IN THE MATTER OF TRIAX GROWTH FUND INC., NEW MILLENNIUM VENTURE FUND INC., E2 VENTURE FUND INC., CAPITAL FIRST VENTURE FUND INC., NEW GENERATION BIOTECH (BALANCED) FUND INC., AND VENTURE PARTNERS BALANCED FUND INC. (COLLECTIVELY REFERRED TO AS THE "FUNDS")

AND

IN THE MATTER OF A REQUEST FOR REVIEW AND HEARING OF A DECISION OF THE DIRECTOR WITH RESPECT TO AN APPLICATION UNDER THE MUTUAL RELIANCE REVIEW SYSTEM PURSUANT TO SECTION 5.7 OF NATIONAL INSTRUMENT 81-102 (THE "INSTRUMENT") FOR APPROVAL, PURSUANT TO SUBSECTION 5.5(1)(B)OF THE INSTRUMENT, OF THE SECURITIES REGULATORY AUTHORITIES OF EACH PROVINCE OF CANADA EXCEPT SASKATCHEWAN (THE "AUTHORITIES") FOR THE AMALGAMATION OF THE FUNDS.

Hearing: Friday, November 18, 2005

Panel:	Paul M. Moore, Q.C.	-	Vice-Chair (Chair of the Panel)
	Suresh Thakrar	-	Commissioner
	Carol S. Perry	-	Commissioner
Counsel:	Yvonne B. Chisholm	-	On behalf of Staff of the
	Mark Mulima	-	Ontario Securities Commission
	Iain Robb	-	On behalf of Covington Group of Funds
	Paul A. Dempsey	-	Inc., NGB Management Inc. and New Millennium Venture Partners Inc.

REASONS FOR DECISION

OVERVIEW

[1] This is a hearing and review by the Ontario Securities Commission pursuant to section 8 of the *Securities Act,* R.S.O. 1990, c. S.5 as amended (the "Act") of a decision of the Director of the Investment Funds Branch (the "Director") on an application brought by three affiliated managers, Covington Group of Funds Inc., NGB Management Inc. and New Millennium Venture Partners Inc. (the "Applicants" or the "Managers") on behalf of six labour sponsored investment funds ("LSIFs"): Triax Growth Fund Inc. ("TGF"), New Millennium Venture Fund Inc., E2 Venture Fund Inc., Capital First Venture Fund Inc., New Generation Biotech (Balanced) Fund Inc., and Venture Partners Balanced Fund Inc. (collectively referred to as the "Funds").

[2] By letters dated September 14, 2005 and October 13, 2005 (together the "Application"), the Applicants sought approval for a merger of the Funds (the "Merger") from the Director pursuant to subsection 5.5(1)(b) of National Instrument ("NI") 81-102 and certain relief pursuant to subsection 12.2(2)(a) of NI 81-106. Furthermore, the Applicants sought to have the Funds, rather than the Managers, bear the costs of the Merger.

[3] In a letter dated October 18, 2005, the Director stated that she agreed with the reasons outlined in a letter from Staff of the Commission also dated October 18, 2005 ("Staff Letter") and indicated that she would approve the Merger under NI 81-102 and grant the requested relief under NI 81-106 provided the costs of the Merger are not borne by the Funds.

[4] The Applicants sought a hearing and review of this aspect of the Director's decision, while indicating that the Merger would proceed whether or not they succeeded in overturning the Director's decision on costs.

[5] This Application was also brought under the Mutual reliance Review System (National Policy 12-201) and involved the securities regulatory authorities of each province of Canada, except Saskatchewan.

[6] At the end of the hearing held on November 18, 2005, we confirmed the Director's decision and indicated that reasons would follow. These are our reasons.

BACKGROUND

[7] The Funds at issue are LSIFs registered under the *Community Small Business Investment Funds Act*, S.O. 1992, c.18 (the "CSBIF Act") formerly the *Labour Sponsored Venture Capital Corporations Act, 1992*. LSIFs are subject to restrictions which require them to invest in private companies. An investment in an LSIF results in both a 15 percent provincial tax credit and a 15 percent federal tax credit, which are provided directly to investors. In order to be entitled to tax credits, investors must maintain their investment in a fund for eight years.

[8] The Managers are incorporated entities and are directly or indirectly subsidiaries of a U.S. public company, Affiliated Managers Group, Inc. and have a registered office in Ontario. The Funds are reporting issuers in Ontario, and one of them, TGF, is also a reporting issuer in every other Canadian province except Saskatchewan. TGF is incorporated under the *Canada Business Corporations Act*. The other five Funds are incorporated under the *Business Corporations Act* (Ontario).

[9] Each of the six Funds has sustained negative returns since its inception.

[10] On October 11, 2005, the Funds announced that their respective boards of directors (the "Boards") approved a merger involving an amalgamation of the Funds into a continuing fund called Covington Venture Fund Inc. (the "Continuing Fund"). The Continuing Fund is expected to assume all of the assets and liabilities of the Funds, including the investment portfolio of each fund. The Boards also recommended that the Merger be approved by shareholders of the Funds at the Annual and Special Meetings of the Funds to be held on November 18, 2005.

[11] The Applicants explained that the Application was precipitated, in part, by an announcement made by the Ontario government on August 29, 2005 terminating the provincial tax credits available for LSIFs. In their Application, the Managers provided several reasons to justify the Merger, most of which pertained to the poor performance of the Funds: (1) all of the Funds, excluding TGF, lack financial liquidity; (2) each of the Funds has a limited ability to raise additional capital; (3) TGF has suffered poor investment performance dating back to the crash of the "tech bubble" in 2000; (4) due to its poor investment performance, TGF is virtually unable to raise additional capital; and (5) two of the Funds are no longer in distribution.

[12] The Applicants also sought relief from subsection 12.2(2)(a) of NI 81-106 by which they would be: (i) permitted to deliver to shareholders a tailored information circular containing summary disclosure regarding the Continuing Fund and inform shareholders how to obtain the full information circular from the Managers or the Internet; (ii) exempted from the requirement to send financial statements of the Funds to shareholders and instead inform shareholders how to obtain the financial statements from the Managers on the Internet; and (iii) with respect to future mergers of LSIFs managed by the Managers or their affiliates that are implemented within one year of the approval granted for the Merger, permitted to provide shareholders with a tailored information circular and not send financial statements of the terminating funds to shareholders and rather make the full information circular and the financial statements available on the Internet or upon request from the Managers.

[13] The Applicants also requested that the costs of the Merger be borne by the Funds.

[14] Following the Application, Staff recommended that the Merger be approved (except in respect of the Merger costs). Staff also recommended that the relief sought under subsection 12.2(2)(a) of NI 81-106 in respect of the Merger and future mergers be granted. It was expected that the relief from the requirement to deliver the information circular would lead to both mailing and printing costs savings of $125,000 to $150,000. Staff estimated the Merger costs to be $287,089.

[15] In her decision, the Director indicated that she would be prepared to grant this exemptive relief on the terms set out in Staff Letter, provided the costs of the Merger would not be borne by the Funds.

[16] Staff submitted that the Director's decision to approve the Merger and to grant exemptive relief took into consideration the interests of all parties involved, including those of the Managers. The decision ensures that the Merger can proceed in a way that provides full and fair disclosure to the Funds' investors, and leads to considerable cost savings for the Managers.

THE ISSUE

[17] The only issue in contention before the Commission was whether the Funds should bear the costs of the Merger.

PARTIES' SUBMISSIONS

A. The Applicants

[18] The Applicants submitted that the primary reason for the Merger is that the Boards believe it is the best available option for investors in these Funds and that it will primarily and significantly benefit them. The Applicants further submitted that the Merger will benefit the investors for the following reasons: (1) all of the Funds excluding TGF lack financial liquidity; (2) if the Funds are managed separately in this period of contraction and decline, the fixed costs of each of the Funds will have to be paid out of a dwindling asset base which is relatively small, thereby significantly increasing the management expense ratios of the Funds; and (3) all of the Funds will benefit from the cost synergies associated with the Merger.

[19] While the Applicants submitted that the Merger will benefit the investors, they also submitted that the Merger will not significantly benefit the Managers. They further argued that it is in the public interest for the Commission to exercise its discretion in favour of the Funds for the following reasons:

a) the Merger will primarily and significantly benefit investors in the Funds;

b) there are no cost savings of significance for the Managers resulting from the Merger and when combined with the proposal to reduce management fees the impact of the Merger on the managers is neutral or marginally negative;

c) it would not be unfair for the Funds to pay the Merger costs;

d) any concerns about a conflict of interest between the Managers and investors in the Funds have been addressed by the corporate governance structure of the Funds (i.e. the Boards have concluded that the Merger, and the payment of associated costs by the Funds, is the right thing to do and in the best interests of investors); and

e) the circumstances of this case are unique to the labour sponsored fund business and therefore the granting of consent by the Commission will not set a precedent applicable to conventional mutual funds.

B. Position of Staff and of Non-Principal Regulators

[20] Staff's position was that the Managers should bear the costs of the Merger. Staff submitted that the poor performance of the Funds and the losses sustained by investors create circumstances in which it would be particularly unfair to compound the investors' losses with costs associated with the Merger.

[21] Staff further submitted that the Applicants had not provided any compelling reason to justify a departure from the apportionment of risk and resulting costs as between investors and fund Managers, nor from the accepted practice as set out in the 1995 Staff Notice: Issues Arising out of Mutual Fund Mergers and Similar Reorganizations.

[22] Staff of the Commission advised staff of the non-principal jurisdictions of its recommendation to the Director, including its position that the Funds should not bear the costs of the Merger.

[23] Staff of each of the non-principal jurisdictions is in agreement with the recommendations of Staff of the Commission, including that the Managers should bear the costs of the Merger, as accepted by the Director in her decision. Staff of the non-principal jurisdictions is awaiting the outcome of this hearing and review prior to making their formal recommendations to their respective decision makers.

LAW AND POLICY CONSIDERATIONS

A. Hearing *de Novo*

[24] The Applicants have sought a hearing and review of the Director's decision pursuant to section 8 of the Act. Section 8 provides that the Commission may "confirm the decision under review or make such other decision as the Commission considers proper." The review of the Director's decision involves a hearing *de novo*. Hence, the Applicants do not have the onus of establishing that the Director made an error in her decision.

[25] Further, it is important to note that, when conducting a review of the Director's decision pursuant to section 8 of the Act, we are not bound in any way by the Director's determination. Accordingly, we are required to decide the substantive question without considering technical questions such as what, if any, deference should be given to the decision of the Director.

B. The Public Interest

[26] The purposes of the Act set out at section 1.1 are to provide protection to investors from unfair, improper or fraudulent practices and to foster fair and efficient capital markets and confidence in them (see *Pezim v. British Columbia (Superintendent of Brokers)*, [1994] S.C.J. No. 58 and *Committee for the equal Treatment of Asbestos Minority Shareholders v. Ontario (Securities Commission)*, [2001] 2 S.C.R. 132).

[27] The issue of imposing merger costs on the existing investors in the Funds engages an important objective of the Commission's mandate, namely to foster fair and efficient capital markets and confidence in them.

C. National Instrument 81-102

[28] National Instrument 81-102 governs mutual funds including LSIFs. Part 5 of NI 81-102 addresses fundamental changes, including mergers of mutual funds.

[29] The approval of the securities regulatory authority of a merger may be required under section 5.5 of NI 81-102, but is not required if the merger meets the requirements set out in section 5.6 of NI 81-102, including:

> …
>
> (h) the mutual funds participating in the transaction bear none of the costs and expenses associated with the transaction.
>
> …

D. Staff Notice: Issues Arising Out of Mutual Fund Mergers and Similar Reorganizations

[30] In 1995, Staff issued a notice to address issues arising out of mutual fund mergers and similar reorganizations. Staff pointed out that managers who propose to merge funds generally argue that

the costs to be charged are insignificant on a per unit basis and that unitholders of the Terminating Fund will benefit from the proposed merger and accordingly should bear the costs. In respect of merger costs, Staff expressed the view that "it is generally inappropriate for any costs to be charged either to the Terminating Fund or to the Continuing Fund."

[31] Staff also suggested that managers benefit from fund mergers:

> A primary reason that mutual fund managers merge funds is to reduce the number of funds with similar investment objectives to be managed, thereby decreasing the manager's costs of managing these funds. Managers still wish to retain the assets under administration and accordingly choose to merge mutual funds rather than choosing to wind up the Terminating Fund. Hence, it is the manager's decision to merge the funds and the manager arguably benefits from the merger at least as much as the unitholders, the costs of the merger are, in staff's view, more properly borne by the manager as opposed to the unitholders.

E. Mutual Funds Report

[32] In addition to the policy considerations arising out of the National Instrument and the aforementioned Staff Notice, Staff submitted that it was important to revisit some of the principles underlying the relationship between Managers and investors. Staff referred the panel to a 1969 provincial and federal study entitled "Report of the Canadian Committee on Mutual Funds and Investment Contracts" (the "Mutual Funds Report"). The authors of this report observed:

> We view the mutual fund investor as a person who wishes to delegate the management of his money, and we think that those who consider the question at all would see the delegation as being to the management company. This is, in our view, true not only of the mutual funds organized by brokerage firms and trust companies to which we refer in paragraph 6.02, but also of mutual funds organized in the manner of the Commonwealth funds. As a practical matter, and regardless of the legal forms used, mutual funds rarely, if ever, function as entities separate from their management companies.

[33] The authors also observed that the only risk investors in funds accept is investment risk, that is the risk of losing money as a result of market decline:

> If a mutual fund investor considered the risks he was prepared to accept in his investment, the only one he would consciously accept would be that his money might be partially or wholly lost as a result of a market decline or of investment decisions which turn out to be mistaken although made in good faith.

ANALYSIS

[34] The request that Merger costs be borne by the Funds is unusual in such circumstances. It appears that since the Staff Notice in 1995, all mergers of mutual funds (including LSIFs) in the same fund family with the same or affiliated managers have been completed on the basis of the manager bearing the costs of the merger.

[35] We are mindful that investors in each of the Funds have suffered investment losses.

[36] We recognize that the Funds have serious problems, all of which predate the provincial announcements. Each of the Funds lack liquidity; all have lost money since their inception; most are experiencing difficulty raising capital; two Funds are out of distribution; and one Fund's poor investment performance dates back to the crash of the "tech bubble". The Applicants acknowledged that merger discussions began 18 months ago to address the challenges facing the Funds and the LSIF industry in general. We accepted that the poor performance of the Funds appears to be the main driver of the Merger and the recently announced provincial government policy change has only exacerbated the situation going forward.

[37] Staff argued that the "investor bargain" between fund investors and Managers is based on the investors only accepting investment risk with all business risks to be borne by the Managers. Staff also argued that the Managers are well compensated by management fees for bearing these business risks and that the Merger costs are a business risk. Staff submitted that, in this particular case, as part of the investor bargain, investors have been paying management fees since the inception of the Funds, and in the past year paid more than $5.5 million, on the understanding that the Managers would assume business costs. We found it difficult to fully accept this argument given the realities of the fee structure of the Funds. In addition to paying management fees to the Managers, the Funds pay other administrative and marketing expenses. However, considering all factors, we believe it is in the public interest for a manager, generally, to bear the costs of a merger of funds.

[38] The Managers argued that the Staff Notice is not relevant to the case before us because LSIFs are different from mutual funds, specifically with regards to the nature of their investments and their liquidity requirements. The Funds primarily invest in venture companies with a 5-7 year investment horizon. As a result of their poor performance and now the proposed removal of certain investor tax incentives, LSIFs' ability to raise new capital has been seriously curtailed. The Applicants also highlighted the fact that Fund investors are essentially "locked-in" because of the adverse tax consequences of selling their Fund units prior the required minimum 8 year investment period. Consequently, because of the nature of the investments and the potentially negative tax impacts on Fund investors, wind-up of the Funds is not a viable option.

[39] We accepted that wind-up of the Funds is not a viable option and that the Merger would confer benefits on the Fund investors through the pooling of "pacing credit" and the elimination of some duplicative costs. We also concluded that the Managers would realize some indeterminate benefits resulting from the Merger, primarily related to having a larger critical mass of assets under

management in one consolidated fund and potential avoidance of reputational harm. However, we were not convinced that the liquidity requirements of an LSIF are substantially greater than that of a mutual fund based on the facts presented, or that if we accept that the liquidity requirements are greater, that fact should make a difference in our decision.

[40] The Applicants argued that the corporate governance structure of the Funds differentiated it from that of mutual funds and addresses any conflict of interest concerns. We were informed that each Fund is a corporation with a board of directors composed of 3 representatives of the sponsoring union, 1 "independent" and 3 nominees of the Manager. However, the sponsoring union holds shares that enable it to elect the majority of the directors. The sponsoring union receives sponsorship fees equal to 25 basis points of the Funds assets under management. Accordingly, its economic interest is aligned with that of the Managers. While the Boards have the power to negotiate with and dismiss the Managers, we were told it was highly unlikely the Managers would ever be terminated.

[41] We were told that the Boards of the Funds had decided to proceed with the Merger and sought to have the Funds pay the associated costs as they believed this would be in the best interests of the investors. The Managers argued that if the Commission upholds the Director's decision on merger costs, it will undercut the authority of the Boards in that the Commission will be second guessing their decision. However, the letter from Gowlings to the OSC dated September 14, 2005, indicated that the Boards believed, at the time they made their decision, that the Merger would not proceed unless the Funds paid for the Merger costs. We were advised, however, that the Merger would proceed whether or not the Director's decision on costs was overturned. On this basis, we concluded that the Boards would not have determined it was in the best interests of their investors to pay the Merger costs had they known the Merger would proceed with the costs being borne by the Managers.

[42] We accepted Staff's position that the Commission's public interest mandate is broader than the mandate of boards of directors, and is driven not only by investor protection but by an oversight responsibility for the entire fund industry. However, we did consider what deference, if any, should be given generally to boards of directors and investment review committees on matters of this type. In this particular fact situation, we determined that we would not give any deference to the Boards' decision.

[43] The Applicants have not convinced us that we should depart from the approach that, generally, costs of a merger will not be borne by investors.

[44] The Funds experienced negative returns since their inception. The investors' investments are locked-in in substance. Wind-up of the Funds is not an option. The Managers are receiving exemptive relief which will significantly reduce the expected merger costs. The Managers will receive fees from the Continuing Fund. For all these considerations, we were not prepared to disagree with the Director's decision.

Dated at Toronto this 13th day of December, 2005.

"Paul M. Moore "

Paul M. Moore

"Suresh Thakrar"

Suresh Thakrar

"Carol S. Perry"

Carol S. Perry