



Citation: 2013 BCSECCOM 108

Headnote

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

Applicable British Columbia Provisions

National Instrument 41-101, ss. 14.1(2), 19.1

April 3, 2013

Exemption Order

British Columbia Discovery Fund (VCC) Inc.

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

Background

- ¶ 1 British Columbia Discovery Fund (VCC) Inc. (Discovery) applied for an exemption from the requirements in Part 14 of National Instrument 41-101 *General Prospectus Requirements* (NI 41-101) that portfolio assets of investment funds be held under the custodianship of one custodian that meets the requirements in NI 41-101 (the Custodian Provisions).

Representations

- ¶ 2 Discovery represents that:
1. Discovery 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; Discovery is not in default of securities legislation in any jurisdiction; as a VCC, Discovery 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; Discovery focuses on ESBs in the information technology, communications, clean-technology and health and life sciences industries;

2. Discovery 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 Discovery makes will, in many cases, be illiquid and should be viewed as long term investments; as a result, Discovery has a low volume of portfolio transactions that typically range from 10 to 20 transactions a year;
3. Discovery's allocation for fund raising each year is determined by the SBVCA administrator; Discovery 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; currently, Discovery has an allocation to raise \$10 million per year, for a total of \$30 million over the next three years;
4. Discovery has operated since 2002 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 Discovery;
5. Discovery's assets consist of cash and portfolio investments; the portfolio investments can be further divided into private company investments and public company investments;
6. Discovery uses its cash to make portfolio investments and to pay operating expenses; the nature and type of operating expenses that Discovery pays are described in detail in its prospectus to be dated on or about April 10, 2013 and filed on SEDAR;
7. Discovery's cash assets are held in a Schedule I bank under the *Bank Act* (Canada) and invested in cash deposits;
8. pursuant to the requirements of the SBVCA, Discovery's cash accounts include a type of restricted cash account called the investment protection account (IPA); Discovery 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; Discovery has one IPA at a Schedule I bank;
9. Discovery receives cash mainly from investor subscriptions and the occasional 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;

10. Discovery's internal controls over the safekeeping of cash include the following:

- (a) signatures from certain senior executives are required to authorize cash transactions (in the case of the IPA, a signature from the SBVCA 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 Accounting Manager reports on a monthly, semi-annual and annual basis to the chief financial officer regarding the safekeeping of cash assets and the chief financial officer in turn reports to the audit committee of Discovery semi-annually and annually;

11. twelve of Discovery's 14 portfolio investments (comprising approximately 63% of its portfolio investments) are private company investments; Discovery'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 Discovery's name;
- (b) any request to the private company for withdrawals or transfers of certificates requires certain authorizing documentation including the signatures of certain executive officers of Discovery on a power of attorney;
- (c) any request to the private company for changes of any kind whatsoever to a certificate (such as certificate replacement or splitting) requires signatures from certain senior executives of Discovery; and
- (d) 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 the articles of the private company; one of Discovery'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;

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 Discovery 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 Discovery complying with the procedures the private company has established for the replacement of missing certificates, which would typically include completing an affidavit of loss, the private company confirming Discovery's ownership in its records and a directors' resolution of the private company issuing a new certificate;
17. two of Discovery's 14 portfolio investments (comprising approximately 37% of its portfolio investments) are public company investments; Discovery's practices and procedures relating to safekeeping of public company securities include the following:
 - (a) publicly traded securities are always registered in Discovery's name when issued and held at Discovery's brokerage firm;
 - (b) Discovery receives account statements from its brokerage account; the statements are reviewed for accuracy against Discovery's financial records, and for changes against previous statements;
 - (c) Discovery's broker requires 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 certain senior executives of Discovery and which also requires a Medallion stamp of a brokerage firm participating in the Medallion program; and
 - (iii) a duly signed and authorized copy of a resolution passed by Discovery's board of directors authorizing the deposit, transfer or withdrawal, which must be signed by all of certain senior executives, authenticated as a true copy of a board resolution by Discovery's secretary, and executed under the corporate seal of Discovery;
 - (d) any request for changes of any kind whatsoever to a publicly traded company certificate (such as certificate replacement or splitting) requires signatures from certain of Discovery's senior executives; and
 - (e) any sale of securities represented by public company certificates requires written authority from a majority of Discovery's executive officers;

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 Discovery's broker; these will usually include affidavits, powers of attorney, and/or certified true copies of resolutions, all of which will require the signatures of certain senior executives of Discovery; in addition, for any request for changes to certificates held by a corporate entity such as Discovery, the transfer agent's legal department will typically review all documentation supporting the request for accuracy and authenticity;
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 Discovery, the brokerage firm is responsible for any resulting liability;
20. one of Discovery's investment managers is usually a director of the publicly traded company and those public companies may be advised of requested certificate changes or transfers by their transfer agents, thereby enabling Discovery to become aware of any such requested share certificate changes or transfers;
21. in the event that a lost, stolen or destroyed certificate needs to be replaced, it can easily be done so by the publicly traded company's transfer agent, with supporting documentation and fees from Discovery, and if necessary, with supporting documentation from the publicly traded company's legal counsel relying on a record of past transactions;
22. Discovery's internal policies and procedures manual includes a section covering the safekeeping of cash and portfolio investments, which includes many of the internal controls described in this decision; Discovery's board of directors and the audit committee review the policies and procedures manual on an annual basis; the majority of the directors serving on Discovery's board of directors are independent;
23. Discovery thinks, after preliminary discussions with potential custodians, that the cost of compliance with the Custodian Provisions would be burdensome and would work against its efforts to reduce management expense ratios for shareholders;
24. Discovery 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; and
25. Discovery has fully complied with the terms of its current relief from the Custodian Provisions, set out in the order dated March 30, 2011.

Decision

- ¶ 3 Considering that it is not prejudicial to the public interest, the Executive Director orders that Discovery is exempt from the Custodian Provisions provided that:

- (a) Discovery will maintain internal controls at least as onerous as it currently has in place for its IPA, 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 Discovery 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) Discovery will not hold any original security certificates representing its investments on its own premises; and
- (d) this decision terminates on April 8, 2015.

Peter Brady
Director, Corporate Finance
British Columbia Securities Commission