, with one to five year initial lock-ups on capital. This provides the manager with a predictable capital base from which to properly execute the lending strategy while allowing them to operate through difficult market cycles without the issues faced by many publically traded strategies.

It is extremely important to understand and evaluate if the liquidity terms of a fund match the underlying strategy and loans. Many investment funds have failed because of issues that emerged from the mismatch between liquidity to investors (too short) vs. the term of their loans, as opposed to the failure of the loans themselves. Furthermore, if one or a few investors that represent a significant portion of the fund decide to redeem, the rest of the investors may be forced into a situation where they are unable to redeem until the fund is able to either find new investors or wind down their loans in an orderly fashion.

## CONCLUSION

- Private debt funds take advantage of regulatory conditions preventing traditional lenders from participating, and take

credit and liquidity risk to generate returns. These strategies are relatively new to retail investors, and have yet to be tested through any kind of economic cycle. As such, extreme caution is warranted, and investors should be prepared for a situation where they are denied liquidity entirely.

- All fund types need to be reviewed for operational risk. The departure of a key manager or failure of a service provider could have adverse effects on the fund. A Private Debt funds workout team, while not busy in recent years, is every bit as important as their credit adjudication team.

## Mortgage Investment Corporations (MICs)

### SUMMARY:

- Though they are a form of Private Debt (mentioned previously) MICs are deserving of their own category in Canada. All the comments from the private debt section would apply, but further considerations are warranted.
- MICs are an easy way for investors to gain exposure to the high yield real-estate backed sector.
- MICs are early in their evolution for investors, and some contain structural flaws.

### OVERVIEW

MICs account for the majority of unregulated mortgage lending in Canada. These entities typically invest in short duration, high yield mortgages and pay out 100% of their income as distributions to investors. This flow through structure allows them to avoid paying corporate taxes and to maintain a constant net asset value (NAV) assuming that interest income exceeds expense and losses. MICs are not allowed to reinvest their earnings. As such, they are dependent on new investor funds to grow. This is fine, as long as investors are willing to provide them with funding. In addition to the discussion concerning the three risk components that follows, we'd also highlight that MICs are subject to regulatory/structural risk. At present, MICs are regulated by OSFI – the bank regulator – and not necessarily by the Ontario Securities Commission or any of the securities regulators; however, there have been more moves recently by the provincial regulators to remedy this.

MICs are not required to publish their NAVs, mostly because of the nature of short-term lending, where loan values are simply their face value unless they are impaired. MICs issue and redeem at a fixed price. While this keeps the structure simple, the U.S. money markets provided a good example of what could happen if those impairments happen. In Q4/16, U.S. prime funds were required to publish net asset values based on the current value of their assets. Prior to the implementation of this regulatory change, prime funds were able to preserve the value of their investments at \$1 a share, providing a certain sense of stability for investors. When that changed, investors sold their positions. The same kind of exodus would not be as straightforward for MICs, since their assets are highly illiquid, but the structural/regulatory risk remains.

We should note that there are many different types of MICs with differing risk profiles – residential, construction, commercial, etc.

The risks that are inherent in one type of lending, may not be applicable to others.

## DURATION

In terms of duration, MICs are not very sensitive to rates because they generally invest in 6-24 month mortgages. Additionally, most MICs are made up of non-traditional debt with rates that far exceed the banks' posted mortgage rates. For this reason, they are less sensitive to change in market levels of rates.

## CREDIT RISK

Most MICs are heavily exposed to credit. To call it subprime is a bit too simplistic, but their borrowers need flexibility for many reasons, including that they have bad credit, and do not conform to the standard CMHC insured loan in Canada (where it applies to residential mortgages). With many different credit profiles, varying income qualities, debt obligations, high leverage, immediate closing time required, or lack of income or asset verification, MICs can be particularly susceptible to a weakening economy or property market, as well as potentially fraudulent applicants.

## LIQUIDITY

Perhaps the most important consideration for MIC investors is liquidity. Aside from the few publicly traded MICs, where liquidity is found from other investors in secondary trades, MICs differ in their redemption policies, from daily to annually. Because MICs are required to pay out all of their income, an investor's demand for liquidity must be met with one of: a) cash on hand, b) new investor money, c) a temporary debt facility, or d) portfolio maturities. Defaults may complicate the liquidity situation for a MIC. If one mortgage goes into default, and the MIC ends up owning the secured asset, it could take months or years to sell the property, tying up the capital unproductively in the meantime. Any losses would need to be absorbed by cash flows on the rest of the portfolio – reducing the available income to distribute to investors. Our primary concern is that this reduction would cause investors to want to redeem – which would not be possible without worsening the situation. Should the defaults become systemic as happens in bear markets, this could be problematic.

Finally, we would note that the fee structure of MICs vary widely. Virtually all have a fee on assets, some have performance bonuses for meeting/exceeding benchmark returns. Also, given the variety of income sources, one must pay attention to what income the investor is entitled. Some pay out only interest to investors, keeping other fees such as closing, early payment, NSF, or renewal fees for the managers.

## CONCLUSION

- MICs offer high current income, but their liquidity profile is worrisome. Given the current situation of high property prices and high household leverage ratios in Canada, we see them as being particularly risky.
- Only look for MICs with the highest levels of underwriting diligence, geographic diversification, and a high proportion of first mortgages. Quality workout teams are a must.

- Being a new offering, (and in a bull market), fee structures vary widely.
- Combining structural and liquidity characteristics, even a minor "rush to the exits" could prove damaging in the MIC space
- We have little history to go on in terms of portfolio diversification, since MICs are a relatively new asset class and have largely not been tested through a cycle.
- MICs are not a good replacement for classic fixed income, and especially poor as a place to "park cash"

## Structured Notes

### SUMMARY:

- There are many varieties of structured notes, with returns that are linked to various underlying, including bonds, equities and even commodities.
- Only Principal Protected notes should be considered true fixed income alternatives.
- When built correctly, structured notes can be a useful part of a portfolio construction.

### OVERVIEW

Structured notes come in all shapes and sizes, but the only one considered as a true alternative to fixed income is the principal protected note (PPN). A PPN is a debt obligation with a promise to repay 100% of capital at maturity along with an agreed upon payoff profile. PPNs are effectively created when a strip bond is purchased at present value and the difference between the present value and maturity value (par) is used to buy call options on a specific underlying, or in some cases generate a fixed coupon. The primary factors in determining the initial price of a PPN is the level of interest rates at which the strip bond is sold, and the volatility of the options being purchased.

### DURATION

As with any debt obligation or bond, there is interest rate sensitivity as it relates to the present value and term of the note. As such, any interest rate movements can temporarily affect the market price of the note on a daily basis, with the range of volatility primarily attributable to the term of the note.

### CREDIT RISK

Structured notes are effectively a debt obligation of the issuing bank. Therefore, as with traditional plain vanilla bonds, the credit quality of the issuer will determine the likelihood of principal repayment at maturity. The guarantee of principal repayment is only as good as the bank providing the guarantee.

### LIQUIDITY

Although PPNs are designed to be held until maturity, clients may want to sell their notes before then. While a daily secondary market usually exists, there can be times when the credit and complexity of structured notes can cause the liquidity to dry up. Investors won't be given notification of this. There is little secondary trading as

most dealers do not keep structured notes in inventory because of the differences between the various structures and payoff profiles.

## CONCLUSION

- Structured notes come in all shapes and sizes to give investors returns exposure to many different markets, but only the PPN – with its issuer-provided guarantee of your capital being returned – should be considered a true fixed income alternative.
- The bespoke nature of many notes can make them very useful in filling “gaps” in portfolio construction
- Investors need to be aware of the embedded complexity and costs

## The Overall Conclusion

Analyzing the alternatives that are currently being used to act as fixed income within a portfolio generally leads us to the same conclusions. In almost all cases, with the exception of reaching for yield through extended duration on government bond portfolios, and well targeted geographic diversification, the examined attempts to boost returns reduce portfolio diversification – the asset classes are more correlated and will not perform as well in equity bear markets.

Structural issues may make certain asset classes appear less volatile than they actually could be. Don't confuse a lack of a daily mark to market for low volatility. Infinity Sharp ratios do not exist. Products which keep a constant NAV do not have good track records in times of stress.

Perhaps the classic 60/40 needs to be re-thought and the amount of risk that one takes needs to be discussed more openly.

Though rising, risk free rates are still low, and all analysis of product returns should be made with the understanding that the risk free rate represents the zero duration, zero credit risk and infinite liquidity solution. Any return in excess of this is moving “down the curve” and taking on greater amounts of one of the three types of risk. Portfolios may need to accept higher levels of risk and lower diversification in order to achieve their goals.

Given the low expected returns in the traditional fixed income space, honest conversations about the risks that are being taken in the 3 major buckets (market/duration, credit and liquidity), as well as how a portfolio will perform in times of stress are a necessity in this market.



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# REVENUE STREAM INVESTING

By Steve Meehan

Investors today are bombarded by stories about market melt-downs/meltups. The pundits proclaim with compelling certainty: The economy is great! Others with equal credentials: The economy is weak and getting worse! Every day it's something different; most recently, although Public Markets overall have performed well, VOLATILITY is the new normal so fasten your seatbelts, the markets are going to be an even bumpier ride. The relative calm of the Private Capital Market is drawing capital from investors looking for a good alternative to publicly traded investments.

Typically Private Market investments are not as volatile on a day to day basis for the simple reason they don't have the same level of liquidity; this, quite simply, means people don't have the opportunity to react to the daily market 'noise' because they can't as readily buy or sell; by default, Private Market investors adopt a longer term investor philosophy (a better investment horizon) v. the shorter term, speculator mentality, that might see the same stock repeatedly bought and sold by the same investor.

As a trade-off for giving up liquidity, many Private Market products offer a yield or distribution attached to it. The promoters of these products say: "Yes, we know you can't jump in and out of this product, so we will PAY YOU TO WAIT." Investors, naturally, will seek out the highest yield with the lowest risk.

Glen Road Capital has created a product offering that is unique in its approach, creating a high yield offering for investors – about 10% per annum – with maximum predictability: the Glen Road Trust.

**Investors typically have two options when investing in companies:**

- 1 Equity, where they own shares in a company and participate in the profits; and
- 2 Debt, where they receive interest payment on the amount they have loaned to the company.

Each of these has pros and cons for both the investor and the company in which the investment is made.

In an equity investment, a company will come up with a valuation that is generally a function of its profitability. Typically, the range would be in the range of three to five times pretax earnings.

Based on that valuation, the investor would buy shares in the company and participate in the ongoing profits. The negative for the investor, however, is that they generally don't have any control over the predictability of profits and therefore their yield can vary year over year (there's the volatility creeping back into Private

Market investing). In addition, the only real opportunity for liquidity is selling the company or finding another investor to take them out. And from the company's point of view they now have a shareholder that may limit their ability to operate their company in a fashion they would otherwise not operate if they did not have outside shareholders.

In a debt investment, the investor receives a prescribed interest rate and generally there is a term to the loan. So, while there is a defined exit strategy, it there is no further upside in the investment and it may be constricting to the company's cash flow to fund the repayment.

Glen Road Capital, in offering our revenue stream investing products, provides investors with the best of both worlds: a high-yielding product with excellent predictability (and, therefore, low volatility). It also offers distinct advantages over similar investments:

- A low correlation to Public Markets;
- The revenue streams are aggregated from many separate investments, providing more diversity, as well as lower volatility;
- The industry knowledge held by the principals raises the bar to others hoping to capitalize on this investment philosophy, providing Glen Road Capital with a special advantage to grow quickly, without sacrificing yield.

In this model Glen Road makes an investment in a company by purchasing a portion of the company's top line revenue. Although the purchase is for a relatively small part of the company's revenue (usually in the range of ten to thirty-five per cent), it takes security over the entire business.



**Steve Meehan**

Chairman, Glen Road Capital

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*Glen Road Trust is approaching completion of its first year of operation. In the last quarter of 2017, the Trust reached the targeted annualized return of 10%. We have produced a brief video giving a broad-brush sketch of our business model. Watch for it on our website:*

🌐 [www.glenroad.ca](http://www.glenroad.ca).



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## THE MARKET OPPORTUNITY

**5.1%**  
Canadian Market  
Penetration<sup>[1]</sup>

**48.2%**  
Projected Industry  
Annual Growth Rate<sup>[1]</sup>

**\$1.35B**  
Canadian Market  
Volume by 2021<sup>[1]</sup>

**10%\***

**ANNUALIZED RATE OF RETURN  
+ 10% PROFIT PARTICIPATION**

  
**MONTHLY  
CASH FLOW**

**A RECURRING  
MONTHLY REVENUE  
BUSINESS YOU CAN  
UNDERSTAND.**

  
**RRSP, TFSA,  
LIRA ELIGIBLE**

Intelife Partnership generates RMR by providing monitoring services to its Customers who purchased Security Smart Home Automation systems from Intelife Security. The chart below provides a hypothetical example of a portfolio of Customer Accounts that provide an average RMR of \$60 per month to Intelife Partnership and shows how the RMR revenue stream can scale as Intelife Partnership generates or acquires more Accounts.

Estimated Annual Gross Revenue<sup>[2]</sup>

\$720K

\$1.8MM

\$3.6MM

\$7.2MM

\$14.4MM

1,000

2,500

5,000

10,000

20,000

Number of Accounts Purchased<sup>[2]</sup>

Month Contracts  
(Month to Month Thereafter)

**\$60**

Average Recurring  
Revenue

[www.intelifecapital.com](http://www.intelifecapital.com)

<sup>[1]</sup> <https://www.statista.com/outlook/279/108/smart-home/canada>

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<sup>[2]</sup> This table does not account for attrition of Accounts within the Intelife Partnership Account portfolio. Please see the heading "Forward Looking Information Relating to Recurring Monthly Revenue in the Offering Memorandum"

\*The Preferred Return is a preferred return, but is not guaranteed and may not be paid on a current basis in each year or at all. The return on an investment in the Units is not comparable to the return on an investment in a fixed income security. Cash distributions, including a return of a Unitholder's original investment, are not guaranteed and the anticipated return on investment is based upon many performance assumptions. Although the Trust intends to distribute its available cash to the Unitholders, such cash distributions may be reduced or suspended in the sole Discretion of the Trustee. The ability of the Trust to make cash distributions and the actual amount distributed will depend on the ability of the Intelife Partnership to successfully operate its business, and will be subject to various factors including those referenced in Item 8 - "Risk Factors" of the Offering Memorandum.

# Proposed Regulations and Distribution

## of Recreational Cannabis in Canadian Provinces and Territories

By Michael Dolphin, Partner, WeirFoulds LLP and  
Shawn English, Associate, WeirFoulds LLP

On April 13, 2017, the Federal Government introduced Bill C-45, *An Act respecting cannabis and to amend the Controlled Drugs and Substances Act, the Criminal Code and other Acts* (the “Act”). Once passed, the Act will establish a national framework for the governance and strict regulation of recreational cannabis in Canada. Under the proposed Act, the Federal Government will be responsible for overseeing the regulatory framework governing the licensed cultivation, production and manufacturing of cannabis and setting industry-wide standards with respect thereto, whereas the provinces and territories will be responsible for regulating the distribution and sale of recreational cannabis within their own jurisdictions.

The Act currently provides a general regulatory framework for recreational cannabis, however, provincial, territorial and municipal governments will be permitted to deviate from certain proposed federal standards, including the following limits and restrictions proposed in the Act:

- The minimum age to purchase, possess and use cannabis will be eighteen (18) years of age (however, provinces and territories can raise such age limit);
- The Act will prohibit individuals aged eighteen (18) years or older from possessing more than thirty (30) grams of dried cannabis (or its equivalent) in public (however, provinces and territories can lower such limit or provide more restrictive limits on possession);
- Adults will be permitted to grow up to four (4) cannabis plants in their home for personal use (however, the provinces and

territories can lower such limit or prohibit personal cultivation); and

- Minimum health and safety standards will be required in provincial and territorial legislation regulating cannabis (however, the provinces and territories are able to decide where and how cannabis will ultimately be retailed and distributed within their jurisdiction, in addition to setting restrictions on where recreational cannabis can be consumed).

Given the latitude afforded to the provinces and territories that permits them to tailor or deviate from certain federal standards contemplated in the Act, as well as their ability to control the distribution and retail of recreational cannabis in their respective jurisdictions, the following is a summary of the proposed regulatory approaches that have been announced by each province and territory. A chart summarizing the proposed regulations in each jurisdiction can be found [here](#).



### Alberta

**Distribution & Retail:** Alberta has proposed a hybrid model consisting of private retailers and government-run online sales of recreational cannabis. The Alberta Gaming and Liquor Commission (“AGLC”) will be the sole wholesaler of recreational cannabis and will be responsible for overseeing the distribution and sale of recreational cannabis in the Province. Private retailers will have to be licensed by the AGLC and will be prohibited from selling recreational cannabis alongside alcohol, tobacco or pharmaceuticals. Alberta recently announced that it expects to issue up to 250 licenses to private retailers.



**Consumption Restrictions:** Consumers will be permitted to consume recreational cannabis in their private residences and in public spaces where tobacco is permitted. Consumption will be banned in motor vehicles and places frequently occupied by children, including, schools, daycares and hospitals. Municipal governments will be permitted to set additional restrictions.

**Minimum Age:** Eighteen (18) years old.

**Personal Cultivation:** Four (4) plants per private residence.



## British Columbia

**Distribution & Retail:** British Columbia intends on implementing a hybrid distribution and retail structure, whereby both private and public retailers will sell recreational cannabis. The BC Liquor Distribution Branch (“LDB”) will be the sole wholesaler of recreational cannabis in the province and will also operate public retail stores. Private retailers will be licenced and monitored by the Liquor Control and Licencing Branch (“LCLB”). In urban areas, licenced retailers will be prohibited from selling cannabis alongside alcohol. At this time, it is uncertain whether online sales in the province will be operated by private or public retailers, or both.

**Consumption Restrictions:** Consumption of recreational cannabis will be limited to those public spaces where smoking tobacco is permitted and prohibited in public areas frequented by children. Cannabis consumption in motor vehicles will be prohibited. Municipal governments will be permitted to set additional restrictions.

**Minimum Age:** Nineteen (19) years old.

**Personal Cultivation:** Four (4) plants per private residence, provided the plants are not visible from public spaces around the property. Personal cultivation will be prohibited in residences used as daycare facilities.



## Manitoba

**Distribution & Retail:** Manitoba intends on implementing a distribution and retail model that would provide for government regulation and management of the supply chain and private retail of recreational cannabis. Manitoba’s Liquor and Gaming Authority (“LGA”) (to be renamed the Liquor, Gaming and Cannabis Authority) will be responsible for regulating the purchase, storage, distribution and retail of recreational cannabis and will oversee the licensing regime for private retail stores. The Manitoba Liquor and Lotteries Corporation (“MBLL”), as provincial wholesaler, will administer and oversee the supply and distribution of recreational cannabis in the Province, whereas the private sector will operate all retail locations and will be required to purchase cannabis from the MBLL. Manitoba has signaled its intention to allow licensed retailers to offer online sales. Retailers will not be permitted to sell cannabis alongside alcohol. Municipalities will be permitted to

prohibit the sale of recreational cannabis upon holding a plebiscite.

**Retail Agreements:** Manitoba recently announced that it has conditionally accepted proposals from the following four (4) entities to operate retail sales in the Province: a joint venture between Canopy Growth Corp. and Delta 9 Cannabis Inc., National Access Cannabis Corp., Tokyo Smoke (a subsidiary of Hiku Brands Company Ltd.) and 10552763 Canada Corp. (a newly formed consortium featuring Avana Canada Inc., Fisher River Cree Nation in Manitoba, Chippewas of the Thames First Nation in Ontario, MediPharm Labs of Ontario, and U.S.-based. cannabis dispensary brand Native Roots Dispensary).

**Consumption Restrictions:** TBD

**Minimum Age:** Nineteen (19) years old (the only province to deviate from its legal drinking age).

**Personal Cultivation:** Prohibited.



## New Brunswick

**Distribution & Retail:** The distribution and sale of recreational cannabis in New Brunswick will be the sole responsibility of the public sector. The newly formed Cannabis Management Corporation, a Crown corporation, will oversee, control and manage retail sales of recreational cannabis in New Brunswick. The New Brunswick Liquor Corporation (“NB Liquor”), through its subsidiary, Cannabis NB, will operate stand-alone retail stores that will be governed by the rules and regulations established by the Cannabis Management Corporation. The New Brunswick government anticipates that there will be approximately twenty (20) retail locations in fifteen (15) communities throughout the Province. Additional locations will be established at a later date based upon market conditions. Online sales will be available province-wide.

**Supply Contracts:** New Brunswick has partnered with three (3) cannabis producers to supply the province with cannabis for the recreational market: Zenabis, OrganiGram and Canopy Growth Corp.

**Consumption Restrictions:** Consumption of recreational cannabis will be prohibited in public spaces. Additionally, cannabis stored in private residences will have to be in a locked container or a locked room to ensure it is not accessible to minors.

**Minimum Age:** Nineteen (19) years old.

**Personal Cultivation:** Permitted, however the number of permitted plants has not been released.



## Newfoundland and Labrador

**Distribution & Retail:** Newfoundland and Labrador has proposed a model whereby the Newfoundland and Labrador Liquor Corporation (“NLC”) will oversee the distribution of cannabis in the province and control the possession, sale and delivery of recre-

ational cannabis, and private retailers, licenced and regulated by the NLC, will be responsible for retail sales of recreational cannabis. Online sales of recreational cannabis will initially only be available through the NLC.

**Supply Contract:** The Province has entered into a supply and production agreement with Canopy Growth Corp.

**Consumption Restrictions:** Consumption of recreational cannabis will be limited to private residences only.

**Minimum Age:** Nineteen (19) years old.

**Personal Cultivation:** TBD



## Northwest Territories

**Distribution & Retail:** The Northwest Territories Liquor Commission will be responsible for the import and sale of recreational cannabis. Initially, recreational cannabis will be sold by the Liquor Commission through its retail stores and via secure online ordering. Unlike other provinces (except Nova Scotia), recreational cannabis will be sold alongside liquor. In the future, the Territory will consider implementing a retail model permitting stand-alone cannabis stores.

**Consumption Restrictions:** Consumption of recreational cannabis will be permitted in private dwellings and select public spaces, but will be prohibited in areas frequented by children, large crowds, and areas where smoking tobacco is prohibited. Areas such as parks, trails and streets, when not being used for public events, will be permitted areas for the use of cannabis (unless municipalities within such areas restrict the use of cannabis in such areas). Cannabis in vehicles must be unopened. If opened, it must be resealed and stored in an area of the vehicle that does not permit access by the occupants in the vehicle. Municipalities will have the option of holding a plebiscite to establish restrictions and prohibitions on recreational cannabis.

**Minimum Age:** Nineteen (19) years old.

**Personal Cultivation:** Four (4) plants per private residence.



## Nova Scotia

**Distribution & Retail:** Nova Scotia has proposed a public distribution and retail model whereby the Nova Scotia Liquor Corporation (“NSLC”) will oversee the distribution and sale of recreational cannabis through its existing retail operations and through secure online sales and home delivery. Although recreational cannabis will be sold alongside alcohol, the area in which the cannabis will be sold will be separate and not visible from the rest of the store. NSLC will initially sell recreational cannabis through nine (9) existing retail locations. The Province intends on reassessing the retail landscape following the first year.

**Consumption Restrictions:** TBD

**Minimum Age:** Nineteen (19) years old.

**Personal Cultivation:** Four (4) plants per private residence.



## Nunavut

**Distribution & Retail:** The Nunavut Liquor Commission (“NULC”) will oversee the distribution and sale of recreational cannabis. Initially, there will be no physical retail stores in 2018. Sales of recreational cannabis will be conducted online and by phone. The Territory will consider implementing a system in which the NULC oversees and controls the sale and distribution of recreational cannabis, but outsources all retail sales to the private sector.

**Consumption Restrictions:** Consumption of recreational cannabis will be permitted within private residences and in public spaces where the consumption of tobacco is permitted, but prohibited in areas frequented by children such as schools and playgrounds, as well as health care centres. Cannabis in vehicles will have to be in closed packaging and not accessible to the vehicle occupants. Municipalities will be able to place restrictions the use of cannabis in public spaces.

**Minimum Age:** Nineteen (19) years old.

**Personal Cultivation:** TBD



## Ontario

**Distribution & Retail:** Ontario has proposed a government-run distribution and retail model. The Ontario Cannabis Retail Corporation (“OCRC”), a subsidiary of the Liquor Control Board of Ontario (“LCBO”), will be the sole provincial retailer of recreational cannabis in Ontario, operating through stand-alone stores and via online sales. The Province has announced that approximately forty (40) stand-alone stores will be open by July 2018, eighty (80) stand-alone stores by July 2019 and one hundred and fifty (150) stand-alone stores by 2020. Online sales of recreational cannabis (via Shopify Inc.’s e-commerce platform) will be available in all regions of the Province.

**Consumption Restrictions:** Consumption of recreational cannabis will be restricted to private residences only. No person will be permitted to consume recreational cannabis in public places or vehicles.

**Minimum Age:** Nineteen (19) years old.

**Personal Cultivation:** Four (4) plants per private residence.



## Prince Edward Island

**Distribution & Retail:** The Liquor Control Corporation will operate four (4) stand-alone cannabis retail stores located in Charlottetown, Summerside, Montague and West Prince, as well as an e-commerce platform with secure home delivery.

**Supply Contracts:** The Province has secured supply agreements with three (3) cannabis producers: Canada's Island Garden, Organigram and Canopy Growth Corp.

**Consumption Restrictions:** Consumption of recreational cannabis in the Province will initially be limited to private residences with the potential to be expanded into designated public spaces. Cannabis being transported in vehicles must remain in unopened packaging. Open packages of cannabis being transported in vehicles will have to be securely stored and inaccessible to those in the vehicle.

**Minimum Age:** Nineteen (19) years old.

**Personal Cultivation:** TBD



## Quebec

**Distribution & Retail:** The Société québécoise du cannabis ("SQC"), which will be a newly created government agency and a subsidiary of the Société des alcools du Québec, will act as the sole distributor and retailer of recreational cannabis in Quebec. Quebec has announced that there will be fifteen (15) retail locations operating by July 2018, with one hundred and fifty (150) retail outlets planned for 2020. Recreational cannabis ordered online will be delivered by the Canada Post.

**Supply Contracts:** Quebec recently announced that it has signed tentative agreements with the following six (6) cannabis producers for the supply of recreational cannabis in the Province: Hydropothecary, Canopy Growth Corp., Aurora Cannabis, MedReleaf, Tilray and Aphria.

**Consumption Restrictions:** Recreational cannabis will be subject to the same laws and regulations in place that govern the use of tobacco. Consumption of cannabis will be prohibited on the property of health care and educational institutions, as well as outdoor areas frequented by minors.

**Minimum Age:** Eighteen (18) years old.

**Personal Cultivation:** Prohibited



## Saskatchewan

**Distribution & Retail:** Saskatchewan has proposed a model whereby the Saskatchewan Liquor and Gaming Authority ("SLGA") will be responsible for regulating the wholesaling and retailing of recreational cannabis while the private sector will be the sole retailers of recreational cannabis. The SLGA intends on issuing approximately sixty (60) retail permits to private retailers in around forty (40) municipalities and First Nation communities with populations of at least 2,500 residents. Regions with larger populations will be allocated additional permits. Retail cannabis locations will be stand-alone stores selling only cannabis and cannabis related accessories. Private retailers will also have the option to offer online sales.

**Consumption Restrictions:** TBD

**Minimum Age:** TBD

**Personal Cultivation:** TBD



## Yukon

**Distribution & Retail:** The Yukon Liquor Corporation will be solely responsible for importing, storing, transporting and distributing (to retail locations) recreational cannabis. Initially, only government-run retail and e-commerce sales will be available. The Territory intends on establishing a licencing regime for private retail sales, although such regulations are still being developed.

**Consumption Restrictions:** Initially, consumption of recreational cannabis will only be permitted in private residences and on adjoining properties. The Territory is considering the possibility of future cannabis consumption in public spaces. Cannabis in motor vehicles will also be prohibited unless it is in a closed container and inaccessible by those in the vehicle.

**Minimum Age:** Nineteen (19) years old.

**Personal Cultivation:** Four (4) plants per private residence.

## Conclusion

Several provincial and territorial governments are still in the process of finalizing the details of their respective regulatory approaches to recreational cannabis.

Although the Liberal Government targeted a legalization date in July 2018, the Senate's vote on the Act schedule on or before June 7, 2018 will likely result in Canadians not being able to purchase recreational cannabis until at least August, and potentially as late as September 2018. The Federal Government has announced that following Royal Assent, which would immediately follow the vote in the Senate, the provinces and territories will need at least eight (8) to twelve (12) weeks to prepare retail operations.



By Michael Dolphin, Partner,  
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and  
Shawn English, Associate,  
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# Senior and Vulnerable Clients

By David Gilkes

There is a lot of attention being given to senior and other vulnerable clients. This is no regulatory definition of senior client or vulnerable client. Consideration should be given to a client's age while recognizing there is no legislated retirement age. The OSC in a study defined a senior as including a person over age 75 whether retired or not. On the other hand Warren Buffet is 87 years old and of course Shoppers Drug Mart provides a seniors discount to anyone over the age of 55. We recommend that registered firms consider any client who has retired or is near retirement as senior.

Vulnerable clients extend beyond seniors and can include individuals with a disability, whose primary language is not English and those individuals with literacy challenges. They also include individuals who are easily influenced, have limited investment knowledge and financial experience, and are unable to make sound and independent decisions.

Given Canadian demographics, you likely have significant client base that could be considered a senior or vulnerable client. The securities regulators have taken note of this fact and have been focussing on clients over the age of 60 in compliance reviews. It is likely the regulators will issue a staff notice providing some guidance on dealing with these clients. In the meantime, we offer some suggested practices for dealing with seniors and vulnerable clients.

One of the roles of an investment professional is ensuring that a client has all the information, including a suitability assessment, to make an informed investment decision. If a Representative is concerned with the capacity or ability of a client to make an informed investment decision or to provide reasonable instructions, this should be brought to the attention of the Chief Compliance Officer. It may be appropriate for the firm to recommend to the client that a power of attorney be given to a trusted relative, friend or other qualified advisor. In the case of a language barrier, an interpreter may be needed. Senior and vulnerable clients are more susceptible to physical (e.g., hearing, vision) and cognitive (e.g., memory, context) impairments which need to be accommodated.

Representatives must always ensure they are aware of changing circumstances of their clients as they age and not recommend an investment even if it may be contrary to what the client hopes to hear. Senior clients may have fears and uncertainty about their future financial situation and life circumstances that can have strong behavioural influences on their investment activities.



When dealing with senior clients it is likely time horizon and risk tolerance will feature more prominently than with younger clients. Senior clients have less time and resources to replenish capital losses through future income from other sources. Representatives should exercise caution when senior clients express an interest in higher risk investments which may not be suitable. In a similar vein these clients may have unrealistic expectations for returns on investments with a low risk tolerance or selected for preservation of capital.

Suitability of investments is a key investor protection provision in securities legislation. In addition to typical factors (risk tolerance, investment knowledge, financial and personal circumstances) considerations relating to age, life stage and liquidity needs, are particularly important in determining suitability of an investment for a senior client. The following factors should be given careful consideration when assessing the suitability of an investment for a senior client or other vulnerable clients:

- Investment knowledge and ability to monitor the performance of the investment;
- Current and planned short-term employment status and other sources of income, e.g. pension entitlements;



- Client focus, i.e. retirement income, or bequests to dependants and others, e.g. charitable causes;
- Liquidity needs for additional expense requirements, e.g. health care services or assisted living;
- Dependent children or grandchildren; and
- Life expectancy.

The need to rely on investment income can result in a client feeling pressured to assume greater risks in the hopes of generating higher investment income. In assessing whether an investment is suitable for a senior client or vulnerable client, Representatives should ensure the client's risk tolerance is reasonable and the client has the ability to meet financial commitments.

Many senior clients will increasingly defer to investment professionals as they age and rely on Representatives for investment advice. However, there are many seniors who rely more on family members than professionals. Where a senior client or other vulnerable clients provides a Representative with inconsistent investment objectives, the Representative must identify the inconsistencies to the client. The Representative must assist the client in deciding which of the objectives takes priority and the risks associated with placing greater emphasis on achieving one or more of the stated objectives over others. This is particularly relevant with the potentially conflicting objectives of capital preservation, income generation, and capital growth.

In dealing with senior clients or other vulnerable clients, Representatives must provide clear, concise information about the investments products being offered. Where possible Representatives should provide senior clients with detailed information in writing and in plain language (i.e. avoiding technical jargon) to support discussions. In some cases, Representatives may want to have a caregiver or trusted relative participate in meetings with the client to ensure there is no misunderstanding regarding the product or the information being provided.

Representatives should increase the frequency of their contact with clients as they age. In addition to ensuring KYC information is current, the Firm needs to be informed about changes in clients' employment status, health and personal circumstances. Representatives must encourage clients to keep them informed of changes in their KYC information and in particular, when the client retires.

Maintaining detailed notes and documentation becomes particularly important if the client begins to have difficulties with memory. Representatives should send follow-up correspondence to clients after meetings or discussions to prevent any misunderstandings. When writing to senior clients, Representatives should use a larger font and plain language formatting for easier reading.

Representatives should strongly encourage senior clients and other vulnerable clients to provide the Firm with an alternate contact, such as a trusted family member. The Firm will obtain instructions from the client relating the matters can be discussed with the alternate contact and if duplicate copies of client statements or other correspondence should be provided to the alternate contact. If the

client has a power of attorney registered firm will confirm that the power of attorney remains valid when KYC information is updated.

Representatives dealing with senior clients and other vulnerable clients should be aware of signs indicating diminished mental capacity. A client with diminished mental capacity will have a reduced ability to make an informed investment decisions. If a Representative is concerned that a client may have diminished capacity the matter should be referred to the CCO and UDP. The reasons for the concern must be documented.

Senior clients and other vulnerable clients often rely on others for investment advice or ask others to make investment decisions on their behalf. Unfortunately, this has the potential to leave these clients vulnerable to financial exploitation. Specifically, a person exploits a position of influence or trust over an elderly person or otherwise vulnerable person to gain access to that person's assets, funds or property. Examples of signs which may indicate that a client may be subject to elder abuse or financial exploitation include:

- The client gives a power of attorney to someone who appears to be inappropriate;
- Indications that the client does not have control over or access to their own money;
- The client's mailing address has been changed to an unfamiliar and unexplained address;
- The Representative is unable or not allowed to speak directly with the client;
- The client appears to be suddenly isolated from friends and family;
- There is a sudden, unexplained or unusual change in the client's transaction patterns;
- There are unexplained disbursements made in a client's account that are outside of the norm;
- The sudden appearance of a new individual involved in the client's financial affairs.

If a Representative is concerned that a client may be the subject of elder abuse or financial exploitation the matter should be referred to the CCO and UDP. Again the reasons for the concern must be documented. The Firm should discuss the matter with the client's alternate contact or the person who has power of attorney (provided the concerns are not related to any of these persons). Situations could arise where the firm should contact law enforcement or government protective service organizations. Representatives should not proceed with any transaction or investment under consideration until the issue is appropriately resolved.



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# SOFTENED PRIVATE TAX MEASURES

## FOR PRIVATE EQUITY IN FEDERAL BUDGET

By Stephen Rupnarain and Bill MacQueen

### 2018 FEDERAL BUDGET COMMENTARY - CAUTIOUS YET RESPONSIVE

The Budget reaffirms that the government will be proceeding with passive investment income tax measures for Canadian controlled private corporations (CCPC), but with reduced complexity that takes into consideration feedback from Canadian businesses.

Key themes identified in the 2018 Federal Budget (Budget 2018) are consistent with pre-budget expectations which emphasized growth, innovation and equality of opportunity. There is an overall theme of tightening existing tax measures to bring them in line with their original policy intent and a signaling from Finance that they intend to conduct a detailed analysis of the recent U.S. tax reform.

Although a cautious budget from an income tax perspective, there are a number of areas that middle market companies need to be aware of:

- Business income tax measures
- Business measures
- Artificial losses using equity based financial arrangements
- Mineral exploration tax credit for flow-through share investors
- Sales and excise tax measures
- International tax measures
- Charities
- Personal income tax measures

There was much anticipation around the 2018 Budget and with good reason given the uncertainty created with the 2017 mid-summer release of the private company proposals. We gathered some of the key tax takeaways for private company investors in this video and article.

#### Passive income proposals

The 2017 private company proposals were of particular concern to angel investors, venture capitalists and family offices given the threat of a higher tax rate of up to 73 per cent on passive income from investments held in Canadian controlled private corporations (CCPCs). Many private investors employ private corporations from which to deploy capital or structure investments, and the proposals would have presented challenges in attracting capital for investment in Canadian small businesses. In a welcome turnaround, the Budget has eliminated the proposed tax increase on passive income and replaced with the softer measures below.

#### Small business deduction

The small business deduction reduces the rate of tax payable by a CCPC on its first \$500,000 of active business income and must be shared between associated corporations. Under the current rules, the small business deduction is gradually phased out for associated CCPCs having between \$10 million and \$15 million of taxable capital.

Budget 2018 proposes a reduction to the small business deduction for passive income earned over \$50,000 with the small business deduction being eliminated at \$150,000 of passive income. The





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## At-risk rules for partnerships

The current at-risk rules provide that a partner of a limited partnership cannot access losses of the partnership in excess of their at-risk amount. This can generally be thought of as their contributed capital and income less any partnership allocations of losses and other tax preference items. Losses allocated to a partner in excess of their at-risk amount are not deductible and may be carried forward and deducted in computing taxable income in a future year if the limited partner's at-risk amount in the partnership has become positive. Any undeducted limited partnership losses of the limited partner are reflected in the adjusted cost base of the partnership ultimately reflected in the capital gain realized on a disposition of the partnership interest.

In a recent case (*Canada v. Green*), the courts found that where a partnership is itself a partner of a limited partnership, the losses in excess of available at-risk amount by the bottom partnership may be allocated by the top-tier partnership to its partners providing that partners of the top-tier partnership had sufficient at-risk available. Budget 2018 effectively reverses this decision by clarifying the longstanding understanding of the at-risk rules as discussed above will apply even in a tiered partnership structure.

These measures will be effective for taxation years ending before and after Budget Day (i.e., retroactive effect).

## GST/HST and investment limited partnerships

Budget 2018 confirms the government's intention to proceed with these proposals with the following changes:

- Budget 2018 proposes to modify the September 8, 2017, proposal so that the GST/HST applies to management and administrative services rendered by the general partner on or after September 8, 2017, and not to management and administrative services rendered by the general partner before September 8, 2017, unless the general partner charged GST/HST in respect of such services before that date.
- In addition, Budget 2018 proposes that the GST/HST be generally payable on the fair market value of management and administrative services in the period in which these services are rendered. This addition to the September 8, 2017, proposal effectively adds a measure that ensures the reporting of the tax payable in respect of taxable management and administrative services rendered by the general partner is not deferred beyond the period in which the services were rendered to the investment limited partnership.
- Budget 2018 proposes to allow an investment limited partnership to make an election to advance the application of the special HST

rules as of January 1, 2018. This addition to the proposal provides investment limited partnerships with the option to elect to have the special HST rules be applicable a full year earlier than would have been possible under the original September 8, 2017, proposal.

## Consultations on the GST/HST holding corporation rules

A Goods and Services Tax/Harmonized Sales Tax (GST/HST) rule, commonly referred to as the 'holding corporation rule,' generally allows a parent corporation to claim input tax credits to recover GST/HST paid in respect of expenses that relate to another corporation. This rule provides that, the expenses are generally deemed to have been incurred in relation to commercial activities of the parent corporation, where the parent corporation:

- resides in Canada, and
- incurs expenses that can reasonably be regarded as being in relation to shares or indebtedness of a commercial operating corporation (a corporation where all or substantially all of the property is for consumption, use or supply in commercial activities), and
- is related to the commercial operating corporation, and the expenses are generally deemed to have been incurred in relation to commercial activities of the parent corporation.

The government intends to consult on certain aspects of the holding corporation rule, particularly with respect to the limitation of the rule to corporations and the required degree of relationship between the parent corporation and the commercial operating corporation. At the same time, the government intends to clarify which expenses of the parent corporation that are in respect of shares or indebtedness of a related commercial operating corporation qualify for input tax credits under the rule.

Consultation documents and draft legislative proposals regarding these issues will be released for public comment in the near future.

At RSM Canada, we expect that these changes will be met as largely welcome news. There will be some increase in complexity associated with compliance, but not to the degree forecast with the 2017 version of these proposals.



**Stephen Rupnarain**, tax partner,  
**Bill MacQueen**, indirect tax partner

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