



April 29, 2004

Prime Minister Paul Martin  
Office of the Prime Minister  
80 Wellington Street  
Ottawa, ON  
K1A 0A2

The Honourable Ralph Goodale, P.C., M.P.  
Minister of Finance  
Department of Finance  
East Tower  
140 O'Connor Street  
Ottawa, ON  
K1A 0A6

Dear Sirs:

Re: Proposed Restrictions on Pension Fund Investment in Income Funds

In our letter of March 31, 2004, we expressed our general support for many of the recent initiatives of the Government of Canada designed to promote the development of a strong venture capital industry in Canada. We continue to support those policies.

However, it has now become apparent to us that certain other policy initiatives, designed for other purposes, will have an unintended but significant negative impact on our industry. Specifically, we are writing to express the concerns of the private equity community regarding the proposed limitations on the direct and indirect investment by certain tax-exempt entities in business income trusts, as set out in the Federal Budget of March 2004 (the "Income Fund Proposals").

Canada's Venture Capital and Private Equity Association ("CVCA") represents investors in various sectors including venture capital, mezzanine, buyout and other similar investment funds, as well as funds-of-funds, which are larger pools of capital formed to invest in these various asset classes. We refer to all of these collectively as "private equity".

#### *Summary*

The CVCA is concerned that the Income Fund Proposals will cause severe and irreparable harm to the Canadian private equity industry. The CVCA believes that the Income Fund Proposals, if enacted in the form proposed, will:

- Materially reduce and restrict investment in the private equity industry by Canadian pension funds;

- Create a significant competitive advantage for non-Canadian investors over Canadian investors in private investments made in Canadian businesses; and
- Create a smaller, less developed, and less active private equity market in Canada thus significantly reducing the amount of capital invested in emerging and established Canadian companies.

The CVCA recommends that the Income Fund Proposals should not be implemented in their current form. We suggest that a task force of affected stakeholders should be formed, including representatives from the CVCA, pension funds, Governments and others, to study the concerns of all sides, analyze the issues that require attention, and develop solutions to address them over the next few months.

### *Private Equity Investment*

Private equity investment is one of the financial foundations of the Canadian economy. It is a broad category of risk capital investments, encompassing professionally managed funds, or fund groups, targeting one or more subcategories of the private markets, such as venture capital investments in early-stage growth companies, mezzanine investments in larger private companies across all industrial sectors, buyout investments of private companies or in divisions of larger companies, as well as funds-of-funds, which are larger pools of capital formed to invest in these various asset classes. A healthy and growing private equity market demonstrably creates economic growth and employment across broad sectors of the economy.

Professionally managed private equity investment funds generally source their capital from larger institutional investors, including significant amounts from Canadian pension funds. While the Canadian private equity community has grown substantially in recent years, it remains underdeveloped. In fact, the total amount of capital invested in private equity in Canada is only 50% of comparable investment levels in the U.S. market (as a percentage of GDP or Domestic Public Market Capitalization).

For the past several years, the CVCA has worked diligently to grow the Canadian private equity market through a number of initiatives designed to persuade the Canadian pension fund community to increase its participation in this asset class to a level approaching its U.S. counterpart, including many specific initiatives which have been directly supported by the Government of Canada. Despite all of our combined work, Canadian pension funds remain significantly under represented as investors in the Canadian private equity industry relative to their U.S. counterparts: Canadian pension funds allocate more than 30% less than U.S. pension funds to private equity (when measured as a percentage of total assets). This is a significant concern that has been recognized by Governments across Canada. A recent federal/provincial task force has interviewed almost 100 pension funds in Canada and the U.S. to determine the reasons for the different allocations by Canadian pension funds and the report of this group is expected shortly. Clearly, we must be encouraging the pension funds to invest in private equity, not discouraging them.

There is a direct relationship between the market for private equity generally, and the specific market for venture capital. We understand that the Government of Canada has supported the growth and development of the venture capital industry, and recognizes its importance to economic growth. We therefore want to ensure that the specific impact of the Income Fund Proposals on the venture capital market is well understood, and does not lead to accidental damage to a fragile financial sector. As indicated above, many important sources of venture capital, including pension funds and funds-of-funds, make their investment allocations first to the general private equity sector and then sub-allocate these overall allocations to individual sub-sectors (venture capital, mezzanine, buyout, etc.). Therefore, any reduction to one sub-sector will, out of the necessity to maintain appropriate investment allocations across all sub-sectors (and appropriate ratios between each sub-sector), directly lead to a reduction of investment

in all sub-sectors, including venture capital. Further, for those pension funds that do not currently invest in the private equity asset class, a new deterrent such as the Income Fund Proposals will represent a new barrier to their participation, and to the growth of the private equity and venture capital markets.

*First CVCA Concern: Shrinking the Private Equity Market*

As currently drafted, the Income Fund Proposals will limit the investment by Canadian pension plans, as well as the Canada Pension Plan Investment Board (“CPPIB”), in “restricted investment property”. Restricted investment property is broadly defined to include an interest in a partnership where more than 1% of the cost amount of the partnership’s property is represented by units of one or more business income trusts. In this situation the entire partnership interest is considered to be restricted investment property. Additional look-through rules could extend the definition of restricted investment property to an interest in a partnership which holds only a nominal indirect interest in a business income trust through other flow-through entities over which the partnership has no control.

Although Canadian private equity funds (which are almost always structured as partnerships) generally do not directly invest in units of business income trusts, it is not uncommon for a fund to acquire business income trust units on the disposition of a particular investment held by the fund. Many initial public offerings (“IPOs”) of successful corporations are structured as the sale of shares (directly or indirectly) to a business income trust in consideration for cash and trust units. In many cases, the private equity fund must continue to hold the publicly traded trust units for an extended period, both as a result of applicable securities regulatory requirements and by contractual commitments which prohibit selling until sufficient public market liquidity can absorb a sale of the units.

As a result, we expect Canadian pension funds (including the CPPIB) to limit their investments in Canadian private equity funds, in order to reduce the risk that a holding of an interest in a private equity partnership will either use up the 1% permitted holding of restricted investment property or result in a monthly tax liability.

The first concern of the CVCA is that the Income Fund Proposals will reduce the amount of Canadian pension plan investment in Canadian private equity funds of all kinds, including venture capital funds. As a result, the private investment community in Canada will inevitably decline in size and sophistication. These Proposals will almost certainly have a severe negative impact on the long-term efforts of the CVCA and the Government of Canada to attract additional pension fund participation into these asset classes, and could negate all of the progress made to date.

*Second CVCA Concern: Discriminating Against Canadian Investors*

The second key concern of the CVCA is the unfairness and market distortion which will be caused by discriminating against Canadian funds. In recent years, many U.S. and other non-Canadian private equity funds have increased their level of investment in Canada. Typically, these funds do not have many investors from the Canadian pension fund sector who would be affected by the Income Fund Proposals.

If the Income Fund Proposals are implemented in their current form, we expect Canadian pension funds (including the CPPIB) to impose restrictions on the private equity funds in which they do invest, in order to prohibit such funds from holding any restricted investment property. In this circumstance, the affected private equity funds would lose the opportunity of an important liquidity channel – effectively “tying one hand behind their back” in managing their investments – while unaffected investors which are not subject to such restrictions would gain a corresponding, and seemingly arbitrary, market advantage. The result would clearly be a weaker Canadian private equity industry overall.

As a result of these general market characteristics, non-Canadian funds will be in a better position than Canadian funds to access the Canadian income fund market for liquidity opportunities, providing a significant advantage to non-Canadians seeking to invest in Canadian businesses. This cannot have been the intention of the Income Fund Proposals, and we therefore feel compelled to suggest that further analysis of the consequences of the Proposals is required before they are implemented, or any other action is taken.

*Recommendation: Further Analysis Is Required*

The CVCA recommends that the Income Fund Proposals should not be implemented in their current form. We suggest that a task force of affected stakeholders should be formed, including representatives from the CVCA, pension funds, Governments and others, to study the concerns of all sides, analyze the issues that require attention, and develop solutions to address them over the next few months.

We would be pleased to meet with appropriate representatives of the Department of Finance to discuss our proposal. We will call you in the next few days to discuss our concerns. In the meantime, if you have any questions, please don't hesitate to contact the undersigned at (604) 891-3260 or Sam Duboc, Senior Vice President (416) 860-3760.

Yours truly,



Robin J. Louis  
President  
Canada's Venture Capital & Private Equity Association

cc: Tim Murphy  
Chief of Staff  
Office of the Prime Minister

Patrick Tobin  
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Department of Finance

Martin Burns  
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