CVCA
CANADA'S VENTURE CAPITAL & PRIVATE EQUITY ASSOCIATION
ASSOCIATION CANADIENNE DU CAPITAL DE RISQUE ET D'INVESTISSEMENT

May 28, 2008

Ministry of Finance
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Toronto, Ontario
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Attention: Colin Nickerson
Senior Manager, Industrial and Financial Policy Branch
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British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Financial Services Commission
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marches financiers
New Brunswick Securities Commission
Registrar of Securities, Prince Edward Island
Nova Scotia Securities Commission
Superintendent of Securities, Newfoundland and Labrador
Registrar of Securities, Northwest Territories
Registrar of Securities, Yukon Territory
Registrar of Securities, Nunavut

Ontario Securities Commission
20 Queen Street West
19th Floor, Box 55
Toronto, Ontario
M5H 3S8
Attention: Mr. John Stevenson
Secretary to the Commission
Fax: (416) 593-2318
Email: jstevenson@osc.gov.on.ca

Autorité des marchés financiers
Tour de la Bourse
800, square Victoria
C.P. 246, 22 étage
Montreal, Québec
H4Z 1G3
Attention: Ms. Anne-Marie Beaudoin
Directrice du secretariat
Fax: (514) 864-8381
Email: consultation-en-cours@lautorite.qc.ca

Dear Sirs/Mesdames:

Re: Response to Request for Comments Regarding National Instrument 31-103 and Proposed Amendments to the Securities Act (Ontario)

I am writing on behalf of the CVCA – Canada's Venture Capital & Private Equity Association ("CVCA"), representing the vast majority of firms in the venture capital and private equity industry across Canada. I am the President of the CVCA and also a full-time Managing Director of Kensington Capital Partners Limited, a private equity firm that actively manages Funds of Funds and direct investments across a broad range of private equity market sectors.

This comment letter has been prepared in response to the request for comments on Proposed National Instrument 31-103 and Companion Policy 31-103 CP – Registration Requirements.

Based on our meetings, discussions and correspondence with Ontario Commission staff, it is our understanding that the Canadian Securities Administrators ("CSA") do not intend to regulate active investors such as venture capital and private equity/debt investors by requiring them and their staff to register as dealers, advisers or investment fund managers in connection with ordinary course activities in which they engage. However, we are concerned that the draft national instrument, read alongside other existing legislation, makes the applicability of these new rules to such active investors unclear. We are therefore asking that further clarification be included in the new rules.

This ambiguity, if unaddressed, would result in substantial uncertainty in the marketplace and possibly in the application of the rule to parties to which its prescriptions were not intended to apply, thereby increasing the regulatory burden without improving investor protection, contrary to the stated principal objectives of the proposed rule. In particular, as noted in greater detail below, our view is that the venture capital and private equity/debt markets have been operating strongly in Canada without any complaints or failures resulting from the lack of, or that would be addressed by the imposition of, registration requirements to the sector.

We think these rules could, if applied to the venture capital and private equity industry, cause serious economic harm to our industry without any appreciable investor protection benefit.

Industry Background

Private Equity Fund Structure

Private equity and venture capital firms are generally comprised of a management company (the "Manager") that employs individuals who run the fund management business as well as various single purpose investment vehicles which constitute individual investment funds (each a "Fund").

The Manager serves a number of functions. Its personnel typically raise the capital to be committed to a new Fund from a combination of institutional, corporate and high net worth individual investors; establish, organize and administer the new Fund; find, negotiate and make the investments in investees on behalf of the Fund; manage the Fund's investments; and report to investors. As part of being an active investor in investees in which its Funds invest, the Manager (or one of its personnel, as applicable) frequently acts as a board member of investees, assists in capital raising for the investees, assists in recruiting management for the investees, assists in developing business strategy, refers customers and business partners and sometimes takes a direct position in a senior management role of investees where necessary.

In return, the Manager is generally compensated by the Fund with a management fee based on a certain percentage of the capital committed by all investors to the Fund, as well as a "carried interest" which is in effect a right of the Manager to participate in the profits of the Fund. The Manager is not typically compensated separately for the corporate finance role of raising capital

for the Fund; fundraising is simply a necessary element of building the Manager's business of private equity investing. Furthermore, the management fee is very often set off against the carried interest so that in many instances the only fee ultimately earned by the Manager of a successful Fund is the Manager's share of profit of the Fund. In this way, the interests of the Manager are closely aligned with the interests of the Fund's investors.

The form of single purpose vehicle which is most often used by Funds is a limited partnership wherein a single purpose corporation (frequently owned by the Manager) is the general partner and investors are the limited partners. The directors and officers of the general partner are typically employees of the Manager. The investors are generally Institutional Investors and high net worth individuals in Canada and abroad. Frequently the officers and employees of the Manager will also invest in the Fund either directly or through a jointly owned entity.

Investors in Private Equity Funds

Institutional Investors who invest in this sector include government funded and corporately funded pension plans (including for example the Canada Pension Plan Investment Board), insurance companies, endowments, and financial institutions who all allocate a portion of their asset base (normally under 10%) to this particular asset class known as "Private Equity". This asset class typically includes venture capital and debt as well. The Institutional Investors are themselves professional investors and will accordingly ensure that Managers are subjected to a rigorous review prior to making an investment in or a commitment to a Fund. These reviews often continue after the funding commitment with monthly financial reporting and updates from the Manager and third party "process and accounting" tests on a quarterly basis; multi-disciplinary operations reviews occur semi-annually in many cases.

High net worth individuals investing in this class are often founders or senior executives from successful companies which were prior investments of the Manager, who now wish to invest with the Manager in other investments. In most cases, members of the Manager's staff are also investors in their own Fund.

Fundraising and Investment Process

An investment in a new Fund is made on a prospectus and registration exempt basis, generally with a confidential offering memorandum showing the track record of the Manager, the investment thesis/mandate and proposed terms of the new Fund. These terms, generally set out in a limited partnership agreement, are extensively negotiated with the prospective limited partners and their legal counsel. The limited partnership agreement typically addresses issues that are not negotiated in the context of a mutual fund, such as conflicts, management and insurance. The Fund does not typically engage a registered dealer to assist with the fund-raising, relying instead on registration exemptions to do the fund-raising itself.

Once terms are agreed upon, investors will make commitments to provide capital over the life of the Fund when called upon, not all up front. Investments in accordance with the investment mandate of the Fund are then made in businesses, typically referred to as "investees" or "portfolio companies", by the Fund under the direction of the general partner with assistance

from the Manager (the general partner and Manager are usually comprised of the same personnel, albeit in separate legal entities). These investments are made by way of equity or debt and always involve a direct business relationship and contract between the Fund and investee.

Active Management

In cases where less than 100% of the equity is being acquired (i.e., where the Fund is not buying the whole company), investments will include a number of rights being granted to the Fund which, may include any of the following: (a) board or board observer seats; (b) approval or veto rights on key decisions; (c) pre-emptive right to participate in future share issuances; and/or (d) transfer restrictions on other securityholders. These rights, granted to the Fund by contract with the investee and/or certain of its shareholders, enable the Fund to actively manage the investee, monitor the progress of the business and contribute to material decisions.

These negotiated rights may disappear over time but they are virtually always present at the time of investment. For example, it is not uncommon for investees to complete a public offering (or merge into a public company) leaving the Fund in a passive investment role holding publicly traded securities that it is contractually or legally restricted from selling for a period of time. In the case of debt funds, security documents and warrant documents, for example, may have different time horizons.

Syndicated Transcations

There is a long standing business practice in the venture capital, debt and private equity industry to frequently make investments as a group of Funds acting together in a syndicate or in a series of transactions over an extended period of time. A group of Funds may form a syndicate prior to making an investment. However, sometimes a Manager completes an investment for a Fund it manages and then subsequently organizes a syndicate of other Funds it does not manage (perhaps by working with the investee) to become investors/shareholders of the investee, either by selling off parts of the just completed investment, or in subsequent rounds of financing. When a syndicate is formed from the outset, frequently one member of the syndicate will take the lead in negotiating the investment and in managing it. As lead investor, it may have a more active role in directing the investee compared to the other co-investing Funds. This is usually accomplished by a person from the Manager of the lead Fund sitting on the board of directors of the investee. However, all Funds in the syndicate will be party to the contractual arrangement with the investee and are in effect participating in active overview of management of the investee through the lead Fund.

Ongoing FundraisingModel

Funds typically have a pre-determined life of approximately eight to ten years with the initial five year period being a limited period in which the Manager can make new investments for the Fund. As the new investment deadline for one Fund approaches, the Manager will begin efforts to raise money for a new Fund. The hope of the Manager is that this process continues to repeat itself. One of our members, for example, has successfully followed this path for the past 30 years.

Some Managers may operate several Funds concurrently whereby each Fund is governed by a different investment mandate (e.g. buyout, subordinated debt, mezzanine debt, venture debt or venture capital). As a result, the Manager and each Fund can be continually involved in the process of raising money from investors, making investment decisions for each Fund and investing the Fund's money.

Skill Set and Proficiency Requirements

It is important to note that the Manager's senior partners/officers and employees often do not have the credentials sought by the regulations for registration. In fact, the Fund investors deliberately select Managers on entirely different criteria in the venture capital, debt and private equity industry. Entrepreneurial skill, technical/scientific expertise, business building/strategy knowledge and networking skills are some of the key characteristics the investor base seeks in Manager employees, particularly among the Manager's senior leadership team. Furthermore, the proposed proficiency requirements involve education in matters which are largely irrelevant to successful venture capital, debt and private equity investors.

Financial Burden

The substantial majority of the members of the CVCA are small firms operating on small budgets with essentially fixed incomes (management fees which, as noted above, have been set for the life of the Fund based on a percentage of committed capital) who cannot afford additional professional staff just to meet the proposed registration requirements. Applying the proposed registration regulation to these firms would amount to an undue hardship for no apparent benefit. The current system has worked well, with no complaints or failures in the market resulting from a lack of registration.

Comments on Proposed Registration Rule NI 31-103

Under the new rule, there are three categories of registrants: (i) investment fund manager; (ii) dealer; and (iii) adviser.

The draft Companion Policy states the following regarding venture capital:

> "1.4.3 **Venture Capital**
> A wide range of potentially registerable activities can be described as "venture capital" investing. While we cannot give specific guidance for every possible situation, we have found that considering the expectations and reliance of investors can be particularly relevant when applying the business trigger factors to venture capital.
>
> For example, whether the general partner (GP) of a limited partnership (LP) that acquires securities would have to register as an adviser depends on:
>
> - the application of the business trigger factors to the business purpose of the LP

- the types of services the GP provides to the LP
- the expectations of the limited partners

If the purpose of the LP is to invest in a trading portfolio of securities and the limited partners are relying on the GP's expertise in selecting the securities and deciding when to buy and sell them, we would require the GP to register as an adviser.

If the limited partners are relying on the GP for expertise other than providing advice on selecting investments in securities, we may not require the GP to register as an adviser. This would be the case where a GP's role is to select small private companies that the GP will actively manage and develop. We would view the purchase and eventual sale of the securities as incidental to the GP's activities on behalf of the LP."

This wording does not establish any "bright lines" for venture capital or private equity exemptions from the registration requirements. The example used is that of a General Partner managing one Fund making small private company investments that the general partner will "actively manage and develop" (not defined).

The Companion Policy does not address the following:

1. What "active management and the development of investees" means (including whether syndicate participation is "active");

2. Whether a Manager must "actively manage" 100% of the investments made by the Fund to meet this test, or whether some lower majority threshold would be sufficient.

3. Whether the involvement of the Manager in the investment decisions of the Fund would require registration as an adviser;

4. Whether the involvement of the Manager in raising capital for the Fund or investees would require registration as a dealer;

5. Whether or not the type of security utilized by a Fund to make its investments has any bearing on the requirement for registration; and

6. Whether changes in role over time (from an active investment to a passive investment) are relevant for classification purposes, including the holding of publicly traded securities.

Investment Fund Manager

Under the *Securities Act* (Ontario) and the securities legislation of Alberta, British Columbia, Nova Scotia, Quebec and Saskatchewan, the following terms are defined as follows:

"Investment fund manager" is someone who directs the business, operations or affairs of an investment fund.

"Investment fund" is a mutual fund or non-redeemable investment fund.

"Mutual fund" is an issuer whose primary purpose is to invest money provided by its security holders and whose securities entitle the holder to receive on demand, or within a specified period after demand, an amount computed by reference to the value of a proportionate interest in the whole or in part of the net assets, including a separate fund or trust account, of the issuer."

"Non-redeemable investment fund" is an issuer

(a) whose primary purpose is to invest money provided by its security holders,
(b) that does not invest,
    (i) for the purpose of exercising or seeking to exercise control of an issuer, other than an issuer that is a mutual fund or a non-redeemable investment fund, or
    (ii) for the purpose of being actively involved in the management of any issuer in which it invests, other than an issuer that is a mutual fund or a non-redeemable investment fund, and
(c) that is not a mutual fund.

Therefore, a Manager who is not a mutual fund manager will not be an investment fund manager if it invests for the purpose of being "actively involved in the management" of any investee in which it invests. It is not clear, however, what "actively involved in the management" means. Accordingly, we are requesting that additional wording be added to the rule to clarify the meaning.

We believe that in any situation where the investment is made by way of a direct contractual investment that provides meaningful restrictions on the management or decision-making of the investee, the investment should constitute "active involvement in management" of the investee.

Dealer Registration

The draft rule also proposed changes to the registration requirement currently set out in section 25 of the *Securities Act* (Ontario) by requiring registration for dealers who are "in the business of dealing in securities". The proposal contemplates amending the *Securities Act* (Ontario) to require registration by a person or company who

(a) acts as a dealer or as a representative of a registered dealer;
(b) acts as an adviser or as a representative of a registered adviser; or
(c) acts as an investment fund manager.

The definition of "dealer" is proposed to be amended to capture the concept of "engaging in the business" that currently exists in the Ontario definition of "adviser". It is proposed that the definition of "dealer" would be amended to refer to a person or company engaging in or holding himself, herself or itself out as engaging in the business of dealing securities.

The draft rule indicates that the definition contemplated for "dealing in securities" includes:

(a) trading a security as principal or agent;
(b) acquiring a security as principal or agent and any act, advertisement, solicitation, conduct or negotiation directly or indirectly in furtherance of acquiring a security as principal or agent; and
(c) acting as an underwriter.

The draft rule also provides that when determining if a person or company is in the business of dealing or advising in securities, the extent to which the person or company engaged in one or more of the following "business triggers" is proposed to be considered:

(1) The person or company undertakes the activity, directly or indirectly, with repetition, regularity or continuity;
(2) The person or company is, or expects to be, compensated for undertaking the activity;
(3) The person or company acts as an intermediary in connection with the activity;
(4) The person or company induces reliance by others on the person or company in connection with the activity;
(5) The person or company produces, intends to produce, or is capable of producing, profit.

The draft rule states that registration is required if any one of the business triggers is triggered.

In addition to the factors set out above, the proposed rules state that the proposed legislative amendments may also include such other factors as are relevant in the circumstances of the particular case. The example given is of a person or company who may be found to be in the business of an activity even if the activity is not the sole or primary business or occupation of the person or company.

The draft rule also provides that it is not intended to require an issuer to be registered to issue its own securities. As noted above, most Funds are single purpose entities that in some cases may not exist at the time the Manager begins seeking to raise capital for it. As a result, the Manager is raising financing for an issuer that does not yet exist. Additionally, the Manager may be seeking to raise money for more than one Fund concurrently. Accordingly, it is possible that the Manager could be considered to have triggered one or more of the business triggers of the proposed rule even where it would seem to be entirely within the spirit of the rule.

We would therefore like clarifying language added to the rule to indicate that a Manager raising capital for Funds to be actively managed by it does not need to be registered as a dealer, provided the Manager is not paid a separate fee specifically for raising money for the Funds. We

also request clarifying language to note that registration is not required for assisting investees in raising financing.

The language currently contained in Section 1.4 of the draft Companion Policy, under the headings "Securities issuers" and "Principal trading activities", "Activities not commonly in the business of trading or advising in securities", should be maintained as that language provides that most issuers are not "in the business".

Advising

Registration is also required for anyone in the business of advising in securities. Again, the draft rule also provides that when determining if a person or company is in the business of dealing or advising in securities, the extent to which the person or company engaged in one or more of the following "business triggers" is proposed to be considered:

(1) The person or company undertakes the activity, directly or indirectly, with repetition, regularity or continuity;
(2) The person or company is, or expects to be, compensated for undertaking the activity;
(3) The person or company acts as an intermediary in connection with the activity;
(4) The person or company induces reliance by others on the person or company in connection with the activity;
(5) The person or company produces, intends to produce, or is capable of producing, profit.

Our concern is that the Manager could be considered to be advising a Fund in both the capital raising and capital investing activities of the Fund. As well, the general partner could also be considered to be advising, even with the helpful language in the draft Companion Policy regarding limited partnerships. That language should therefore be broadened to apply more generally to investment funds and not just limited partnerships; an investment for the purpose of engaging in active management, as defined above, should not constitute a business trigger. We would like to have clarifying language added to make it clear that a Manager need not register when advising Funds that it is responsible for actively managing with respect to raising capital and investing that capital.

Market Intermediary

In Ontario and Newfoundland and Labrador, certain registration exemptions under National Instrument 45-106 are not available to a "market intermediary". The rationale would appear to be that a market intermediary is required to be registered so registration exemptions should not be available to them. The registration exemptions that are unavailable include the accredited investor exemption. As noted above, Funds typically raise their capital in the exempt market without using a registered dealer or a prospectus. Accordingly, it is important that they not be restricted from accessing those registration exemptions. If it is determined that Managers and Funds are not required to be registered in respect of the activities described above, then it should follow that the registration exemptions in National Instrument 45-106 should be available to them.

Under the proposed amendments to National Instrument 45-106, the registration exemptions are for the most part being removed from the Rule so that it is primarly a prospectus exemption rule. The intention seems to be that Rule 31-103 will govern registration and anyone not required to register will be entitled to use the prospectus exemptions without registration.

Proposed Additions to Companion Policy

We believe these issues could be addressed by adding the following language to the existing language of Section 1.4 of the draft Companion Policy under a revised heading of Venture Capital and Private Equity.

1. None of (a) the management firm managing (whether by contract, through ownership of the general partner, manager or otherwise) a venture capital or private equity/debt fund (each a "Fund"), (b) the Fund itself (including its general partner or other similar managing entity), or (c) their respective officers, directors or employees will be required to be registered (i) to raise capital for a Fund (or a prospective Fund) or for an investee of a Fund (in the case of a management firm, an investee of a Fund managed by the management firm), or (ii) to make on behalf of, or assist that Fund in making, investment decisions provided that (I) the stated purpose of the Fund is to be actively involved in the management of investees, and (II) at the time each Fund investment is made in an investee, the Fund is actively involved in the management of that investee either directly or through a syndicate partner or other Fund. A management firm, a general partner or other similar managing entity that is paid a separate fee for raising capital for Funds or investees (as opposed to management fees for managing a Fund or sharing in gains of a Fund) may be required to be registered as a dealer having regard to the business triggers.

2. "Actively involved in the management of the investees" means an investment in an investee pursuant to a written contract that entitles the investor to certain rights in respect of the management, direction or oversight of the investee. Examples of those rights could include (without limitation) one or more of the following: board or observer nominee rights; approval rights or vetoes with respect to specified management, board or shareholder matters or material transactions; approval of annual budgets; financial covenants for the purpose of monitoring the business; special information rights beyond that which is normally required under general corporate law; or special rights to participate in subsequent financings. The effect of the rights granted must be to enable the investor to have (or to have had) some meaningful influence on some material decisions which might be taken by the investee. Those rights must extend beyond the rights the investor would have as an investor at law without the benefit of the specific contract negotiated with the investee. The characterization of active involvement in management would not change if a Fund were to cease to be actively involved in the management of an investee over time as an investee's business develops and changes. For example, if an investee becomes a public company, the Fund would likely cease to have any further contractual rights to be involved in management of the investee. The change in status of an investment from active to passive will not require registration.

3. A Fund will be considered to be "actively involved in the management" of an investee if (a) it co-invests in an investee through a syndicate of investors (contemporaneously with the initial investment by a lead investor or at a later juncture) in which at least one investor obtains management rights of the sort described in the preceding paragraph granted pursuant to a written contract with the investee, and (b) the Fund is also a party to the agreement with the investee.

4. Any person or entity that is not required to be registered to engage in the activities referred to in paragraphs 1 to 3 will be entitled, without registration, to use the prospectus exemptions in, and will not be a "market intermediary" for the purposes of, applicable securities legislation when engaging in those activities.

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We are pleased to have had the opportunity to provide our comments.

Yours very truly,

Richard Nathan
President
CVCA – Canada's Venture Capital & Private Equity Association