

# 2009 BCSECCOM 448

## Head note

National Instrument 41-101, Part 19 - *General Prospectus Requirements* - An investment fund wants relief from the requirement to appoint a custodian - The issuer is a venture capital corporation and is different from a standard investment fund in that it may only invest in companies that qualify as eligible small businesses; the issuer has sufficient internal controls and safekeeping practices in place for the portfolio assets of its investment fund that are an adequate substitute for a custodian; before the introduction of the new provisions requiring the appointment of a custodian, the issuer operated without using a custodian and did not incur any losses related to the safekeeping of its portfolio assets

## Exemption Order

### B.C. Advantage Funds (VCC) Ltd.

#### Section 19.1(1) of National Instrument 41-101 *General Prospectus Requirements*

## Background

- ¶ 1 B.C. Advantage Funds (VCC) Ltd. (Advantage) applied for an exemption from the requirements in Part 14 of National Instrument 41-101 *General Prospectus Requirements* that portfolio assets of investment funds be held under the custodianship of one custodian (the Custodian Requirements).

## Representations

- ¶ 2 Advantage represents that:
1. Advantage is registered as a venture capital corporation (VCC) under the *Small Business Venture Capital Act* (British Columbia) (the SBVCA) and is a reporting issuer in British Columbia; as a VCC, Advantage is substantially different from a standard investment fund in several respects, including that it may only invest in companies that qualify as eligible small businesses (ESBs) under the SBVCA;
  2. Advantage typically invests with the expectation that it will not realize on an individual investment until the portfolio company is either sold or becomes publicly traded; as such, the investments Advantage makes will, in many cases, be illiquid and should be viewed as long term investments; as a result, Advantage has a low volume of portfolio transactions that typically range from 8 to 12 transactions a year;

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3. Advantage's allocation for fund raising each year is determined by the SBVCA administrator; Advantage receives a rolling three year allocation for fund raising, whereby upon completion of a fund raising year, a new year is added to the three year allocation;
4. Advantage and its predecessor entities have operated since 2003 without using a custodian, and during that period, no events related to poor safekeeping of assets have occurred that have resulted in any loss to Advantage or its predecessor entities;
5. Advantage's assets consist of cash and portfolio investments; the portfolio investments can be further divided into private company investments and public company investments;
6. Advantage uses its cash to make portfolio investments and to pay operating expenses; the nature and type of operating expenses that Advantage pays are described in detail in its prospectus dated July 20, 2009 and filed on SEDAR;
7. Advantage's cash assets are held in Schedule I or Schedule II banks under the *Bank Act* (Canada) and invested in money market securities at brokerage firms that participate in the Canadian Investor Protection Fund and are governed by the Investment Industry Regulatory Organization of Canada;
8. pursuant to the requirements of the SBVCA, Advantage's cash accounts include a type of restricted cash account called the investment protection account (IPA); Advantage must deposit 30% of all capital it raises into its IPA; the purpose of an IPA is to serve as a source of capital should a VCC need to make a remittance back to the Province of British Columbia; in order to have the funds in the IPA released, a VCC needs the consent of the SBVCA administrator; the SBVCA administrator will only authorize a release of funds from the IPA if and when the VCC has made or proposes to immediately make an investment into an ESB; Advantage has two IPAs at a Schedule I bank;
9. Advantage receives cash from investor subscriptions and the sale of portfolio investments; investor subscriptions are processed via the FundSERV order system, which is the primary order and cash settlement system used in the Canadian investment fund industry; in substantially all cases, investor subscriptions, and also redemptions, are settled via the FundSERV system; the FundSERV system includes controls over settlement and authentication of transactions, which occur principally at the dealer level;

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10. Advantage's internal controls over the safekeeping of cash include the following:
  - (a) multiple signatures from certain senior executives are required to authorize cash transactions (in the case of the IPA, a signature from the SBVC Administrator is also required);
  - (b) regular reconciliations of cash accounts are performed and reviewed;
  - (c) supporting documentation for all cash transactions is reviewed; and
  - (d) the Controller reports on a monthly, quarterly and annual basis to the chief financial officer regarding the safekeeping of cash assets and the chief financial officer in turn reports to Advantage's fund manager monthly and the audit and valuation committee of Advantage quarterly and annually;
11. approximately 68% of Advantage's portfolio investments are private company investments. Advantage's practices and procedures relating to safekeeping of private company securities include the following:
  - (a) at the time of purchase, all private company investment certificates are registered in Advantage's name;
  - (b) any request to the private company for changes of any kind whatsoever to a certificate (such as certificate replacement or splitting) require multiple signatures from certain Advantage senior executives; and
  - (c) security certificates are held offsite with the private company's corporate records, which are typically located at the offices of the private company's legal counsel;
12. a record of the private company securities is typically held by the private company's legal counsel at the company's records office in the company's central securities register and can be used to verify the existence, date of issuance and amount of any private company certificate;
13. any changes to the private company certificate, including an attempted security transfer, will typically require a resolution of the private company's board of directors in order to comply with corporate law; one of Advantage's investment managers is typically a director of the private company and if not a director, has a close working relationship and therefore, would be aware of any requested share certificate changes;

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14. the private company's legal counsel would typically be responsible for processing any changes of any kind whatsoever to the private company certificate and would communicate with the private company and likely Advantage as well in this regard;
15. there is usually no liquid market for private company securities, so even if lost or stolen, they cannot be readily sold;
16. in the event that a private company certificate is lost or stolen, it can be replaced by Advantage complying with the procedures the private company has established for the replacement of missing certificates, which would typically include the private company confirming Advantage's ownership in its records and a directors' resolution of the private company issuing a new certificate;
17. approximately 32% of Advantage's portfolio investments are public company investments; Advantage's practices and procedures relating to safekeeping of public company securities include the following:
  - (a) publicly traded securities are always registered in Advantage's name and held at one of Advantage's brokerage firms;
  - (b) Advantage receives account statements from each brokerage account; the statements are reviewed for accuracy against Advantage's financial records, and for changes against previous statements; and
  - (c) Advantage's brokers require the following documents and forms to be completed to deposit, transfer or withdraw a publicly traded security:
    - (i) the original security certificate (in the case of a deposit only);
    - (ii) a power of attorney to transfer authorizing the brokerage firm to receive, transfer or issue the certificate and which must be signed by multiple Advantage senior executives;
    - (iii) a duly signed and authorized copy of a resolution passed by Advantage's board of directors authorizing the deposit, transfer or redemption, which must be signed by all of certain senior executives and must also be authenticated as a true copy of a board resolution by Advantage's secretary;

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- (iv) any request for changes of any kind whatsoever to a publicly traded company certificate (such as certificate replacement or splitting) require multiple signatures from certain of Advantage's senior executives; and
  - (v) the sale of the securities represented by the certificate in the public markets requires signatures from all of certain senior Advantage executives;
18. any changes to a publicly traded company certificate will also involve a review of the requested action by the company's transfer agent; the transfer agent will typically require documents and forms similar to those required by Advantage's brokers; these will usually include affidavits, powers of attorney, and/or certified true copies of resolutions, all of which will require the signatures of multiple Advantage senior executives; generally, the transfer agent will also seek approval from the publicly traded company to process the action request;
19. publicly traded securities held in deposit at a brokerage firm are also subject to the safekeeping controls of that brokerage firm, which includes custodial services and related controls; in the event that a brokerage firm loses or damages a publicly traded certificate registered to Advantage, the brokerage firm is responsible for any resulting liability;
20. one of Advantage's investment managers is usually a director of the publicly traded company and if not a director, has a close working relationship and therefore, would be aware of any requested share certificate changes;
21. in the event that a lost or stolen certificate needs to be replaced, it can easily be done so by the publicly traded company's transfer agent, with supporting documentation from Advantage and the publicly traded company's legal counsel by relying on record of past transactions;
22. Advantage's internal policies and procedures manual includes a safekeeping of assets protocol, which includes many of the internal controls described in this decision; Advantage's board of directors and the audit and valuation committee review the policies and procedures manual on an annual basis; the majority of the directors serving on Advantage's board of directors are independent;
23. Advantage thinks, after preliminary discussions with potential custodians, that the cost of compliance with the Custodian Requirements would be

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burdensome and would work against its efforts to reduce management expense ratios for shareholders;

24. Advantage thinks that the risk of loss due to current custodial procedures in respect of its cash, private company securities and publicly traded securities is negligible due to its current internal controls and safekeeping practices;

### **Order**

- ¶ 3 Considering that it is not prejudicial to the public interest, the Executive Director orders that Advantage is exempt from the Custodian Requirements provided that:
- (a) Advantage will maintain internal controls at least as onerous as it currently has in place for its IPAs, other bank and brokerage accounts and its security holdings for the term of the relief,
  - (b) any new IPAs, other bank accounts or brokerage accounts established by Advantage during the term of the relief will have internal controls associated with them similar to those described in representations 10, 11 and 17, respectively;
  - (c) Advantage will not hold any original security certificates representing its investments on its own premises; and
  - (d) this decision terminates on August 8, 2011.

- ¶ 4 August 6, 2009

Martin Eady, CA  
Director, Corporate Finance  
British Columbia Securities Commission