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Saskatchewan Securities Commission
Manitoba Securities Commission
Ontario Securities Commission
Securities Administration Branch, New Brunswick
Office of the Attorney General, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Registrar of Securities, Department of Justice, Government of the Northwest Territories
Registrar of Securities, Government of Yukon
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Re: Proposed National Instrument 81-106 – Investment Funds Continuous Disclosure

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 – Investment Funds Continuous Disclosure (the "Proposal" or "NI 81-106"). ALSIF's membership includes almost all labour-sponsored investment funds ("LSIFs") currently operating in Ontario with total assets under management of almost $3 billion. ALSIF greatly appreciates the opportunity to provide comments on behalf of its members and to participate in the regulatory process.

Organization

Our comments have been divided into three parts. The first part provides background information on the differences between a typical mutual fund and an LSIF. The second part sets out our general thoughts on NI 81-106 and answers certain questions posed by the CSA. The third part includes a section specific review of, and comment on, some of the more salient provisions of NI 81-106.

Background

Although LSIFs are treated as mutual funds by most members of the CSA, they are very different from traditional mutual funds in many fundamental respects. In assessing the relevance of the Proposal to LSIFs, the most important of these differences is the investment time horizon of LSIF investors, which is rooted in the policy underlying the LSIF program.

LSIFs exist as a result of government support for the growth of a stable pool of venture capital in Canada, which is enabled through the provision of tax credits to LSIF investors from the federal and many provincial governments. 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.

To focus LSIF investment in this area, the Income Tax Act (Canada) (the "Tax Act"), the Community Small Business Investment Funds Act (Ontario) (the "CSBIF Act") and analogous laws of many other provinces 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. The result of these provisions is that LSIFs must invest primarily in private companies. Since these investments are illiquid, LSIFs typically hold each investment for several years. Furthermore, LSIFs are not overly focused on swings in the short term performance of their portfolio companies – generally, an LSIF realizes on an investment only when a company is sold as a whole or goes public, and these seminal events only occur after a business has been operating successfully for many years, not just a few quarters. To effectively raise, deploy and mature an entire portfolio of investments of this type takes about five to eight years. This is recognized in the Tax Act and provincial legislation which provide that LSIF investors must repay the tax credits that they received at the time of investment if they redeem in less than eight years. As a result, although LSIF shares are technically redeemable on demand, from both a business and legal perspective an LSIF is at least an eight year investment and very few LSIF shareholders redeem any earlier.

This long term perspective contrasts with the underlying thesis of the Proposal, which is to require funds to provide more frequent short-term information to investors. The introduction to the Proposal states that it is anticipated that the additional disclosure required should "allow an average investor to better assess an investment fund's performance, position and future prospects … [I]nvestors, or potential investors, will use the information to compare investments and make appropriate investment decisions". In contrast, there may be little practical utility to reviewing quarterly financial results about the long term prospects of a venture portfolio that will take years to mature.

There are many more critical differences between LSIFs and traditional mutual funds, including the following:

- LSIFs are generally hands-on, active investors who typically serve on the boards of their portfolio companies
- LSIFs determine their net asset value per share based on the estimated fair value of each portfolio company, most of which are not publicly traded. These valuations are subject to the oversight of a valuation committee independent of the LSIF's manager and to an annual review by a firm of professional business valuators.
- LSIFs are structured as corporations overseen by majority-independent boards of directors that are required to be controlled by a sponsoring labour organization
- LSIF investors have statutory shareholder rights such as oppression and dissent rights, and the directors and senior officers of LSIFs have the fiduciary duties imposed by the corporate statutes
- 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 all 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 (Ontario), 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 majority of the Proposal was drafted with traditional mutual funds, and not LSIFs, in mind and therefore we believe that many of its key objectives are unnecessary or inapplicable to LSIFs.

Specific Questions of the CSA

Management Reports of Fund Performance
Question 1*: The CSA invite comments as to whether the quarterly management reports of fund performance will achieve the goals that they are intended to achieve. Should there be more or less frequent disclosure of fund performance information and why? Should there be quarterly reporting for all investment funds? Does the proposed type of information allow an investor or an adviser to make informed investment decisions?*

We understand from instruction 9 to proposed form 81-106F1 that the main thrust of the proposed management discussion of fund performance ("MDFP") is to provide investors with information about fund performance, with particular emphasis on known material trends, commitments, events, risks or uncertainties that are reasonably expected to have a material effect on the investment fund's future performance or investment activities. We do not believe that this quarterly reporting will achieve this objective or provide investors with meaningful information. We feel that the current semi-annual continuous disclosure reporting regime is an appropriate one for LSIFs.

Unlike traditional mutual funds which invest exclusively in publicly traded firms, LSIFs invest in mainly in private companies which must necessarily be held for a significantly longer period of time. It is respectfully submitted that analyzing these investments on a fiscal quarter by fiscal quarter basis is less relevant for LSIFs or their investors than it is for traditional mutual funds investing in publicly traded securities. First, short term (quarterly) performance of an investment is less relevant when the investment must be held over a period of years and when realization on the investment is generally conditional on a material event such as a sale of the entire company, public offering or refinancing (as opposed to a short term change to trading price or volume that may arise from good or bad quarterly results). Second, given the stage of development of investee companies, there will inevitably be an enormous number of trends, events or risks that could reasonably be expected to have a material effect on the performance of each investment made by a LSIF. Item 4 of Form 45 (Risk Factors) requires a fulsome disclosure of those factors. They are highly unlikely to change on a quarterly basis, making updating them on a quarterly basis of little value. Third, given the investment timetable mandated by provincial legislation such as the CSBIF Act which requires LSIFs to make investments on a regulated schedule, none of the enumerated risks can have any effect on the investment activities of a LSIF.

Moreover, even if the MDFP contains helpful information, it would not help LSIF investors to make investment decisions. This is because the vast majority of investments in LSIFs occur at the beginning of each calendar year prior to the RRSP cut-off date. Once investors have purchased securities of a LSIF during the year, they are generally unable to make subsequent purchases during that year and be entitled to the tax credits available to purchasers of LSIFs because the credits available to each investor are capped on an annual basis. Therefore, it is unlikely that providing information quarterly throughout the year will result in a decision to purchase more shares (because tax credits have been used up) or to redeem existing shares (because of the punitive provisions relating to the repayment of tax credits).

For the larger mutual fund companies, the additional expense burden of preparing these reports (including staff time, marketing and layout, translation, printing, fulfillment, delivery and legal) is somewhat mitigated by the scale and scope of applying these costs across many funds. But LSIFs tend to be smaller than traditional mutual funds and are much more impacted by these expenses. Ultimately these expenses are borne by LSIF shareholders, and we submit that there is no public policy goal served by imposing such costs for so little, if any, benefit.

Financial Statements

Question 2*: The CSA invite comment on whether the financial statement requirements set out in the proposed Rule meet the needs of the users of the financial statements? Does the amount of detail provided in the proposed National Instrument assist with the preparation, consistency and comparability of the financial statements? Is the proposed National Instrument too detailed? Is more detail or specific direction necessary? The majority of investment funds currently prepare and file six- month interim financial statements. Should all investment funds be required to prepare and file quarterly financial statements in addition to the proposed quarterly management reports of fund performance?*

We are generally in agreement with the NI 81-106 proposals to shorten the time periods for the filing of annual financial statements (from 140 to 90 days after year-end). However, we do not believe that there is any benefit to shortening the time for filing of interim financial statements (from 60 to 45 days after the end of the interim period) or to require additional detail in those financial statements through additional line items.

With respect to the shorter interim statement filing deadline, we believe that this would provide no meaningful benefit to LSIF investors for the reasons outlined above – namely, 15 days of advance information is irrelevant in monitoring an investment with an eight year time horizon. Yet the tighter deadlines could impose costs on LSIF shareholders, particularly since many LSIFs outsource back-office and administrative functions that are commonly delivered in-house by traditional mutual fund managers.

Many of the steps to preparing financial statements cannot be performed in a quicker or more consolidated manner without additional costs. If the CSA is inclined to expedite delivery, it should do so with respect to information that it knows that investors actually use and consider on an expedited basis. From our perspective, information that is not actually used by the average LSIF investor will not be rendered more useful by delivering it faster and with greater frequency and we urge the CSA to avoid shortening filing deadlines simply for the sake of disseminating information that may be of questionable value to investors more quickly.

With respect to the additional line items, we question whether the information is material, relevant or appropriate. The additional line items in the Proposal generally require the provision of information that, in our view, would not be material or useful in assisting the typical LSIF investor in making informed investment decisions. Generally speaking, we propose that the additional line items only be disclosed if they otherwise meet GAAP thresholds of materiality, in which case they ought to be disclosed as a separate line item. Please see Part Three for more detailed and section specific comments on the proposed financial statement requirements.

Accordingly, it is our opinion that any requirement that would impose additional and faster financial reporting to LSIF shareholders is not appropriate, necessary or in their best interests.

Disclosure of Risk and Volatility

CSA Question 3*: The CSA invite comments on whether alternative methods of disclosing risk and volatility should be used. For example, should there be disclosure of the fund's best and worst quarter returns or disclosure of the correlation of the fund to a benchmark index? Is there additional disclosure that would provide useful information to the investors and advisers?*

We strongly disagree with the proposed additional disclosure regarding risk and volatility for LSIFs as this could be very problematic to prepare and easily misunderstood. Neither the mutual fund nor LSIF industry has adopted standard measures of risk and volatility and there is no relevant benchmark index. As a consequence, we do not believe that requiring mandatory discussions/disclosure of risk/volatility would be appropriate or assist in providing investors with practical or meaningful information.

Specific Section Comments

Section 1.1 - Definition of "current value" (Section 4.4 – Statement of Investment Portfolio, requires disclosure of investments at "current value")

This definition incorporates by reference the Restricted Security provision from NI 81-102 which the ALSIF believes has inherent problems. This definition is unworkable in the context of private company securities that have no reported quotation or obvious market value and for which the time remaining until they become "unrestricted" is unknown. LSIFs currently articulate at length in their prospectuses the policies and practices they use to calculate estimated "fair value". In the statement of investment portfolio, all securities should have a "current value" which is equal to the market value or fair value, and an LSIF's Manager should have the ability to determine what that market value or "fair value" is in accordance with their valuation policies.

Section 2.2 and 3.2 – Delivery of Financial Statements

We believe that once a shareholder has provided notice that he/she does not wish to receive financial statements, an LSIF should not be required to circulate an annual request form to the shareholder. As currently drafted, this requirement could compel LSIFs to continue costly annual mailings that might otherwise be unnecessary.

Section 4.3 – Statement of Operations, Item 15

Item 15 provides that the Statement of Operations must include amounts waived by the Manager. This item affects LSIFs because, as purchasers of treasury securities, they receive commitment, financing or work fees from time to time (similar to fees charged by banks). In many LSIF management agreements, these fees are paid to the LSIF Manager and the management fee is reduced by the same amount – this arrangement benefits LSIF shareholders because the fund gets the benefit of the fee and in addition saves GST that would have otherwise been payable on the management fee that has been reduced. Our concern is that in such cases Item 15 would compel inclusion in the Statement of Operations of a fee that was never in fact paid by the fund.

Section 4.4(1) – Statement of Investment Portfolio

LSIFs frequently hold several classes of securities of the same private issuer. The requirement for disclosure of the designation of each security causes the statements to be cluttered with superfluous information which is not useful to shareholders, particularly in the case of private companies. We would propose that, for private company holdings, the LSIF be allowed to aggregate designations of equity and debt into a reduced number of line items where the designation differences are not material, with disclosure of the aggregate number of shares or face value of debt instruments and cost of these securities with an annotation that discloses these as private company holdings and have been aggregated.

Section 7.4(2) & (3) – Incentive or Performance Fees

We have seen, since the implementation of the requirement to include incentive or performance fees (IPA) in the MER, that the LSIFs that have an IPA expense typically do not disclose, even though they could, what the MER would have been without the IPA. In the cases where LSIFs had an IPA expense that was negative and thus lowered their MER, those LSIFs disclosed the lower MER without explanation because they currently have that option.

We believe the MER should fundamentally be a relevant piece of information that prospective purchasers and shareholders can use to compare fund expenses. This could be implemented with a requirement for disclosure of a second MER which includes only operational (non-IPA) items when there is an IPA expense. For transparency purposes, we would recommend that the LSIF provide additional disclosure to help shareholders distinguish between performance fees and other MER components.

We are still of the opinion that performance fees are of a different nature than other ongoing operational expenses which are included in the MER calculation.

Section 7.5 – Costs of Distribution of Securities

Based on our meeting earlier this fall, we understand that it was not intended that this provision would require any change to existing LSIF practices at this time and would appreciate your confirmation of this point.

Section 8.3 – Labour Sponsored Funds

This section permits a LSIF, assuming it obtains a formal valuation, to elect to present the statement of investment portfolio in accordance with section 4.4 or section 8.3 at their option regardless of how they have reported in the past. Is it the CSA's intention that an LSIF can opt one year to file in accordance with section 4.4, file the next year in accordance with section 8.3 and then be able to return to filing in accordance with section 4.4? If it is, we believe this would not be helpful to investors.

This section provides two alternatives for meeting the disclosure requirements of section 4.4 with regard to securities for which a market value is not readily available. The first alternative requires disclosure of the current value of each individual security; the second alternative requires disclosure ofan aggregate adjustment from cost to current value and the filing of a "formal valuation" relating to these investments, in accordance with Section 9. We greatly appreciate the flexibility to keep individual private company valuations off the public record, since we feel that disclosing such information would be extremely harmful to our business for reasons that we have previously described in submissions to the OSC. However, we question the need for a "formal valuation" in addition to the valuation report that LSIFs are already required to obtain from their independent valuators. LSIFs currently receive an annual report on the valuation of their net asset value per share as required under the CSBIF Act – as an LSIF's venture portfolio is generally the largest component of its balance sheet, rigorous analysis of each security in the portfolio makes up almost all of the work involved in preparing this report (particularly since an LSIF's non-venture assets are largely cash and marketable securities which are relatively simple to value). As a result, we believe that the existing valuation report effectively provides third party validation of an LSIF's valuation of its venture portfolio, which is exactly what we believe the CSA are seeking in the formal valuation contemplated in section 9. We therefore submit that there should be no need to require a second report which significantly, if not entirely, overlaps the report already obtained but which would inevitably result in additional costs to LSIF shareholders.

Section 8.3(1)(b)(i) – Labour Sponsored Funds

We recommend the reference to “formal valuation” which is later explained in Part 4 of the Companion Policy, be changed to “valuation report”. We understand from our meeting earlier this fall that your expectation is that such a report would (subject to the issue described in the preceding section) be similar to the valuation reports already obtained by many LSIFs. The use of the word “formal” has a direct meaning in other jurisdictions and legislation and could easily be taken out of context by shareholders. The term “valuation report” would be less problematic and in our opinion does not promote false expectations.

Section 8.3(1)(b)(ii) – Labour Sponsored Funds

We question the requirement to disclose that the formal valuation has been obtained and request guidance in the companion policy on how an LSIF should disclose this information.

Section 9.1(1) – Formal Valuations

Section 4.2 of the Companion Policy does not clarify whether an LSIF’s auditors qualify as independent. For most LSIFs, the valuation report is currently provided by the audit firm. If an LSIF’s auditors were not considered independent, it would require the duplication of many functions by the auditor and valuator and would in turn substantially increase the audit and valuation costs to the LSIF.

Section 9.1(2) – Disclosure Concerning Valuator

If it is a question of fact whether a valuator is qualified and independent as contemplated by Section 9.1(1), then why is there a requirement for parts (a), (d) and (e)? We believe this information provides no additional benefit or comfort to shareholders and should not be required.

Section 9.4 – Filing of Formal Valuation

We question the requirement to file the valuation report. LSIFs have always filed a valuation report with the Ministry of Finance as required by the CSBIF Act with a copy to the OSC pursuant to the Securities Act (Ontario). As the existence of this report is a requirement of this tax program, we do not believe this report should be publicly disclosed. The shareholders’ ability to obtain the valuation report on SEDAR in our opinion does not provide any further level of comfort since every LSIF is already required to have this report. This requirement increases the audit risk and inevitably will result in an increase in costs to LSIFs.

Section 10 – Annual Information Form

This section seems to require a significant new disclosure document from LSIFs that are no longer in distribution. We do not believe it was intended to apply to LSIFs and seek your confirmation of this point.

Section 13 – Restricted Share Disclosure Requirements

The information required by NI 51-102 has never been provided to investment fund shareholders in the past and we question why it would be now. This could amount to a substantial increase in the information provided to shareholders by an LSIF due to the nature of its investments. In our opinion this information is not useful or relevant to a shareholder.

CP - Section 4.2(2)(a) – Independent Valuators

As discussed above under Section 9.1(1), if an LSIF's auditor were not considered independent this would require duplication of many functions that need to be performed by the auditor and the valuator and would in turn substantially increase the audit and valuation costs to the LSIF. The audit and valuation functions are inevitably linked since the venture portfolio assets make up the largest item on the balance sheet.

Application of the Proposal to CSBIFs

Because of the definitions of "investment fund" and "non-redeemable investment fund", we are concerned that the Proposal as drafted would technically apply to Community Small Business Investment Funds {"CSBIFs"). We do not believe that this is the CSA's intention or consistent with the underlying policy purpose – CSBIFs are generally funds with a very small number of institutional investors (usually just an LSIF and a community based institution such as a hospital or university) who are capable of bargaining for level of financial disclosure that they wish to receive. They are not available for sale to the public, so there is no concern of protecting retail investors. We ask that you confirm that the Proposal is not intended to apply to such entities.

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

Yours truly,

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