Association of
Labour Sponsored Investment Funds

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British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Financial Services Commission
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Office of the Administrator, New Brunswick
Registrar of Securities, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Registrar of Securities, Northwest Territories
Registrar of Securities, Yukon Territory
Registrar of Securities, Nunavut

c/o Mr. John Stevenson
Ontario Securities Commission
20 Queen Street West
19th Floor, Box 55
Toronto, Ontario M5H 3S8

and c/o Ms Anne-Marie Beaudoin
Autorité des marchés financiers
Tour de la Bourse
800, square Victoria
C.P. 246, 22e étage
Montréal, Québec H4Z 1G3

Dear Sirs,

Re: Proposed National Instrument 81-106

We are writing on behalf of the Association of Labour Sponsored Investment Funds ("ALSIF") to provide comments of our membership on the proposed National Instrument 81-106 (the "Instrument"). ALSIF's membership includes almost all labour-sponsored investment funds ("LSIFs") currently operating in Ontario and others from across Canada, with total assets under management of almost $3 billion.

1. General Comments

Our submission focuses mainly on issues in the Instrument that impact uniquely on LSIFs. We have largely avoided commenting on issues of broader application, knowing that the CSA will be receiving such comments from IFIC and individual large fund companies. However, we would like to point out that the administrative and financial burdens that will arise from the Instrument, particularly through the shorter deadlines for preparing financial statements and the requirements to produce additional disclosure documents such as the annual and interim MRFP, will hurt LSIFs disproportionately. Unlike the larger diversified mutual fund dealers that dominate the investment funds business in Canada, LSIFs and their managers are small and thinly staffed. The burdens of complying with the Instrument will no doubt require significant time and attention of LSIF management, which means either increasing staff (and pressure on MERs) or spending less time on other matters (to the detriment of shareholders). When considering the comments of groups like IFIC, the CSA should be aware that any concerns expressed about compliance costs and administrative burdens will be doubly true for LSIFs.

2. Part 8 – Segmented Disclosure

Section 3.5 requires investment funds to provide information as to the historical cost and current value for each investment. As ALSIF has argued in previous correspondence, this will often commercially harm the private companies in which LSIFs primarily invest as competitors and others may use publicly reported "writedowns" against them when speaking with customers, suppliers etc. Part 8 permits alternative disclosure for LSIFs by requiring disclosure of only an aggregated adjustment from cost to fair value. Under this alternative, LSIFs must also obtain independent valuations of fair value.

It seems that the CSA views the application of Part 8 as a choice that LSIFs can freely make. This is indicated by the CSA statement in its Appendix B to its notice where it states: "the valuation report is only required if the labour sponsored fund chooses to aggregate venture portfolio". However, this apparent choice places LSIFs and managers in an untenable conflict. They must choose between disclosing previously confidential information about the carrying values of individual investee companies or following the requirements of Part 8. Such disclosure may breach a fund's confidentiality restrictions, cause the investee company commercial harm as others use this newly accessable information against the company in the marketplace, and/or adversely affect the fund's future deal flow as it becomes known in the entrepreneurial community that the fund publishes this information. We submit that for reputable, fair minded managers looking to protect the fund's interests this is not a choice at all. Moreover, we believe the Instrument ought not to impose this result given the injury that disclosure of private company carrying values can cause to investee companies, the fund and fund shareholders. So while we are generally supportive of the approach taken in section 8.2, we believe that our comments below and under the heading "Valuation" below are critical.

Our first group of comments on Part 8 pertain to section 8.2(b)(i), which provides that LSIFs are not required to provide disclosure of the carrying value of each venture investment so long as they provide detailed segmented information (including aggregate carrying value) by stage of development and industry class. We agree that segmented disclosure should be an acceptable alternative. However, we are concerned that mandating segmented disclosure by stage and industry class may not be suitable for all LSIFs since some focus mainly on one industry class while others focus mainly on companies at one particular stage. Furthermore, many funds with small portfolios may have only one investment in a particular stage and class such that 8.2 would effectively require the fund to disclose the carrying value of that individual investment, which undermines the purpose of Part 8 We would suggest that LSIFs be entitled to simply choose the appropriate subgroups for segmented disclosure, based on their particular areas of concentration of portfolio value. We believe that this would be the best way to ensure that such concentrations of value are brought to investors attention in the clearest way. We note that this approach is consistent with Item 5(2)(a) of proposed Form 81-106F1 (MRFP) which requires all investment funds to provide a summary of their investment portfolios broken down into "appropriate subgroups". Although we concede that such an approach would not necessarily provide for comparability among LSIFs, we submit that it would provide more meaningful disclosure to investors, since it would specifically highlight areas of concentration of portfolio value in the manner deemed most appropriate by the LSIF.

If this approach is unacceptable, in the alternative we would suggest the following clarifications or changes to the regime outlined in section 8.2(b):

(a) We suggest that the reference in section 8.2(b)(i) to "a table" be changed to "two tables", one of which would show segmentation by sector and one of which would show segmentation by stage. We believe this would result in clearer disclosure to investors of an LSIF's portfolio concentration by these two different measures. It would also reduce the likelihood that any one "cell" on the table would only contain one or two companies, thereby resulting in disclosure that could permit readers to deduce the carrying value of an individual investment. To further allay this latter concern, LSIFs should also be permitted to aggregate segments where any particular segment represents less than 15% of the aggregate carrying value of all the LSIF's venture investments ("Venture NAV") or less 15% of its venture investments by number. For example, assume an LSIF is segmenting its venture investments by sector in the categories of Information Technology, Life Sciences, Manufacturing and Services. Assume further that the LSIF has 25 venture investments with a Venture NAV of $50 million. If the Manufacturing sector includes less than 4 investments or less than $7.5m of Venture NAV, the LSIF would entitled to aggregate its Manufacturing investments with those of another sector (for example, the LSIF could provide combined disclosure for the Manufacturing and Services sectors).

(b) The requirement to provide the segmented data should not apply until an LSIF has 15 venture investments. Given the investment "pacing" rules governing Ontario LSIFs and the requirement that an LSIF put no more than 10% of its equity capital into any one investment, an LSIF that raises a stable amount of money at a stable NAV per share would normally cross this threshold within two to three years from inception.

(c) Sector-specific LSIFs should only be required to provide segmented disclosure by stage. Requiring such funds to split their portfolios into sub-sectors will probably not be useful to investors or comparable as between LSIFs.

3. Valuation

Overview

Our second area of commentary on Part 8 pertains to the valuation requirements. In our view, it is premature to implement the requirement of valuation reports under Part 8 at this time because there will likely be significant developments in measuring fair value under GAAP in the near future. Deferring this element pending completion of that development would also be consistent with the fact that the CSA has indicated that study of investment valuation is the second phase of the Instrument.

During the study of investment valuation, we propose that LSIF industry players, their accounting/valuation professionals, government departments with primary responsibility for the LSIF program and securities regulators work on defining a prescriptive, standardized valuation framework for LSIFs that includes rules designed to address the unique challenges of valuing emerging private companies within evolving GAAP requirements. We believe that such a a common set of LSIF valuation rules consistently applied and independently verified will result in the better comparability of fund performance the CSA is seeking in a much more effective and cost efficient way.

It is important to note that LSIFs are currently required under LSIF legislation in Ontario to have the value of the fund's shares determined on an annual basis by means of a "valuation" carried out by an independent qualified person. If the application of Part 8 is not deferred, then we submit the current annual reviews be accepted in satisfaction of the valuation requirements of Part 8. If the CSA does not accept these annual reviews, the Instrument will be imposing a higher standard than that required under enabling legislation. Not only is this in conflict with the premise on which Regulation 240 under the *Securities Act* (Ontario) is based, it will also increase operating costs for the funds and thereby increase management expense ratios for shareholders.

Anticipated Changes to GAAP

On June 23, 2004, the United States Financial Accounting Standards Board ("FASB") issued for comment an Exposure Draft, *Fair Value Measurements*. In the accompanying press release, FASB stated that the fair value framework would clarify the fair value

measurement objective and its application under other authoritative pronouncements that require fair value measurements, thus replacing any current guidance for measuring fair value in those pronouncements. "An important aspect of this project is to provide guidance for measuring fair value that can be generally understood and consistently applied by preparers, auditors, and valuation professionals," said Linda A. McDonald, FASB Project Manager. FASB's exposure draft on *Fair Value Measurements* will likely influence future pronouncements on fair value measurement made by the CICA. Indeed, in a related activity the CICA in conjunction with the IASB will be issuing a report on a conceptual framework for fair value measurement before the end of the year. The AASB will also be releasing by year's end an auditors toolkit to assist the auditor in the implementation of the recently issued section 5306 - Auditing Fair Value Measurements and Disclosure. It is also important to note that the Canadian Venture Capital Association recently released recommended valuation guidelines for its members. This industry standard may also influence further pronouncements by the CICA.

LSIFs - The Requirement for Independent Valuations

LSIFs are currently required under the *Community Small Business Investment Funds Act* (Ontario) to have the value of the fund's shares determined on an annual basis by means of a valuation carried out by an independent qualified person. We request confirmation that these annual reviews in the form currently accepted by the Ministry of Finance (Ontario) satisfy the requirements of an independent valuation under Part 8 of the Instrument if the application of Part 8 is not deferred. This would include the form of reports received by certain funds that report on compliance with valuation policies despite certain comments in the companion policy which seem to suggest these reports would not be acceptable. We would also like confirmation that other forms of annual reviews that have been previously filed with the CSA are satisfactory. If these annual reports filed with the Ministry of Finance are not accepted, the Instrument will be imposing a higher standard than that required under enabling legislation. This seems to conflict with the premise on which Regulation 240 under the *Securities Act* (Ontario) is based. In addition, it will result in higher operating costs to the Funds which translates into higher MERs for shareholders.

An LSIF Valuation Framework

During the second phase of the Instrument, we are committed to working with the CSA, the CICA and other stakeholders to develop a prescriptive, standardized valuation framework for LSIFs (the "LSIF Valuation Framework"). This common LSIF Valuation Framework when applied will result in fair values under an evolved GAAP, take into account the special challenges in valuing emerging private companies and draw on established standards in the venture capital industry. This should enhance the ability of investors to compare "apples to apples" when looking at LSIF values.

Once a LSIF Valuation Framework has been development, we also agree with the CSA that <u>independent verification</u> by a qualified professional should be made. This will give comfort to all stakeholders that the new common standard has indeed been applied.

We believe that an LSIF's auditor is an appropriate, independent and qualified person to provide that verification. In the companion policy, the CSA states that a report confirming compliance with stated valuation policies and practices cannot take the place of an independent valuation. The CSA explains the reasons why such compliance reports are not acceptable in Appendix B to its notice where it states "valuation policies and procedures are established by the investment fund or manager. A report of compliance with these valuation policies and procedures does not address the appropriateness of the policies and procedures." [*emphasis added*].

Given that the LSIF Valuation Framework would establish a common set of rules that the CSA and others will be able to assess as being appropriate prior to implementation, a verification report from an independent auditor should be acceptable. This approach would also be cost-effective, which will assist in keeping MERs down.

Changes to Section 240 of the Ontario Regulation

The Notice of the Instrument indicates that the Ontario Securities Commission is proposing to amend parts of section 240(2) of the Regulation under the *Securities Act* (Ontario). The relevant parts of the section currently read:

> *"… a rule, policy or practice of the Commission or the Director respecting any of the following subjects shall not apply to labour sponsored investment fund corporations: …*
>
> *8. The pricing, sale or redemption of securities of mutual funds.*
>
> *9. Valuation requirements for mutual funds and the calculation of the net asset value of securities of mutual funds."*

The proposed changes to this section are to delete paragraph 9 above and to delete the word "pricing" from paragraph 8 such that it would read "*The sale or redemption of securities of mutual funds*."

Section 240 was drafted to reflect the dual character of LSIFs: as an investment product for retail investors, LSIFs were an obvious candidate for regulation by the OSC; but as a tool of public policy intended to provide a pool of venture capital for small and medium-sized businesses, the provincial Ministry of Finance wanted to retain jurisdiction over many aspects of the LSIF program. Section 240 draws the line between areas to be dealt with by the OSC and areas to be dealt with by Finance. This line was drawn in the early 1990s through extensive debate, consultation and discussion (including public hearings that included presentations by, among others, the OSC, IDA, labour constituents, the venture capital industry, small business representatives and co-operative leaders) and we do not believe that it should be changed without a similar process. The OSC's area of interest and expertise is protecting investors, not determining economic sectors worthy of public support and the ideal means of providing such support. We do not believe that the OSC should seek to broaden its mandate for regulating LSIFs unless it also wishes to assume from the Finance Ministry the obligation to assess the public policy ramifications

of its decisions in these new areas. Absent a broad change of the OSC's mandate (which seems unlikely, particularly given competing demands on the OSC's resources and the tiny size of the LSIF industry relative to the markets under the OSC's regulation) we believe that the line drawn by section 240 should stay where it is.

With respect to the question of jurisdiction specifically over pricing and valuation, as discussed above we believe that GAAP is evolving to provide more guidance on the fair value of illiquid private companies and ALSIF intends to be actively involved in this discussion. The decision by the OSC to take jurisdiction over LSIF valuations raises the possibility that there could be two sets of valuation practices, one set by the OSC and one set by the CICA. This would obviously not be in the interests of LSIFs or their investors. Instead, we would suggest that the OSC refrain from seeking jurisdiction in this area at least until the second phase of the Instrument, at which point the CSA should be in a position to evaluate the evolution of GAAP and the LSIF Valuation Framework. Until such time, discussion about amending section 240 would be premature.

4. Proxy Voting

Part 10 of the Instrument requires mutual funds to establish policies and procedures for voting proxy materials and to make their voting records available to security holders. We are concerned about the application of these rules to private companies in LSIF portfolios. We believe that any requirement to place decisions in respect of a private company on the public record could be extremely detrimental to such companies (for many of the same reasons why we object to disclosing valuations of private companies). Moreover, in the private company context this requirement could potentially apply to a vast number of decisions - typically, LSIF private investments are governed by shareholders agreements that refer to shareholders many decisions of a type that a public company would take at the board level. Given the extensive nature of these items, any stated policies would have to be general in nature thereby providing limited value to LSIF investors. As a result, we propose that Part 10 not apply to LSIFs' venture investments.

5. Related Party Transactions

Section 3.6 of the Instrument requires detailed note disclosure of transactions between a mutual fund and a "related party", which is defined by reference to section 4.2 of National Instrument 81-102. This includes as a related party any company with less than 100 shareholders where an officer/director of the mutual fund serves as an officer/director of the company. As a result, any follow-on investment by an LSIF in an existing portfolio company in which the LSIF has a board seat (a very common occurrence) would be a related party transaction. This type of disclosure would clutter the financial statements and be of limited use since LSIF shareholders know that LSIFs are active investors that frequently serve on the boards of their portfolio companies. We suggest that LSIFs be broadly exempt from disclosing these circumstances. LSIFs that offer their securities outside Ontario already have exemptions from the relevant provisions of NI 81-102 – in at least one case the wording of the exemption is that it applies to an investment by a "Fund"

in a "person or company" where an officer, director or partner of the Fund or its manager is an officer, director or partner of the person or company:

> *only with respect to the purchase of securities from the treasury of a person or company, only with respect to a partner, officer or director of the Fund or its manager being a partner, officer or director of a person or company (not where the partner, officer or director of the Fund or its manager is a security holder of the person or company) and only where the partner, officer or director of the Fund or its manager holds its position with a person or company as a result of the Fund or any other fund managed by the manager of the Fund's investment in the person or company*.

We request that similar language be incorporated into the Instrument.

6. MER Segmentation.

Part 15 of the Instrument and Part 10 of the companion policy outline the calculation and presentation of the MER. We suggest that LSIFs be permitted to continue providing segmented disclosure of certain MER components, particularly changes to incentive fee accruals, as this information is relevant to distinguish the recurring components of the MER from one-off items. The commentary on section 7.4 in Appendix B of the Notice of the Instrument suggests that the CSA believe this is permitted, but it is not specifically included in the Instrument itself.

7. Standing Instructions for Statement Delivery

We are concerned that the process outlined in Section 5.2(4) of the Instrument for soliciting instructions at the time of purchase is administratively incompatible with Fundserv. We would also appreciate clarification that funds can use the annual instructions in one year and subsequently move to standing instructions.

With respect to annual instructions, we are concerned that the requirement in Section 5.3(3) for mailing on the earlier of six months from year-end or at the time of the first mailing could impose an additional mailing burden (depending on the time that an LSIF holds its AGM). Instead we suggest that this be at the time of the first written communication, even if this takes more than six months.

8. Implementation.

Section 5.2(3) states that within 3 months of the Instrument coming into force, funds must send the registered holder or beneficial holder a document explaining the choices as to what the holder can receive and to solicit instructions as to delivery of those documents. Similarly, section 18.5 states that despite Part 5, a fund must deliver to every shareholder

the MDFP for the first year with an explanation. Depending on when LSIFs hold their AGM relative to their year-end, these timetables could have the effect of requiring an additional mailing for no compelling policy reason. Instead, we suggest that this be changed to require these documents to be included in the next otherwise scheduled mailing by the fund with a deadline of 12 months from when the Instrument comes into force.

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We appreciate the opportunity to provide our input and would welcome the opportunity to discuss our comments with you in detail.

Yours truly,

*(*signed*) Dale Patterson*
Executive Director