# Association of
# Labour Sponsored Investment Funds

Suite 5100 – 1 First Canadian Place, Toronto, ON M5X 1K2
tel: (416) 643-7095 • fax: (416) 643-7148 • Email: dpatterson@cmdf.com

June 26, 2002

***Via Facsimile (416) 593-8240***
***Original via regular mail***

Ontario Securities Commission
Suite 800, Box 55
20 Queen Street West
Toronto, Ontario
M5H 3S8
Attention: Rebecca Cowdery and YuMee Chung

Dear Rebecca and YuMee,

**Re: OSC Concept Proposal 81-402**

Further to our meeting of June 6, we are writing on behalf of the members of the Association of Labour Sponsored Investment Funds ("ALSIF") to provide the comments of our membership on OSC Concept Proposal 81-402 (the "Proposal"). By way of background, ALSIF's membership includes almost all labour-sponsored investment funds currently operating in Ontario with total capital under management of almost $3 billion. Our members greatly appreciate the opportunity to provide our comments to you and to participate in the regulatory process.

Our comments that follow are organized into four sections: overview of the applicability of the Proposal to labour-sponsored investment funds ("LSIFs") in light of the fundamental differences between LSIFs and traditional mutual funds; the governance agency proposal; the manager registration proposal; and our own recommendations for dealing with the issues covered by the Proposal.

***Overview***

Although LSIFs are treated as mutual funds by the OSC, they are very different from traditional mutual funds in many fundamental respects, including the following:

- LSIFs are a creature of public policy. They exist as a result of government support for the growth of a stable pool of venture capital, which is enabled through the provision of tax credits to LSIF investors. Such government support is needed because the markets have traditionally not provided sufficient capital for smaller private companies, and the LSIF program was created in the early 1990s to fill the void. The program has been very successful in achieving this objective; in 2000, LSIFs provided 82% of all venture financings of less than $5 million in Ontario.
- The public interest served by creating a stable pool of venture capital is the financing of companies that will create jobs, exports and research and

development spending in Canada. To focus LSIF investment in companies that deliver on these objectives, the *Income Tax Act* (Canada) and the *Community Small Business Investment Funds Act* (Ontario) contain various provisions that restrict the types of investments that LSIFs may make. These include requirements that LSIFs must purchase treasury securities only, and that LSIF portfolio companies must have less than 500 employees and $50 million of gross assets.

- LSIFs are required to invest primarily in private companies. Since these investments are illiquid, LSIFs typically hold each investment for several years.
- LSIFs are generally hands-on active investors. They typically serve on the boards of their portfolio companies and devote significant time and attention to these companies as needed (for example, negotiating subsequent rounds of financing with agents and other investors, taking part in the search for new members of management and facilitating introductions to key suppliers, customers and partners).
- Because their portfolios consist mainly of companies for which no published market exists, LSIFs determine their net asset value per share based on the fair value of each portfolio company. These valuations are subject to the oversight of a valuation committee independent of the fund manager and to an annual review by a firm of professional business valuators.
- If they redeem in less than eight years, LSIF investors lose the tax credits that they received at the time of investment. Although LSIF shares are technically redeemable on demand, this effectively requires investors to hold their investment for at least eight years, and in practice almost none redeem earlier. This is a significant difference from traditional mutual funds, where early redemptions are common.
- LSIFs are required by governing legislation to be structured as corporations overseen by boards of directors that must be controlled by the labour organization that sponsors the LSIF. All LSIFs of which we are aware have a majority of directors independent of the fund manager, and their key board committees (typically audit/valuation and investment committees) also have a majority of members independent of the manager. LSIF investors have statutory shareholder rights such as oppression and dissent rights. In addition, the directors and senior officers of LSIFs have the fiduciary duties imposed by the corporate statutes (and since the senior officers of LSIF managers are typically also senior officers of the fund, this duty applies to those with day to day managerial responsibility). All LSIFs hold annual shareholder meetings plus additional special meetings when required under their governing corporate statute.
- Typically LSIFs outsource one or more of the sales, marketing, back-office and administrative functions, whereas all of these are commonly delivered in-house by traditional mutual fund managers.
- LSIFs tend to be much smaller than traditional mutual funds, and are therefore less able to bear the costs of complying with the Proposal. Moreover, since running an LSIF is a hands-on business, LSIFs need significantly more investment professionals per dollar under management than is the case with traditional mutual funds. As a result, LSIFs tend to have higher operating costs than other mutual funds.

For these reasons, many aspects of mutual fund regulation do not work well for LSIFs. This is recognized in section 245 of the regulation under the *Securities Act*, which gives the OSC the discretion to vary the regulation as it applies to LSIFs where the OSC is satisfied that doing so would not be prejudicial to the public interest having regard to the spirit and intent of the legislation governing LSIFs. The OSC itself has recognized the distinctiveness of LSIFs in the past; for example, LSIFs are exempt from National Instrument 81-101 and instead offer their securities under a long-form prospectus that is mirrored on the prospectus form used by ordinary industrial issuers.

We understand that the Proposal was drafted with traditional mutual funds, and not LSIFs, in mind and therefore we believe that many of its key objectives and most of its key pillars are unnecessary or inapplicable to LSIFs. Moreover, the Proposal is part of a broader regulatory objective to move mutual fund regulation away from detailed product regulation and towards a governance model, but LSIFs are already exempt from much of this product regulation and already have highly evolved governance structures. Therefore, we believe that LSIF investors would be best served if LSIFs were not subject to the regime contemplated by the Proposal.

***Governance Agency***

The governance agency section of the Proposal contemplates that mutual funds should be overseen by board-like entities. LSIFs are already in compliance with the spirit of this proposal. As corporations, LSIFs are governed by boards of directors that have the fiduciary duties outlined in their governing corporate statute (along with the directors' liability imposed by dozens of other statutes). Moreover, to our knowledge all LSIF boards have a majority of members independent of the manager, and a majority of independent members on key board committees including the investment and audit/valuation committees.

However, LSIF boards are (and should be) different in many key respects from the governance agencies contemplated by the Proposal. Depending on what services are provided in-house and what are outsourced, the boards of different LSIFs may need different types of expertise and focus, and any universal list of board responsibilities will be inevitably flawed. While large mutual fund dealers may have the resources to develop detailed written policies and procedures for each fund they manage, for small LSIFs this could be a significant burden. Moreover, the role of an LSIF's board must evolve as the fund's investment portfolio and investor base mature much the same way that any corporation's board must tailor its activities to the corporation's particular circumstances and stage of development. Finally, under the *Community Small Business Investment Funds Act* (Ontario), an LSIF's labour sponsor must have the right to nominate a majority of an LSIF's directors and any regulation that affects board composition could interfere with this requirement.

***Manager Registration***

The manager registration concept in the Proposal envisages a traditional mutual fund manager. The Proposal requires management proficiency obtained in the fund/securities industry and minimal capital, insurance, systems and procedures to handle the complexities of administering a large fund business. However, these are not the attributes that LSIF investors need from their fund managers. All LSIFs

contract out the complex and capital intensive back-office and administrative functions and though they need some expertise to monitor their service providers, by no means do they need the capability to manage such operations. Therefore, the Proposal's requirement for minimum capital is not applicable to LSIFs, and the requirements for internal controls and insurance should be revised to reflect the unique business that LSIFs conduct. In addition, LSIF investors would not be well served if their funds' senior executive ranks were filled with securities industry professionals – since LSIFs are active investors in illiquid private companies, they need managers who have the requisite venture capital or operating industry expertise to make and monitor these types of investments (for example, LSIFs that focus on biotechnology generally have senior personnel who have worked in the life sciences industry). If the Proposal applies to LSIFs, then there will be too much focus on obtaining the wrong kind of expertise.

***Our Recommendation***

Because LSIFs are a unique type of investment product, they have unique needs for governance and management expertise. We acknowledge that it is in the best interests of LSIF investors that these needs be met and addressed, but we do not believe that the requirements of the Proposal would achieve this. However, over the past decade as the LSIF industry has grown and matured, funds have developed structures that provide for these needs. We believe that the best practices and procedures for managing an LSIF, and for overseeing such management, can already be found within our industry. On page 12, the Proposal queries whether there are alternatives to the approach adopted by the OSC, and the first alternative explored is voluntary guidelines developed by a trade association such as IFIC. The members of ALSIF have begun to discuss developing a set of best practice guidelines for fund governance and managerial expertise in the LSIF industry for voluntary adoption by our members. If adopted, LSIFs could in their prospectuses compare their own governance practices and management qualifications to these guidelines. We feel strongly that this approach is far more likely to lead to LSIFs run in the best interests of their investors. Until these guidelines are developed, we would recommend that LSIFs be exempted from the Proposal but required to disclose in their prospectuses and in their annual meeting materials the extent to which they are not in compliance with the Proposal and the reasons why.

* * *

We would welcome the opportunity to meet with you again to discuss these issues in more detail. Once again, we thank you for the opportunity to provide our input.

Yours truly,


| ______________________ | ______________________ |
| --- | --- |
| Jay Heller | Dale Patterson |
| Chair | Executive Director |
| Regulatory Issues Sub-Committee | Association of Labour Sponsored Investment Funds |