



Office of the Auditor General

500 - 330 Portage Avenue
Winnipeg, Manitoba R3C 0C4

May 2005

The Honourable George Hickes

Speaker of the House
Room 244, Legislative Building
Winnipeg, Manitoba
R3C 0V8

Dear Sir:

I have the honour to transmit herewith my report on the *Examination of the Crocus Investment Fund* to be laid before Members of the Legislative Assembly in accordance with the provisions of Sections 16(3) and 28 of The Auditor General Act.

Respectfully submitted,

Jon W. Singleton, CA•CISA
Auditor General

TABLE OF CONTENTS

REFLECTIONS OF THE AUDITOR GENERAL	1
1.0 EXECUTIVE SUMMARY	3
2.0 INTRODUCTION	14
2.1 Initiation of the Examination	14
2.2 Limited Review Summary	14
2.3 Expansion of Examination	14
2.4 Objectives, Scope and Approach	15
3.0 GENERAL BACKGROUND	17
3.1 Venture Capital and Labour-Sponsored Investment Funds (LSIFs)	17
3.2 Crocus Investment Fund	18
3.2.1 Nature of Operations	18
3.2.2 Subsidiaries	20
3.2.3 Shareholders	21
3.3 The Canadian Securities Industry	23
3.4 Industry, Economic Development and Mines	24
4.0 DETAILED OBSERVATIONS AND CONCLUSIONS	26
4.1 Events Leading up to December 10, 2004	26
4.2 Investment Management Processes and Procedures	29
4.2.1 Summary of Investments Reviewed	29
4.2.2 Overview	30
4.2.3 Investment Strategy	32
4.2.4 Portfolio Construction	38
4.2.5 Staffing Adequacy	40
4.2.6 Initial Screening and Selectivity	42
4.2.7 Due Diligence	43
4.2.8 Investment Approvals	45
4.2.9 Initial and Follow-on Financings	47
4.2.10 Documentation and the Use of Puts	48
4.2.11 Account Management and Monitoring	48
4.2.12 Valuation	53
4.2.13 Internal Reporting within the Fund	61
4.2.14 Exiting	63

TABLE OF CONTENTS (cont'd.)

4.3	Crocus Operations	64
4.3.1	Financial Results	64
4.3.2	Share Pricing	68
4.3.3	Liquidity, Cash Flow, and the Solidarity Transaction	72
4.3.4	Employee Travel and Other Expenses	80
4.3.5	Recovery of Costs from Portfolio Companies	84
4.3.6	Management Expense Ratio	87
4.3.7	Cash Receipt and Payment Processes	90
4.3.8	Executive Compensation	91
4.3.9	Director Fees from Portfolio Companies	93
4.3.10	Income from Portfolio Companies	94
4.3.11	Conflict of Interest and Interwoven Roles of Individuals	97
4.3.12	Donations	100
4.3.13	Other CIF Initiatives	100
4.3.14	External Reporting	103
4.4	Board Governance	107
4.5	Compliance with The Crocus Investment Fund Act and By-Laws	115
4.5.1	Use of Capital from the Sale of Common Shares	119
4.5.2	Liquid Reserve Requirements	121
4.5.3	Investment in Qualified Manitoba Business Entities	123
4.5.4	The Size of Investments in Any One Entity	125
4.5.5	Eligibility of Investments	128
4.5.6	Maintenance, Pacing, and Small Business Investing Requirements	129
4.5.7	Limit on Common Share Sales	130
4.5.8	Policy Considerations Regarding Investments	132
4.5.9	Investments in Early Stage and Turnaround Entities	134
4.6	CIF and The Public Sector	135
4.6.1	The Vision and Business Plan	135
4.6.2	Infrastructure for Sub-Fund Development and Fund Initiatives	137
4.6.3	Sub-Fund Initiatives	138
4.6.4	The SuperFund Concept	139
4.6.5	The Manitoba Local Investment Council (LIC)	140
4.7	Monitoring by Industry, Economic Development and Mines	143
4.7.1	IEDM Had Many Roles: Monitoring was not Sufficiently Emphasized	143
4.7.2	Indications that More Intrusive Actions Were in Order	144
4.7.3	Monitoring by IEDM is Focused on Investment Placement and Share Sale Limits	146
4.7.4	Eligibility of Investments Not Assessed by the Department	148
4.7.5	Department Misinterpreted the Legislated Pacing Timeframe ..	150
4.7.6	Information Supporting the Returns Not Audited or Otherwise Reviewed	151

TABLE OF CONTENTS (cont'd.)

4.7.7	It Should be Clear How the “Spirit of the Act” is Met in Those Instances Where the Minister Deems an Investment Eligible ...	152
4.7.8	The Need to Monitor Compliance with the Requirements of The Crocus Investment Fund Act	152
4.8	Monitoring by the Manitoba Securities Commission	153
4.8.1	Review of CIF’s 2004 Prospectuses (January 2004 & October 2004 Amendment) Focused on Changes from Earlier Documents	154
4.8.2	Required Financial Information was Monitored for Timely Receipt and Compliance with GAAP	157
4.8.3	Compliance Review of Crocus Capital Inc. in December 2000 was Well Performed	157
4.8.4	The 2003 and 2004 Continuous Disclosure Reviews	159
4.8.5	Advertising Only Reviewed if Complaints are Received	163
5.0	RECOMMENDATIONS	164
5.1	For the Deputy Attorney General and the Manitoba Securities Commission	164
	<i>Response from the Deputy Attorney General</i>	<i>166</i>
	<i>Response from the Manitoba Securities Commission</i>	<i>167</i>
5.2	For the Province of Manitoba	168
	<i>Response from the Province</i>	<i>168</i>
5.3	For the Crocus Investment Fund	170
5.4	For Industry, Economic Development & Mines	182
	<i>Response from the Department</i>	<i>183</i>
5.5	For the Manitoba Securities Commission	186
	<i>Response from Manitoba Securities Commission</i>	<i>186</i>
6.0	GENERAL OBSERVATIONS	188
APPENDICES		
A.	Glossary of Terms and Acronyms	
B.	The Crocus Investment Fund Act	
C.	Employee Expense and Travel Policy	
D.	Draft Conflict of Interest Policy	
E.	Pension and Perquisite Policy	
F.	Announcement of \$10 Million Solidarity Transaction	
G.	Sections of The Income Tax Act (Manitoba) Related to the Pacing Requirements of a Labour-Sponsored Fund	
H.	Inter-jurisdictional Comparison of Legislation	
I.	Summary of Requirements for Calculation of Net Asset Value	

Investors in the Crocus Investment Fund (CIF or “the Fund”) were informed, between September 2004 and April 2005 that the value of their Fund’s investment portfolio assets declined by \$61.1 million or 47.8%.

Many asked: How could this have happened?

In my opinion:

- *This is an unfortunate example of what can happen when you have a Board of Directors that lacked appropriate oversight and governance. The Board of Directors and Senior Officers, namely the former Chief Executive Officer, the former Chief Investment Officer, and the Chief Financial Officer, failed to fulfill their responsibilities to CIF. This may have contributed to the production of misleading financial statements, prospectuses, and overstated share price valuations.*
- *The carrying value of the Fund’s venture investment portfolio as at August 31, 2004 (and accordingly, the Fund’s net asset value per share [NAVPS]) appears to have been overstated. Further, it is likely that the portfolio was overstated at earlier dates, based on specific observations in Section 4.2 of this report (primarily the “Account Management and Monitoring” and “Valuation” sections). Accordingly, past monthly, quarterly and annual reporting disclosures including the Fund’s consolidated statements of net assets, NAVPS, deficit and operations for the last year at a minimum, appear to have been significantly misstated.*

This report provides information on the factors that contributed to the need for the Board and Senior Officers of the Fund to request the Manitoba Securities Commission (MSC) to halt the sale and redemption of CIF shares on December 10, 2004. Although our examination did not explore in depth all of the issues facing CIF, I believe that the level of examination provides observations, conclusions and recommendations that will provide the reader with an understanding of the serious consequences of the Fund’s weaknesses in operations and governance.

During the course of our review, we noted several problems that should have alerted the Fund’s Board, as well as the government officials responsible for monitoring the Fund, that a deeper review of the Fund’s operations was warranted. Yet, insufficient attention was given to identifying, communicating, and addressing these problems.

As always, when we encounter an unfortunate circumstance, we try to identify opportunities to learn from the events and provide constructive recommendations that could help prevent similar situations in the future. As a result, my report should not be read as an indictment of venture capital investing or of Labour-Sponsored Investment Funds (LSIFs). Rather, it should be read with a view to identifying opportunities to improve LSIF governance, and as a source of reference for improving the LSIF legislative framework in Manitoba.

It is important to acknowledge at the same time, that the Fund has had some success stories, and has contributed to job creation and the retention of investment capital in the province.



It is also important to note that CIF, through The Crocus Investment Fund Act, was given the privilege to issue tax credits to investors. Tax credit issuance replaces the receipt of taxation revenue by the Province from citizens. Therefore, the granting of the right to operate an LSIF brings with it the added responsibility on the part of directors and senior management to ensure that it operates openly, transparently, in compliance with its Act, and with due regard for the prudent use of monies raised from shareholders. This responsibility is amplified by the fact that LSIFs set their share price themselves. This accountability extends to the citizenry of Manitoba who in turn benefit from knowledgeable venture capital investing in the Province of Manitoba.

The Manitoba Federation of Labour (MFL), under The Crocus Investment Fund Act, is able to appoint the majority of the Board of Directors. With this control, there rests a responsibility to all stakeholders to ensure that the organization is effectively governed.

We understood from the outset that our review of CIF would be a challenging undertaking and assigned a significant portion of our resources to this examination over the past three months. I wish to thank the staff of the Fund and the Special Advisor to the Board who assisted our review during a time of upheaval and uncertainty at the Fund. I also wish to take this opportunity to acknowledge the extensive efforts of my staff who worked diligently and were committed to ensure that an independent and objective report could be provided to the Members of the Legislative Assembly on a timely basis.



Jon W. Singleton, CA•CISA

1.0 Executive Summary

This report sets out several contributing factors that resulted in the Fund's need to record a sudden decline in investment portfolio value:

- Based on our examination, the Fund did not have in place the necessary leadership, the necessary structure, the necessary culture, and the necessary processes to handle the planning, growth and monitoring of the investment portfolio. Further, we believe that:
 - The important issues were not addressed;
 - The appropriate information was not being produced;
 - The appropriate resources were not in place; and
 - When problems were identified, the Fund did not have the appropriate follow-through.
- Adequate investment management policies, processes and procedures were not established for governing and managing activities in the Investment Department. The Board of Directors should have ensured that such protocols were in place and should have actively monitored Senior Officers' performance. At a minimum, the Board of Directors should have ensured that policies and procedures were in place in the areas where they had previously expressed concerns. For example, the Board of Directors requested a report on the lessons learned from the write-off of a particular portfolio investment in 2001, and received the completed report in June 2002. The report highlighted key process deficiencies in the Investment Department; however, the Board of Directors did not follow-through to ensure that these deficiencies were fully addressed.
- It should be noted that between September 30, 1999 and September 30, 2004 (after including only \$15.3 million of the \$61.1 million valuation adjustment), CIF's share price declined from \$14.62 to \$10.61. Surprisingly, this decline was not due to any additional significant write-down in the overall venture investment portfolio, but can be attributable to the following:
 - Annual operating expenses exceeding annual operating revenues during that period; and
 - An increase in outstanding shares, with share sale proceeds partially being used to cover operating losses, realized investment losses, and share redemptions.
- By not managing, nor addressing its operating losses (otherwise known as a run-rate gap) on a timely basis, CIF was heading for financial difficulties and non-compliance with its legislated liquidity requirements. These liquidity concerns necessitated the Solidarity transaction (**Section 4.3.3**). Further, CIF incurred considerable discretionary expenses associated with investment monitoring. We noted significant abuse of CIF's Expense and Travel Policy as described in **Section 4.3.4**.
- We acknowledge that CIF has tried to serve two masters through much of its history. One objective, as set forth in the latest prospectus, was the Fund's primary objective of achieving long term capital appreciation in the value of its investments. The other was the balance of the "multiple bottom lines" referred to in the Fund's 2004 Business Plan - economically-targeted investment (ETI) and socially-responsible investing (SRI).

- We note as well, that the monitoring activities of Manitoba Industry, Economic Development and Mines (IEDM) and the Manitoba Securities Commission (MSC) were not designed to prevent or detect issues regarding portfolio investment valuations.

In addition we noted the following:

- The Board did not operate as effectively as was necessary given the operational and financial risks associated with the governance of an LSIF.
- The Fund misled investors in a significant way by failing to properly disclose and publicly communicate the essence of the Solidarity transaction.
- Based on our review of specific investments, it appears that CIF did not operate in compliance with respect to certain sections of The Crocus Investment Fund Act.

CIF HALTS TRADING

In **Section 4.1**, we describe the events leading up to CIF's halt in trading on December 10, 2004. On December 10, 2004, CIF approached the MSC and requested and received regulatory approval to suspend redemptions and to halt sales of its shares pending a comprehensive assessment of the value of its portfolio using external valuation consultants.

Board members expressed surprise in September 2004 when informed of the need for a significant write-down in the value of the portfolio, and were further surprised in November 2004 when told of the need for a further significant write-down.

One sign of trouble that the Board clearly missed was that the gradual decline in share price over the last several years took place while the valuation of the portfolio remained relatively constant. What should have been recognized was that funds raised through the selling of shares were being used to cover operating losses, realized losses on investments, and share redemptions, a situation that exposes any fund to greater risks.

Prior to December 10, 2004, considerable Senior Officer and Board effort was spent dealing with the Fund's liquidity issues and pursuing the creation of sub-funds and other CIF initiatives. In order to address the liquidity issue facing CIF an arrangement was made in 2002 for \$10 million to be received from Fonds de Solidarité FTQ (Solidarity) a Quebec-based Labour-Sponsored Investment Fund. Meanwhile, the quality of the Fund's investment portfolio was deteriorating with little evidence that the Board of Directors was aware of the situation.

LIMITED EXAMINATION

On December 16, 2004, after receiving a number of requests from citizens, the Office of the Auditor General (OAG) advised CIF that the OAG would be conducting a limited examination.

In early January 2005, the OAG contracted with a Toronto-based, external consultant knowledgeable of Labour-Sponsored Investment Funds (LSIFs) and venture capital investing.

After a preliminary review of a number of CIF investments, initial discussions with current and previous CIF employees, and meetings with representatives from IEDM and the MSC, we identified concerns related to governance, investment processes and procedures, fund management, and a number of CIF operational issues. It became apparent that a broader examination should be conducted in order to provide Members of the Legislative Assembly and the citizens of Manitoba with an understanding of the factors contributing to the December 10th halt of trading of Fund shares.

EXPANDED EXAMINATION

Based on observations early in our limited examination, we communicated to CIF on February 7, 2005 our intention to expand the scope of this examination to address objectives within the following areas:

- Board Governance;
- Management of the investment portfolio and general operations;
- Compliance with The Crocus Investment Fund Act; and
- Compliance with The Securities Act.

The expanded examination addressed objectives mainly within the time period October 1, 2000 to September 30, 2004. The timeframe covered within this period varied dependent on the issue reviewed.

CIF's initial reaction to our decision to expand the scope of our work was that they planned to make an Application to the Court of Queen's Bench for an interpretation of the extent of our right to examine the Fund. However, after we advised CIF that we had been formally requested by the Minister of Finance and the Minister of IEDM to conduct this work, CIF subsequently withdrew this position and our expanded examination commenced on February 16, 2005.

Our expanded examination was conducted from February 2005 to April 2005 and consisted of such examinations and procedures that we determined were necessary to address the objectives, as well as any other issues that arose during the course of this examination. Our work was performed at a level sufficient to support the conclusions and recommendations contained in this report.

We are concluding our examination with a number of questions around particular CIF investment transactions and CIF operations still outstanding. We believed that it was necessary to conclude and report in a timely manner in order for the Legislative Assembly and the citizens of Manitoba to gain an understanding of what contributed to the halt of sale and redemption of CIF shares on December 10, 2004.

Through our recommendations, we have suggested that a more in-depth review of certain issues and transactions may be warranted.

CONCLUSIONS

The following table provides a synopsis of the areas examined and key conclusions. More detailed conclusions are contained within the body of the report.

Portfolio company names are not used in this report. Companies were given alpha references that are used for the same company consistently in the report. CIF's Board and Senior Officers were provided with detailed information for all alpha references.

Objective	Report Section	Conclusions
To understand the chronology of events leading up to December 10, 2004	Events Leading Up to December 10, 2004 Section 4.1	- It appears that the CIF Board was surprised about the September 30, 2004 write-down to CIF's investment portfolio, and were subsequently surprised about the potential for an additional reduction of value in the investment portfolio brought to their attention in November, 2004. It is never a good sign when a Board is surprised by an event of this magnitude. It is possible that had access to the Board by staff been encouraged, issues that are highlighted further in this report may have been brought to their attention sooner. - Members of the Executive and Personnel Committee of the Board may have acted inappropriately when they discussed the potential sign-off of the draft 2005 prospectus by the former COO at an amount potentially higher than a realistic valuation.
To assess the effectiveness of the governance processes and practices of the Fund's Board of Directors	Board Governance Section 4.4	The Board did not operate as effectively as was necessary given the operational and financial risks associated with the governance of an LSIF. - The Board did not provide sufficient control and oversight of the Fund and did not hold Senior Officers sufficiently accountable for the Fund's operations and performance. - The quality of the investment and financial information provided to the Board did not facilitate the Board's ability to assess the Fund's operational and management performance. - The Board lacked the necessary knowledge and expertise to fully scrutinize and critique the completeness and quality of the investment and financial information provided to them. - The Board's adoption of a Sub-Committee structure and decision to lessen the frequency of full Board meetings served to relegate the role of Board meetings to a minimal discussion of Committee items. Full Board meetings became little more than a 'rubber-stamp' for the Committee decisions. - Significant governance improvements are required in order to ensure the Fund's Board more effectively fulfills its role and responsibilities as a mechanism of corporate accountability and to ensure that the Board, its Sub-Committees, and the Investment Advisory Committee, are operating consistent with that described in CIF's prospectus.
To assess the effectiveness of the investment management processes and procedures used in CIF	Investment Management Processes and Procedures Section 4.2	Many areas of CIF's investment management processes and procedures were either weak or deficient. Our overall conclusions are as follows: The carrying value of the Fund's venture investment portfolio as at August 31, 2004 (and accordingly, the Fund's NAVPS) appears to have been overstated by up to approximately \$61.1 million or 47.8%. Further, it is likely that the portfolio was overstated at earlier dates, based on specific findings in other areas of Section 4.2 (primarily the "Account Management and Monitoring" and "Valuation" sections). Accordingly, past monthly, quarterly and annual reporting disclosures including the Fund's consolidated statements of net assets, NAVPS, deficit, and operations for the last year at a minimum, appear to have been significantly misstated.

Objective	Report Section	Conclusions
		• In spite of the general downward trend in LSIF performance in Canada, the need for two large one-time write-downs of the carrying value of an LSIF's investment portfolio is a highly unusual matter at this point in time. It certainly would not be classified as the result of good investment management, and strongly suggests that certain write-downs of individual portfolio companies in CIF's venture investment portfolio should have been made much earlier and perhaps in prior fiscal periods. • The large overstatements of CIF's venture investment portfolio and NAVPS both as at August 31 and September 30, 2004 indicate to us that the investment strategy and investment management processes and procedures had been wrong and had gone wrong. • Adequate investment management policies, processes and procedures were not established for governing and managing activities in the Investment Department. The Board should have ensured that such protocols were in place and should have actively monitored Senior Officers' performance. At a minimum, the Board should have ensured that policies and procedures were in place in the areas where they had previously expressed concerns. For example, the Board requested a report on the lessons learned from the failure of Company GG in 2001, and received the completed Company GG report in June 2002. It highlighted key process deficiencies in the Investment Department; however, the Board did not follow-through to ensure that these deficiencies were addressed. • Responsibility for all of the foregoing resided with the Board of Directors and Senior Officers, namely the former CEO, the former CIO and the CFO. Ultimately, the Fund did not have the appropriate governance and the Board of Directors and Senior Officers did not fulfill their responsibilities to the Fund. • Based on our review of specific investments, it appears that CIF did not operate in compliance with respect to certain sub-sections within Section 15 of The Crocus Investment Fund Act regarding valuation practises. <i>This Section identifies a number of concerns regarding the investment management processes and procedures within CIF in the areas of investment strategy, portfolio construction, staffing adequacy, initial screening and selectivity of investments, due diligence, investment approvals, initial and follow-on financings, documentation, account management and monitoring, valuation, internal reporting within the Fund, and exiting. Our conclusions in these specific areas are contained in Section 4.2.</i>
To assess whether CIF had appropriate management and operating practices in place	Crocus Operations Section 4.3	Our work in Section 4.3 confirmed that CIF did not have, in all instances appropriate internal controls, documented policies and procedures, and appropriate expense management practices. A review of the financial results of CIF over the past six years led us to the following conclusions: • The decline in share value (price) over the last few years was not due to a significant downward valuation of the portfolio, but rather can be mainly attributed to realized losses on investments and operating losses, thus eroding shareholder value. Further, funds raised from new shareholders were needed to cover redemptions. The rising number of outstanding shares meant that net assets were being spread over more investors.

Objective	Report Section	Conclusions
		- By not managing, nor addressing its operating losses (otherwise known as a run-rate gap) on a timely basis, CIF was heading for financial difficulties and non-compliance with its legislated liquidity requirements. This in turn, necessitated the Solidarity transaction (Section 4.3.3). Insufficient attention was given to the fact that CIF was operating at a loss for the last four years. No significant constraints were placed on spending as discretionary spending continued (i.e., investment monitoring including travel and other expenses, donations, salary increases, and other CIF initiatives.) Extracts of some conclusions from Section 4.3 are as follows: - The Board should have commissioned a review of the weekly pricing as required under its prospectus and The Crocus Investment Fund Act. - The lack of appreciation of the significance of Board sign-off on weekly valuations exposed the Fund to considerable risk of misstating the weekly share price. Given the importance of the valuation processes on weekly share prices, the Board should have called for Valuation Sub-Committee meetings between April 20, 2004 and September 14, 2004. Further, given the significant impact of the overstatement of the investment portfolio as discussed in Section 4.2, it is highly likely that the Fund's NAVPS has been significantly overstated over the last year at a minimum. - The Board sign-off on the weekly share price added no assurance as to the accuracy and reliability of the weekly share price. Board members placed considerable reliance on CIF staff. - The Fund misled investors in a significant way by failing to properly disclose and publicly communicate the essence of the Solidarity transaction. This is an unacceptable practice. The "spin" provided by the press releases and the comments made by the former CEO and former CIO to shareholders regarding the investment from Solidarity helped to conceal the liquidity challenges confronting the Fund. The former CEO and former CIO painted the picture of a financially strong company – one that was able to attract a significant equity investment from a Quebec LSIF on the strength of the Fund's management team and investment portfolio. However, the actual nature of the transaction, as a loan, was not disclosed to shareholders or the public. - The audited September 30, 2003 financial statements significantly misrepresented the fundamental characteristics of the investment from Solidarity as an equity investment. This resulted in an understatement of liabilities and an overstatement of Shareholders' Equity on the Balance Sheet. In addition, the loss for the year ended September 2003 was understated by \$875,000 or 16%. Combined, these misrepresentations present a better financial picture of the Fund than actually existed. - The impact of incorrectly recording the Solidarity transaction in the annual financial statements for the year ended September 30, 2003 and the unfinalized draft statements for the year ended September 30, 2004, significantly contributed to the understatement of the Management Expense Ratio (MER), including that disclosed in the January 2004 prospectus. - The prospectuses issued by the Fund in 2003 and 2004 did not fully disclose all of the significant covenants of the Agreement between

Objective	Report Section	Conclusions
		Solidarity and the Fund. The transaction was misrepresented in the prospectuses as an equity investment while the fundamental characteristics were those of a liability. Because of these factors, a reader of the prospectuses would not have been able to adequately assess the risk of investing in the shares of the Fund. - Many expenses of the former CIO were extravagant and inappropriate given the responsibilities associated with managing an Investment Department. With a significant amount of these expenses being charged back to portfolio companies, both the companies and ultimately the shareholders funded the former CIO's extensive travel to international destinations. - The past management of CIF's debt portfolio (funds provided to portfolio companies in the form of debt instruments), including documentation, had been deficient. The collection of interest income had been inconsistent. The creation of new debt instruments, when previous debt instruments matured, may have been used to defer the recognition of the debt as uncollectible. The current CIO has improved this situation and the write-down of some of this debt has now been taken. - Interwoven relationships can be advantageous to the portfolio companies within a venture investment fund. However, conflict of interest situations can develop because what is in the best interest of a fund may not always be in the best interest of the portfolio companies and their principals. Such "off the books" transactions as the \$5,000 credit and the vehicle benefit do not demonstrate appropriate business practices, and significantly increases an organization's risk of abuse. Even if the amounts are not significant, we are concerned with the corporate ethics of such "off the books" transactions. Shareholders and others have no way of knowing whether or not it was in their best interests, nor the total amount of Fund income that was forfeited.
To assess whether Crocus operated in accordance with The Crocus Investment Fund Act and By-laws	Compliance With The Crocus Investment Fund Act and By-laws Section 4.5	Our work in this section highlighted a number of circumstances where CIF appears to have acted in non-compliance with The Crocus Investment Fund Act (formerly The Manitoba Employee Ownership Fund Corporation Act). Use of Capital From the Sale of Common Shares - The Fund did not adequately manage their cash requirements, including the divestiture of its investment portfolio, to ensure that adequate funds would be available to pay for the redemption of common shares as they came due. The Fund would have been required to use some portion of the capital raised from the sale of new shares to pay for share redemptions. This is not one of the Fund's stated uses of share capital. Because this results in less capital being available for investment, this practice, if it continues, jeopardizes the long term viability of the Fund. Liquid Reserve Requirements - The Fund has met the minimum liquid reserve requirements as set out in The Crocus Investment Fund Act. However, without the additional capital obtained from Solidarity and invested by the Fund in marketable securities, the Fund may have fallen below its minimum reserve requirements. If the Fund had failed to meet its minimum reserve requirements for more than 60 days, it would have risked losing its tax credit status.

Objective	Report Section	Conclusions
		- The inclusion in the Regulation of a proposed investment in Smart Park as an allowable liquid reserve investment would have allowed Fund management to circumvent liquidity controls, the Fund's normal due diligence processes and Board approval controls. In addition, this transaction would not have been clearly disclosed to shareholders and the public. - While the Fund did not proceed with this investment in Smart Park, in amending the Regulation, the government should have ensured shareholder safeguards were maintained and that Fund management could not by-pass compliance provisions of The Act and Fund controls. This amendment weakened the safeguards provided to shareholders. Investment in Qualified Manitoba Business Entities - The Crocus Investment Fund Act is confusing with respect to the definition of qualified Manitoba business entity when read in conjunction with Section 3(2). This creates an undue risk of misinterpretation by those who use this Act. The Size of Investments in Any One Entity - At June 30, 2001, the Fund's investment in Company GG exceeded the 10% maximum allowable investment amount for a single investment as set out in The Manitoba Employee Ownership Fund Corporation Act. - Because of the amendments made to The Manitoba Employee Ownership Fund Corporation Act prior to the Fund's September 30, 2001 year end, the Fund was able to state that they were in compliance with the legislative requirement to not invest more than 10% of the fair value of their investment assets in any one business. By changing the basis for determining the maximum allowable investment limit from cost to fair market value, the government increased the risk exposure to investors. Fair market value is an estimate of value as determined by Fund management and as such, is subjective. Fair market value does not reflect the actual capital invested and at risk. - Changing from cost to fair market value for determining the maximum allowable investment has resulted in an investment exceeding the 10% limit on the basis of fair market value while the cost of the investment is significantly below the 10% limit. This change to The Act could penalize successful investments that have appreciated in value while allowing the Fund to continue to invest in businesses that have been written down. Under the current Act, the Fund could have continued to invest in Company GG, because of the write-down in the value of the investment. This does not serve the best interests of shareholders. Policy Considerations Regarding Investments - Socially Responsible Investing (SRI) reviews have had a positive impact on the investment decision-making process. However, there have been instances where the review process has been curtailed by the former CEO and the former CIO. Had these SRI reviews been completed, the results may have influenced the Board's decision to invest. - The Board did not fulfill their responsibility for investment valuations as set out in the Fund's By-laws.

Objective	Report Section	Conclusions
To gain a general understanding of the relationship between CIF and the Public Sector	CIF and the Public Sector Section 4.6	- The time and effort that CIF, most especially its former CEO, put into the sub-fund and Superfund concepts may have distracted them from paying proper attention to portfolio construction and investment management issues. - CIFs corporate development strategy (i.e., expanding into sub-fund development and education programs for pension trustees) may not be consistent with their current legislative framework. An IEDM 2001 internal communication indicated similar concerns. - The evolution of CIF's strategies and nature of investments into the management of sub-funds attributable with local institutional investing could have been handled in a separate fund. As an alternative to creating and funding sub-funds out of CIF, sub-funds could have been the result of launching a Crocus II Fund that would have been marketed using a separate prospectus. Crocus II could have sourced subscriptions from Manitobans and financial institutions (as co-investors) interested in supporting the unique investment strategies connected with each sub-fund including institutional investing. Separate funds may have been clearer to incumbent and prospective shareholders in terms of their understanding of the different investment strategies involved. This would have ensured that the strategies and nature of investments of the original CIF would have remained relatively consistent with their prospectus. - We believe that CIF's involvement in the Premier's Economic Advisory Council (PEAC), the Investment Task Group and the Local Investment Council was key to CIF's strategy to expand into development and management of funds in Manitoba.
To assess the monitoring of CIF by IEDM for compliance with The Crocus Investment Fund Act	Monitoring by Industry, Economic Development and Mines (IEDM) Section 4.7	- Overall, IEDM's roles as monitor, advisor, investment partner, Board representative and program advocate have conflicting priorities. IEDM may have placed themselves in a perceived conflict of interest situation by working with CIF in these varying roles. - The failure to develop a comprehensive monitoring approach and reluctance to use more intrusive actions in performing its monitoring role appears to have occurred because IEDM struggles with its conflicting roles. It sees itself first and foremost as an advocate for the LSIF initiative and only secondarily as compliance monitor. - We concur that IEDM is not responsible for CIF's performance. However, there were sufficient "red flags" to justify a detailed review in the latter part of 2002. While such a review may not have identified problems with CIF's valuations and investment performance, it is our view that such a review would have highlighted the gaps between CIF's management and investment practices and the legislated rules. The findings of such a review would have provided IEDM with the support to put CIF on notice that it needed to manage its operations in a manner consistent with its legislation. - The Minister responsible for IEDM did not ensure that the issue regarding the interpretation of "asset value" for the purposes of determining a 'qualified Manitoba business', an issue that has been in dispute throughout our period of review, was resolved in a timely manner.

Objective	Report Section	Conclusions
		• IEDM was not proactive in assessing CIF's compliance with critical sections of The Act and thereby missed an opportunity to provide assurance to Manitobans that CIF complied with its legislation.
To assess the monitoring of CIF by MSC	Monitoring by the Manitoba Securities Commission (MSC) Section 4.8	It should be noted that the MSC has been monitoring CIF's current activities since the December 10, 2004 halt of sale and redemption of shares. • We commend the MSC for beginning to perform continuous disclosure reviews in 2003. Our observations indicate that there are several ways that these reviews and the documentation thereof could be made more robust. We noted that the MSC review of CIF's Board minutes in April 2004 did not result in further MSC enquires at that time. Sufficient information regarding valuation concerns were noted in the minutes and could have prompted the MSC to make more timely enquiries. MSC began a second continuous disclosure review in October 2004 in response to the significant September 2004 valuation write-down reported by CIF.

RECOMMENDATIONS

Report recommendations for CIF, IEDM and the MSC are contained in **Section 5.0**.

As well, we have recommendations for the Deputy Attorney General, the Manitoba Securities Commission, and the Province of Manitoba, as follows:

Deputy Attorney General

- That the Deputy Attorney General review this report and make an assessment as to whether certain matters should be referred to the appropriate law enforcement agency for criminal investigation. In particular:
 - With respect to Section 380(1) and Section 400 of The Criminal Code, we refer the Deputy Attorney General to **Section 4.0** of this report;
 - With respect to Section 464 of The Criminal Code, we refer the Deputy Attorney General to **Section 4.0** of this report; and
 - With respect to Section 15.4(1) of The Crocus Investment Fund Act, we refer the Deputy Attorney General to **Section 4.0** of this report.
- That the Deputy Attorney General review this report and make an assessment as to whether CIF transactions and involvement with two portfolio companies should be referred to an appropriate law enforcement agency for criminal investigation.

The Manitoba Securities Commission

- That the Manitoba Securities Commission (MSC) review the report and assess whether there have been any violations under The Securities Act warranting further action by the MSC. In particular, we refer the MSC to **Section 4.0** of this report to assess whether there are any material false or misleading statements in CIF's prospectuses, financial statements, and other public communications.

The Province of Manitoba

- That in light of the current challenges facing the Crocus Investment Fund and the observations contained in this report, the Province establish a review process to consider:
 - The impact of this situation on the Province's monitoring role; and
 - Whether there are any beneficial changes to The Crocus Investment Fund Act and The Labour-Sponsored Investment Fund Act that may be required.
- That should a review be conducted, the following be considered:
 - The continued need for an Investment Advisory Committee in LSIFs in light of the fiduciary responsibilities held by Board members serving on the Investment Committee of an LSIF;
 - Amending The Crocus Investment Fund Act to base the calculation of the 10% rule on the cost of investments and not value. Changing both the numerator and denominator to "cost" would prevent the Fund from manipulating the timing or results of valuations to affect the 10% calculation. This would better protect shareholders from the risk of catastrophic loss by restricting the amount of capital the Fund could invest in any one business;
 - Amending the provisions of The Income Tax Act regarding maintenance, pacing, and small business investing with a view to simplifying and clarifying these provisions. To help ensure clarity and to facilitate monitoring for compliance, regulations should be developed that include forms for reporting compliance by LSIFs;
 - Amending The Crocus Investment Fund Act to clearly define "Investment Assets"; and
 - Amending The Crocus Investment Fund Act to clarify the understanding of Section 3(2) of The Act as read in conjunction with the definition of a "qualified Manitoba business entity".
- That the Province address the perception of conflict of interest by appointing individuals other than government employees as its representative on LSIF Boards, unless there is reporting back to the Province from a monitoring perspective.

GENERAL OBSERVATIONS

A summary of general observations from the examination of CIF has been provided in **Section 6.0**

2.0 Introduction

2.1 INITIATION OF THE EXAMINATION

On December 10, 2004, the Crocus Investment Fund (CIF or the Fund) approached the Manitoba Securities Commission (MSC) and requested and received regulatory approval to suspend redemptions and to halt sales of its shares pending a comprehensive assessment of the value of its portfolio using external valuation consultants.

On December 16, 2004, after receiving a number of requests from citizens, the Office of the Auditor General (OAG) advised CIF that the OAG would be conducting a limited examination involving:

- An examination of the due diligence process in respect of CIF investments that were made in partnership with, or involve, entities in the Manitoba Public Sector; and
- An assessment of whether CIF's current valuation process identifies any operational issues that should be examined by the OAG.

2.2 LIMITED REVIEW SUMMARY

In early January 2005, the OAG contracted with a Toronto-based, external consultant knowledgeable of Labour-Sponsored Investment Funds (LSIFs) and venture capital investing.

After a preliminary review of a number of CIF investments, initial discussions with current and previous CIF employees, and meetings with representatives from Industry, Economic Development, and Mines (IEDM) and the MSC, it became apparent that a broader examination should be conducted in order to provide Members of the Legislative Assembly and the citizens of Manitoba with an understanding of the factors contributing to the December 10th halt of trading of Fund shares.

Our limited review identified concerns related to governance, investment processes and procedures, fund management, and a number of CIF operational issues. We also became aware of the influence and the impact of CIF in local institutional investing discussions with provincial government representatives, and in actual local institutional investing in the Province of Manitoba.

2.3 EXPANSION OF EXAMINATION

Based on observations early in our limited review, we decided to expand the scope of this examination to address issues within the following areas:

- Board Governance;
- Management of the investment portfolio and general operations;
- Compliance with The Crocus Investment Fund Act; and
- Compliance with The Securities Act.

A letter was sent to the Interim CEO of the Fund on February 7, 2005 indicating that the scope would be expanded. A meeting was held to discuss the expanded scope with Fund representatives on February 7, 2005, whereby the OAG was informed that CIF would seek legal advice regarding the jurisdiction of the OAG in conducting an expanded examination.

On February 8, 2005, in order to avoid the necessity of resorting to the courts, the Auditor General wrote to both the Minister of Finance and the Minister of Industry, Economic Development and Mines requesting specific support for the expanded review.

On the morning of February 9, 2005, Fund representatives formally indicated that they would be making an Application on an expedited basis to the Court of Queen's Bench for an interpretation of the legislated authority of the OAG.

On the afternoon of February 9, 2005, the Minister of Finance requested that the OAG carry out a special audit of the Fund under Section 16(1) of The Auditor General Act. It was the Minister of Finance's opinion, that the change in 2001 to The Auditor General Act brought the Fund within the scope of the OAG's authority.

Also on February 9th, the Minister of Industry, Economic Development and Mines appointed the Auditor General as "an authorized person" as defined in Section 15.3 of The Crocus Investment Fund Act for the purposes of conducting an examination. This provided the audit and inspection powers under Sections 15.3(3) and rights of entry and cooperation under subsection 15.3(4). On the afternoon of February 9, 2004, the Auditor General further advised the Minister of Finance that he would be conducting the special audit.

CIF subsequently indicated that they would no longer make an Application to the Court of Queen's Bench. The expanded examination commenced on February 16, 2005.

2.4 OBJECTIVES, SCOPE AND APPROACH

The expanded examination addressed the following objectives mainly within the period October 1, 2000 to September 30, 2004. The timeframe covered within this period varied dependent on the issue reviewed.

Our expanded examination was conducted from February 2005 to April 2005. Extensive interviews and documentation review were conducted and included:

- A review of documentation such as Board and Committee minutes, correspondence, and analyses of various types;
- Interviews conducted with present and former employees and Board members of CIF;
- Discussion with representatives of the external audit firm for CIF;
- Meeting with the valuator preparing concurrence reports for the Fund; and
- Interviews conducted with present employees of the Province of Manitoba including representatives from IEDM and the MSC.

Our work consisted of such examinations and procedures that we determined were necessary to address the objectives, as well as any other issues that arose during the course of this examination.

We contracted with an individual knowledgeable of LSIFs and with experience in venture capital investing to assist in the performance of this expanded examination.

Our objectives were as follows:

- **Events (Section 4.1)**
 - To understand the chronology of events leading up to December 10, 2004.
- **Management of the Investment Portfolio and General Operations (Sections 4.2 and 4.3)**
 - To assess the effectiveness of the investment management processes and procedures used in CIF.

- To assess whether CIF had appropriate management and operating practices in place, including: financial results; external reporting; share pricing; liquidity, cash flow and the Solidarity Transaction; employee travel and other expenses; recovery of costs from portfolio companies; management expense ratio; cash receipt and payment processes; executive compensation; director fees; interest, dividends, management fees and other income; conflict-of interest and interwoven roles of individuals; donations; and in CIF initiatives.
- **Board Governance (Section 4.4)**
 - To assess the effectiveness of the governance processes and practices of the Fund's Board of Directors.
- **Compliance with The Crocus Investment Fund Act and By-laws (Section 4.5)**
 - To assess whether Crocus operated in accordance with The Crocus Investment Fund Act and Regulations.
- **Compliance with The Securities Act**
 - To assess whether there is reason to believe that CIF may have contravened any of the provisions of this Act and to provide recommendation to the MSC, in particular Section 41(1): *"A prospectus shall provide full, true and plain disclosure of all material facts relating to the security proposed to be issued"*.
 - To assess whether there is reason to believe that CIF may have committed an offence under The Corporations Act that relates to the filing of documents with MSC or to the contents of any document that has been so filed and to provide recommendation to the MSC.
 - To assess whether there is reason to believe that CIF has committed an offence under the Criminal Code (Canada) in connection with a trade in securities.
- **Involvement with the Public Sector (Section 4.6)**
 - To gain a general understanding of the relationship between CIF and the Public Sector.
- **Monitoring by IEDM (Section 4.7) and the MSC (Section 4.8)**
 - During the Limited Review, we determined that it was also important to assess the monitoring of CIF by IEDM for compliance with The Crocus Investment Fund Act.
 - Similarly, we considered it important to assess the monitoring of CIF by the Manitoba Securities Commission.

In order to report to the Legislative Assembly on a timely basis, we limited the scope of our review to key issues within the objectives listed above. Given the complexities and breadth of CIF operations, not all areas were reviewed.

Our work was performed at a level sufficient to support the conclusions and recommendations contained in this report.

We are concluding our examination with a number of questions around particular CIF investment transactions and CIF operations still outstanding. We believed that it was necessary to conclude and report

in a timely manner in order for the Legislative Assembly and the citizens of Manitoba to gain an understanding of what contributed to the halt of sale and redemption of CIF shares on December 10, 2004.

Through our recommendations, we have suggested that a more in-depth review of certain issues and transactions may be warranted. An initial presentation on the report contents was made to current Senior Officers and current Board Members on April 5, 2005.

The draft report was provided in late April 2005 to current Senior Officers, the Special Advisor to the Board of Directors, and the current Board of Directors for review of factual accuracy. Additionally, observations were reviewed for factual accuracy by appropriate Investment Department and Finance Department staff as determined necessary by current Senior Officers.

3.0 General Background

3.1 VENTURE CAPITAL AND LABOUR-SPONSORED INVESTMENT FUNDS (LSIFS)

GENERAL

Venture capital is an important source of funds for both start-up companies and established companies that are in a growth phase. Funds are invested in rapidly growing companies that have the potential to develop into significant economic contributors. Professionally managed venture capital firms can be funded through various means including contributions from individuals, corporations, and private and public pension funds. Venture capitalists will help companies grow, but they eventually seek to exit its investments.

An early stage investment may take seven to ten years, or more, to mature while a later stage investment may take less, so the appetite for the investment life cycle must be consistent with a fund's need for liquidity. A venture investment is initially neither a short term nor a liquid investment, but a long term investment that must be made with careful diligence and expertise.

CANADA

Labour-Sponsored Investment Funds (LSIFs) were established to promote venture capital investing in Canada with the aim of job creation and encouraging investment in small companies.

LSIFs were initiated in response to the 1981-83 recession which contributed to high levels of unemployment in Canada. The LSIF model was started in 1984 by the Quebec Federation of Labour (FTQ) in Quebec with the purpose of meeting identified equity capital gaps for small and medium-sized businesses. Three funds were developed following this model including CIF. In an article written by the former CEO, he noted that:

*"These funds are committed to earning competitive returns. At the same time, the funds set out to provide capital to needed sectors and in addition, to meet social goals the unions have established, including job creation and retention, and regional economic development....The target market is small and medium sized businesses. Typically, an equity interest is sought in companies employing less than 500 workers and have total assets of less than \$50 million. Most investments range from \$500,000 to \$2 million."*¹

¹ <http://www.uswa.org/usa/program/content/437.php> - Kreiner, Sherman, Labour-Sponsored Investment Funds in Canada

LSIFs are a type of government-sponsored venture capital in which federal and provincial governments encourage individuals to invest in these funds by offering large tax credits. LSIFs are also referred to as Labour-Sponsored Venture Capital Corporations (LSVCCs). They were created by the federal government by way of amendments to The Income Tax Act of Canada in 1988. An LSIF registered as an LSVCC under The Income Tax Act of Canada entitles its shareholders to receive a federal tax credit. A number of provinces, including Manitoba, then created their own version of the federal LSVCC legislation. All of the provincial legislation is similar in that they offer a provincial tax credit equal to the federal tax credit, provided that the LSIF meets and maintains a specific, local or regional investment criteria.

Regulation in the LSIF industry specifies the investment requirements of a potential recipient of Labour-Sponsored capital for the tax benefits to be realized. The individual provinces have legislation specifying the amount of the provincial credit and the eligibility requirements of such an investment. These rules also require a minimum amount of annual investing of the proceeds of capital raised from individual shareholders. These regulations are known as pacing requirements. They are put in place to maximize the benefit to the economy and to match the lost tax revenue from the government with the multiplier-effect benefits to the economy.

There have been a number of recent changes in the legislation and trends in the LSIF industry. Specifically, in the last several sales seasons, a number of newly registered LSIFs failed to raise sufficient capital to be viable investment companies for the long term, resulting in capital being too thinly spread among too many LSIFs. This prompted a moratorium on new LSIFs in the 2005 Federal Budget.

MANITOBA

Manitoba is unique in having two statutes that govern LSIFs: The Crocus Investment Fund Act (specific to CIF); and The Labour-Sponsored Venture Capital Corporation Act that applies to other LSIFs. Presently, only ENSIS Growth Fund Inc. (ENSIS) has been established under this Act. In Manitoba, an LSIF must also qualify as an LSVCC under The Federal Income Tax Act.

CIF was formed on March 21, 1992. ENSIS was formed on December 10, 1997. CIF and ENSIS received the privilege from the Province of Manitoba of issuing tax credits to investees. As per the MSC, *“essentially, LSIFs are a mutual fund-like security whose investment objective is to achieve significant long term capital appreciation, primarily though investment in venture capital opportunities”*.

3.2 CROCUS INVESTMENT FUND

3.2.1 Nature of Operations

Legislation

CIF was incorporated on March 21, 1992 under the provisions of The Manitoba Employee Ownership Fund Corporation Act (later changed to The Crocus Investment Fund Act in July 2001) (see **Appendix B**) and The Corporations Act. The Fund was incorporated to respond directly to the need for investment capital for Manitoba's small to mid-size companies. CIF is a prescribed LSVCC for the purposes of The Income Tax Act (Federal).

An investment fund is generally an entity that operates on behalf of individual and institutional investors by “pooling” their funds to provide them with diversified investments and professional investment management services. There are various types of investment funds. “Open-end” investment funds, commonly called mutual funds, usually offer their shares or units for sale to the public on a continuous basis.

As per Section 3(2) of The Crocus Investment Fund Act:

“The business of the fund is restricted to:

- (a) the operation of an investment fund that will make investments in qualified Manitoba business entities **with a view to earning income** and promoting and maintaining

 - (i) capital retention and economic stability in Manitoba,*
 - (ii) employee ownership of qualified Manitoba businesses, and*
 - (iii) business continuity, job retention and creation, and ownership of Manitoba businesses by Manitobans; and**
- (b) providing investment capital and other financial assistance and other services to Manitoba businesses to enable them to create, maintain and protect jobs.” (emphasis added)*

As per CIF’s December 23, 2004, letter to the Manitoba Legislative Assembly, which was posted on the Fund’s website:

“The Fund strives to be the pre-eminent private sector economic development organization in Manitoba. To achieve this goal it seeks:

- To provide **a competitive rate of return for our Crocus shareholders** through investments in socially responsible businesses that strive to operate in accordance with ethical policies with respect to employment practices, workplace safety, environmental suitability and other matters;*
- To maintain continuity of local ownership of Manitoba businesses;*
- To help ensure local capital is available for investment in Manitoba;*
- To maintain existing jobs and to create new ones in Manitoba; and*
- To promote employee ownership and employee participation in Manitoba companies.” (emphasis added)*

As per page 1 of its January 21, 2004 prospectus for the continuous offering of common shares:

“The Fund was established to raise capital primarily through the sale of its Common Shares and to invest the proceeds raised thereby in qualified Manitoba businesses pursuant to the provisions of The Crocus Investment Fund Act and the Fund’s Investment Policies with the primary objective of achieving long term capital growth in the value of its investments.”

The federal and provincial Income Tax Acts make available personal income tax credits to individuals who purchase shares of the Fund. As at January 5, 2005, CIF had 33,678 Class “A” shareholders.

As per Crocus’ September 30, 2003 Management, Discussion and Analysis Section from its 2003 audited financial report:

“Crocus Investment Fund is a Manitoba Labour-Sponsored Investment Fund (LSIF) focused on creating shareholder value through long term capital appreciation from investments in Manitoba businesses. Additional investment objectives of the Fund include: capital retention, business continuity and economic stability in our province, job retention and creation, and maintaining ownership of Manitoba businesses by Manitobans.”

Financial Results

Financial Results are presented in **Section 4.3.1.**

Organizational Structure

Responsibility for management of the business and affairs of the Fund rests with the Board of Directors (the Board). For the majority of the period under review in this report, the Board consisted of nine Directors. The Board has delegated responsibility for the day to day management of the Fund to its Senior Officers. As at halt of trading on December 10, 2004, the Senior Officer positions included the Chief Executive Officer (CEO), the Chief Investment Officer (CIO), the Chief Operating Officer (COO), and the Vice-President and Chief Financial Officer (CFO). During 2004, there were approximately 40 full-time staff at CIF. The Finance Department operated with approximately 3.3 full-time equivalent staff and the Investment Department with approximately 7.8 full-time equivalent staff.

Since inception, the Fund has invested in over 60 businesses.

According to CIF, as at June 30, 2004 they created, saved and maintained approximately 14,370 jobs since its inception in January 1993. This number includes total jobs created of 8,700; jobs saved of about 170; and jobs that have been maintained by the portfolio of approximately 5,500. CIF estimates that there has been one job created for every \$28,000 invested by CIF. In addition, approximately 28% of employees have the opportunity to become owners in the company where they work.

Pricing

The Fund, up until December 10, 2004, issued a share price weekly. The share price is determined by “self-pricing”, by CIF, given that shares are not traded on the open market. CIF is a reporting issuer (a registrant) under The Securities Act.

3.2.2 Subsidiaries

Crocus Capital Inc. is a wholly-owned subsidiary of CIF. It was incorporated on October 29, 1992 under The Corporations Act of Manitoba. Crocus Capital Inc. is registered under The Securities Act (Manitoba) as a broker-dealer restricted to the sale of shares of the Crocus Investment Fund.

Crocus Hockey Holdings Inc. is a wholly-owned subsidiary of CIF, and was incorporated on July 18, 1996 under The Corporation Act of Manitoba. It holds the Fund’s investment in the Manitoba Moose Limited Partnership.

Scitech Management Inc. is a wholly-owned subsidiary of CIF. It was incorporated on January 13, 1998 under The Corporations Act of Manitoba. Scitech Management Inc. is the general partner and manager of Manitoba Science and Technology Fund (MS&T).

Manitoba Science and Technology Fund, Limited Partnership (the Partnership) was formed by an initial Limited Partnership Agreement dated February 20, 1998 which was replaced by an Amended and Restated Limited Partnership Agreement dated June 18, 1999. Operations of the Partnership commenced in June 1999 with the receipt of capital from the limited partners. The general partner is responsible for costs and expenses that are incurred by the general partner in rendering the administrative, management and other services required in the ordinary course of business. The Partnership is responsible for all other costs incurred by the general partner on behalf of the Partnership. The Partnership was formed for the purposes of raising capital and investing in small to medium sized Manitoba-based business in the science and technology sectors with a view to achieving long term capital appreciation and return for the partners.

3.2.3 Shareholders

Share Capital

According to the January 2004 prospectus, the classes of shares that the Fund is authorized to issue, the number of shares of each class authorized, the maximum consideration for which shares of each class may be issued, and the aggregate number of shares of each class outstanding at November 30, 2003, are as follows:

FIGURE 1

Class	Maximum Authorized	Maximum Consideration Authorized	Number Issued and Outstanding	Consideration Received
A - Common	Unlimited	Unlimited	13,499,190.4542	\$177,616,022
G - Province - Founder/Shareholder	Unlimited	2,000,000	2,000,000	\$2,000,000
L - MFL - Founder/Shareholder	Unlimited	Unlimited	2,000,000	\$200
I (Series One)	200,000	Unlimited	Nil	Nil
I (Series Two) - WCB, MGEU, Blue Cross	1,000,000	Unlimited	59,126.21	\$700,005
I (Series Three) - Solidarity	Unlimited	Unlimited	790,513.83	\$10,000,000

Description of "Class A" Common Shares

The Crocus Investment Fund Act provides that Common Shares may be issued only to individuals and to RRSPPs. Each holder of Common Shares is entitled to one vote at shareholder meetings without regard to the number of Common Shares owned. Holders of Common Shares as a group are entitled to elect two persons as directors of the Fund. Subject to the rights attaching to Class L Shares, the Series Three Shares and any series of Class I Shares other than Series One and Series Two, upon a liquidation, dissolution or winding-up of the Fund, the holders of Common Shares, together with the holder of Series One Shares, if any, and the holders of Series Two Shares are entitled to receive rateably, share for share, the remaining property and assets of the Fund.

Description of Class G Shares

Class G Shares may be issued only to the Province. The Province is entitled to one vote at meetings of the Fund's shareholders and the Province can elect one person as a director of the Fund. The Province is not entitled to receive dividends or otherwise participate in the earnings or growth of the Fund and is not entitled to any distribution on liquidation, dissolution or winding-up of the Fund.

Description of Class L Shares

Class L Shares may be issued only to the MFL. The MFL is entitled to one vote at meetings of the Fund's shareholders. The MFL is entitled to elect a majority of the Board of Directors, but cannot receive dividends or otherwise participate in the earnings or growth of the Fund. Upon the liquidation, dissolution or winding-up of the Fund, the MFL is entitled to be repaid, in priority to the rights of the holders of Common Shares and Class I Shares, the Class L Liquidation Entitlement (being \$200).

Description of Class I Shares

Class I Shares may only be issued to Institutional Investors. The Board of Directors can issue more than one series of Class I Shares and have broad authority to determine the rights and restrictions attaching to each series. Currently there are three series of Class I shares:

Series One Shares

The Fund does not intend to issue Series One Shares other than to the Province. The holder of Series One Shares is entitled to one vote without regard to the number of Series One Shares owned and is not entitled to elect any directors of the Fund. Series One Shares are not entitled to any fixed or cumulative dividend or any preference, but are entitled to participate rateably, share for share, in any dividend declared by the Board of Directors on Common Shares. Holders of Series One Shares are entitled to cause the Fund to redeem all or part of the Series One Shares held upon one month's prior notice at a redemption price equal to the Redemption Price payable by the Fund on a Permitted Redemption of Common Shares. Series One Shares are entitled to share equally with the holders of Common Shares and with the holders of all shares or series of shares ranking equally to the Common Shares in all remaining property and assets of the Fund in the event of a liquidation, dissolution or winding-up of the Fund.

Series Two Shares

Series Two Shares may be issued only to Institutional Investors and have the same rights and restrictions attaching to the Series One Shares as described above, except that for so long as at least 50,000 Series Two Shares are issued and outstanding, holders of Series Two Shares (as a group) are entitled to elect one person as a director of the Fund and can request a redemption of shares by the Fund for a period of 30 days commencing on the fifth anniversary of the date such shares were issued. Series Two Shares are entitled to share equally with the holders of Common Shares and with the holders of all shares or series of shares ranking equally to the Common Shares in all remaining property and assets of the Fund in the event of a liquidation, dissolution or winding-up of the Fund.

Series Three Shares

Series Three Shares may be issued only to Institutional Investors and is entitled to one vote without regard to the number of Series Three Shares owned. Holders of Series Three Shares are not entitled to elect any directors of the Fund.

Holders of Series Three Shares are entitled to require the Fund to redeem all or a portion of the Series Three Shares owned by them, commencing on the date that is eighteen months from the date of issue or earlier upon the occurrence of certain specified events as set out in the Articles.

Series Three Shares are also redeemable by the Fund at any time after the date that is twelve months from the date of issue. The Series Three Shares can be redeemed for the higher of the Pricing NAV Per Common Share on the redemption date less an amount equal to all dividends paid, or an amount equal to the original purchase price of the shares.

Holders of Series Three Shares are guaranteed a minimum rate of return equal to 10% per annum that is payable in advance starting on the last day of April and October in each year.

In the event there are any Series Three Shares issued and outstanding on November 15, 2004, the holder of Series Three Shares will also be entitled to an additional annual fixed preferential cumulative cash dividend equal to 10% of the Series Three Redemption Amount on November 15, 2004 for each Series Three Share held at that date and, thereafter, on November 15 of each year. Such additional dividend is payable on November 15 of each year beginning in 2004.

The holders of Series Three Shares shall be entitled, in priority to the holders of all other classes of shares to share equally in all remaining property and assets of the Fund in the event of the liquidation, dissolution or winding-up of the Fund.

3.3 THE CANADIAN SECURITIES INDUSTRY

CANADA

Regulation of the securities industry in Canada occurs to a greater or lesser degree at three levels: the federal, provincial and industry levels.

- **The Federal Level** – No formal federal securities regulatory body exists in Canada, in contrast to the United States, where the Securities and Exchange Commission (SEC) has exerted considerable regulatory authority on a national level since the early 1930's. In addition, each state and US territory has a securities regulator as well. The division of responsibility between state and Federal responsibility is set by Federal law. Despite the fact that there is no federal regulatory body in Canada responsible for securities regulation, the securities regulators from 10 provinces and 3 territories have formed a joint panel, referred to as the Canadian Securities Administrators (CSA), to coordinate and harmonize regulation of the Canadian capital markets.
- **The Provincial Level** – Each province regulates securities activities within its borders. Since 1966 there have been efforts to make legislation in most of the provinces compatible. In Canada, there are three types of securities policies/instruments:
 - **National Policies/Instruments** – Apply to all jurisdictions in Canada. The primary difference between a national instrument and a national policy is that the national instrument has the force of a binding rule, whereas the national policy does not. The national policy may be considered more akin to a guideline as it informs market participants of the manner in which the securities commission may exercise its statutory discretionary authority.
 - **Uniform Act Policies** – Apply in Ontario and the four Western Provinces. (The Acts and regulations now incorporate many Uniform Act Policies). Most Uniform Act Policies have been repealed or have been replaced by regulations or National Instruments.
 - **Provincial Policies** – Reflect local difference in legislation, regulation and procedure. Even within this latter group of policies there is substantial agreement between the jurisdictions in many areas.
- **The Industry Level** – These are industry organizations that have the privilege of regulating their own members, whether as officially recognized Self-Regulatory Organizations (SROs) or under the stock exchange portions of their provincial acts. In Canada, there are no SROs monitoring LSIFs.

THE MANITOBA SECURITIES COMMISSION (MSC)

Background

The MSC is responsible for administering and enforcing The Securities Act, The Commodities Futures Act, The Real Estate Brokers Act and The Mortgage Dealers Act. The MSC was structured in its present form in 1968. The MSC became a provincial government Special Operating Agency on April 1, 1999.

As per the 2004 Annual Report for the MSC:

"The mission of the MSC is to protect and promote the public interest by facilitating dynamic and competitive capital and real estate markets that contribute to the economic development of Manitoba while fostering public confidence in those markets."

The mandate of the MSC is to act in the public interest to protect Manitoba investors and to facilitate the raising of capital while maintaining fairness and integrity in the securities marketplace. Similarly, its real estate industry mandate is to regulate brokers, salespeople and mortgage dealers to ensure adequate standards are maintained for the protection of the public.

3.4 INDUSTRY, ECONOMIC DEVELOPMENT AND MINES

Industry, Economic Development and Mines (IEDM) is a provincial government department responsible to the Minister of IEDM. The Department operates with a budget of \$30.5 million and 239.6 full-time equivalent employees.

The Department's 2003/04 Annual Report indicates that their mission and vision are as follows:

MISSION

To work collaboratively with businesses, people and communities to:

- Increase their capacity to succeed;
- Enhance the competencies they need to prosper;
- Raise their profiles, locally, nationally and internationally; and
- Foster an environment that supports sustainable economic growth.

VISION

"An internationally competitive economy, with the best quality of life in the world." In pursuit of this vision, the Department has identified the following critical priorities:

- Productivity and competitiveness;
- International economic opportunities;
- Community capacity; and
- Sustainable resource development (stewardship).

The Department is organized into five divisions. Two of the Department's divisions are involved with CIF: the Business Services Division and the Community and Economic Development Division.

THE BUSINESS SERVICES DIVISION

The Branch within the Business Services Division responsible for the Labour-Sponsored Investment Fund Program is the Industry Development – Financial Services Branch. The role of the Branch is to facilitate the creation, growth and expansion of businesses in Manitoba. The role is one of support to the government's economic development strategies. In providing the support, the Branch performs five functions:

- Administers several of the programs that provide financial assistance to businesses;
- Provides expertise on business case development and business financing;
- Provides best practices expertise for the use of economic development tools;
- Administers the affairs of the Manitoba Development Corporation; and
- Provides accounting and financial management services to other units in the department.

The monitoring of the two LSIFs are included among the duties of an account manager and one analyst within the Branch.

The Industry Development – Financial Services Branch also administers the Manitoba Industrial Opportunities Program (MIOP). MIOP provides financial support to assist businesses to expand in Manitoba. The financing is in the form of repayable, secured loans and the repayment terms can be flexible. Favorable interest rates are available to businesses that undertake significant investment in fixed assets and/or create jobs. The loans usually are in the range of \$250,000 to \$5,000,000. Since its inception in 1988, MIOP has loaned a total of \$282 million for 129 business expansion programs. MIOP expenditures for 2003/04 were \$9.7 million.

COMMUNITY AND ECONOMIC DEVELOPMENT DIVISION

The Division provides the following:

- Analytical expertise and administrative support to the Community Economic Development Committee of Cabinet;
- Coordination of all major government initiatives relating to community and economic development in the province; and
- Advice and support in the on-going development of Manitoba's economic strategy including identifying priorities, soliciting community input, and assisting in formulating policy and recommendations.

4.0 Detailed Observations and Conclusions

4.1 EVENTS LEADING UP TO DECEMBER 10, 2004

In order to understand the factors that contributed to the halting of the sale and redemption of CIF shares, it is important to consider the chronology of events leading up to December 10, 2004 when representatives from the Fund met with the MSC and requested the halt in trading.

During April to November 2004, internal staffing changes and differences of opinion on valuation issues were bringing both historic issues and new issues to a head at CIF. The newly hired Chief Operating Officer (COO) and the current Chief Investment Officer (CIO), assisted by both former and recently hired investment staff, decided to assess the apparent operational problems. When the result of their analysis was brought to the attention of the Board, partially in September 2004 and more fully in November 2004, Board members indicated to us that they were “stunned”.

The former Chief Executive Officer (CEO), upon advice from the current CIO, arranged for the departure of the former CIO effective September 30, 2004. The Board passed a motion on December 2, 2004 to negotiate the former CEO's transition out of his position.

OBSERVATIONS

- **Figure 2** outlines significant events over the last two years leading up to December 10, 2004:
- No Staff Valuation Committee or Board Valuation Committee meetings were held between April and September 2004.
- When presented with the potential for an additional downward valuation of the investment portfolio in November 2004 that would negatively impact share price, the Board was surprised. As a result of differences of opinion between members of Senior Officers, the Board was unsure of how to respond to the potential for a downward share price adjustment. There was also concern expressed that this would impact CIF's ability to obtain the management of third party funds. In order to resolve the impasse, the Board decided to engage independent firms to provide external valuations. Recognizing that this process would take some time, and in order to avoid a disadvantage to any shareholder purchasing or redeeming Fund shares in the interim, the Board contacted the Manitoba Securities Commission and requested a voluntary halt to trading of the Fund's shares.
- The December 5, 2004 conference call (referenced in **Figure 2**) apparently solicited an opinion as to whether a 20% write-down would be sufficient for the former COO to sign off on the draft 2005 prospectus.
- A considerable number of Board meetings (minuted and in-camera) and Investment Committee meetings were held leading up to the decision to go to the Manitoba Securities Commission on December 10, 2004.
- Staff at the Fund had concerns in a number of areas, regarding investments, valuations, and credit card expenses. However, we were informed that they did not believe that they had access to the Board to raise their concerns. Changes to securities regulations in Canada will require CIF to put a “whistle blower” policy and guidelines in place.

FIGURE 2

Date	Events
November 15, 2002	Upon request from CIF, Fonds de Solidarité FTQ (Solidarity) provided \$10 million in the form of retractable preferred shares.
2002 to Present	Considerable discussion continues to take place around creation and management of sub-funds and the potential for a SuperFund.
January 23, 2003	CIF Prospectus issued.
September 5, 2003	Formation of Manitoba Centre for Labour Capital Inc.
November 4, 2003	Announcement of creation of Centre for Employee Ownership.
January 2004	New COO starts with the Fund.
January 21, 2004	CIF Prospectus issued.
April 2004	New Senior Investment professional starts with the Fund (current CIO).
May 2004	Minister notification of change in Class G Shareholder (provincial) representative to be confirmed at Annual General Meeting (AGM).
June 8, 2004	The Executive and Personnel Committee of the Board received background information from the former CEO on the various methodologies currently used in the Valuation Department and the challenges created by the Fund's approach to valuation. One investment was used for illustrative purposes.
June 15, 2004 to January 31, 2005	A number of staff changes occurred with the departure of two Investment Analysts, the Vice-President of Sales and Marketing, the former CIO, the former CEO, and the former COO. The departures resulted in the hiring of two new Investment Analysts, a new Vice-President of Sales and Marketing (who subsequently departed), the return of a former Vice-President of Sales & Marketing and the hiring of an Interim CEO.
June 30, 2004	Manitoba Property Fund deal closes.
June to September 2004	Investment Department staff, with the exception of the former CIO, worked on a review of the entire CIF portfolio.
June 2004	Former COO assumes responsibility for valuation.
July 22, 2004	CIF Annual General Meeting (typically held in May each year). Class G shareholder representative changed at Annual General Meeting. Former Class G shareholder officially resigns, and new Class G shareholder representative is appointed to CIF Board.
August to December 2004	Conflicts and differences of opinion in Senior Officer group escalating.
September 14, 20 and 23	Board Valuation Committee Meetings resulting in recommendation at September 23, 2004 Board Meeting for a write-down of the value of the portfolio.
September 23, 2004	Board approves write down in investment portfolio of approximately \$15 million. Certain details of former CIO severance package is presented at Board Meeting by former CEO. Board Chair resigns to accept a position as Vice-President, Labour Affairs at CIF and as General Manager of the Manitoba Centre for Labour Capital Inc.
September 30, 2004	Separation Agreement finalized with former CIO. (Some discussions continued past this date.)
October 1, 2004	Senior Investment Professional appointed as new CIO.
October 14, 2004	Supplementary Prospectus issued.
October 26, 2004	An Independent Board member (appointed by the Board) joins the Board. Two Class L Shareholders (MFL) representatives join the Board.
October 26, 2004	Investment Committee Meeting – Current CIO identified the need to meet to further discuss the portfolio.
October 26, 2004	Former CEO made a presentation to Board on Strategic Priorities for 2004-2005 – A follow-up on a June 2002 Board presentation by the former CEO on Fund maturity and liquidity issues.
November 2004	Three day mediation session among Senior Officer's group, facilitated by an external consultant.
November 10, 2004	Senior Officer's meeting to review portfolio information prepared by the current CIO. The former COO concluded that at least a \$25 million reduction in the investment portfolio value required with other uncertainties outstanding. Senior Officers discussed that financial statements should not be taken for approval to the Finance and Audit Committee.

Date	Events
November 15, 2004	Finance & Audit Committee of the Board met to discuss finalization of the annual audited financial statements. The Committee was advised by the CFO that there was an issue on valuations, and of one portfolio company in particular, but that the impact was not yet known.
November 18, 2004 Board Meeting (Meeting of Investment Committee with Directors and Officers)	Former CEO informed the Board that there were issues revolving around cash flow adequacy, the Fund's reserve requirements, and that there were material valuation challenges in the portfolio. There was not enough incoming cash flow from investments to support ongoing operations. Current CIO indicated to the Board that a comprehensive portfolio risk review and liquidity review was underway. The former CEO indicated to the Board that in his view the current CIO's report in some respect was contrary to the economic development philosophy of the Fund; that it was desirable for the Fund to invest long term for development purposes; that there was no need to divest portfolio assets as CIF was a perpetual fund and that further discussion would have to take place with legal counsel. The former COO indicated that he along with other management had a responsibility to the Fund and to the shareholders to ensure that the share price is fairly valued each day. The Crocus Investment Fund Act and the Fund's By-laws specify how the Fund's portfolio is to be valued. The former COO indicated that he felt there was a material valuation issue that had to be dealt with now and once the valuation process was finished the Fund's share price would be affected adversely. He also indicated that there were material operating issues and a structural problem with the debt. Senior Officers in the Fund were not in agreement that additional valuation reductions were needed. The former CEO suggested that an independent third party would be required to be appointed. The Board did not believe they could agree to an adjustment without a third party review of certain investment values. The Board indicated to the OAG that they obtained legal advice supporting the conduct of external valuations and the respective timetable.
November 19, 2004	One of the Class A Shareholder representatives resigns from the Board.
November 23, 2004 Investment Committee Meeting	CFO communicated through email to the former COO suggesting the preparation of material for sign-off by the external auditors. The former COO suggested that a meeting with the external auditors was needed so that the former COO could voice concerns in person.
November 23, 2004	Current CIO identified material performance, liquidity, compliance and solvency issues associated with the investment portfolio. Material presented stated, <i>"The reason that we have brought this matter forward as an urgent priority for attention is that the implications of the Department's conclusions and due diligence imply a material difference between the underlying value of the portfolio, as compared to current posted value per share, and is outside any range of outcomes expected by investment staff or previously communicated to Committees and the Board"</i> .
November 30, 2004	The former CEO made a presentation to Board indicating not enough revenue is being generated to cover ongoing operational costs. Indicated that, <i>"further devaluation not appropriate based on future liquidity concerns"</i> .
November 30, 2004 Board Meeting	Board passed a motion that the former COO contract for valuations of certain of the Fund's portfolio companies.
November 30, 2004	Certain Investment and Valuation Department Staff wanted to talk to the Board about concerns that the former CIO advised them to follow certain valuation and investment practices. Staff waited to make their presentation to the Board but the Board chose not to hear their concerns. Concerns were subsequently provided in writing to the Chair of the Board.
December 2, 2004 Board Meeting	Board passed motions initiating a governance study and a search for a new Acting or Interim CEO. As well, the Board passed a motion to negotiate a severance agreement with the former CEO.
December 4, 2004	The Board requested that the Executive and Personnel Committee talk to the former COO and current CIO to discuss their intentions.
December 5, 2004	We were told that during a conference call with the former COO and current CIO, a member of the Executive and Personnel Committee asked the former COO whether he would sign off the draft 2005 prospectus with a 20% reduction in valuation. We were also told that the former COO and current CIO indicated that they would not sign a prospectus until they believed that the valuation of the portfolio was fair.
December 6, 2004 Board Meeting by Teleconference	The Executive and Personnel Committee reported on their December 5th conference call. The Board passed motions to contract for valuations, to hire legal counsel for the Board; to appoint the former Chairman of the Board (now VP, Labour Affairs) as an acting Senior Officer of the Fund; and to finalize the terms and conditions of an agreement with a new Acting/Interim CEO. The former COO and the current CIO and CFO were not involved in this meeting.

Date	Events
December 9, 2004	Class I (Series Two) Shareholders representative resigns from the Board.
December 9, 2004 Board Meeting by Teleconference	The Board passed a resolution appointing a new Acting/Interim CEO, and a resolution to meet with the MSC for the purpose of obtaining an immediate voluntary trading halt.
December 10, 2004	Separation Agreement finalized with former CEO.
December 10, 2004	Representatives from CIF (the former COO, the current CIO, the current CFO, and a CIF Board member) attend at MSC office to request halt to share sales and redemption.

Conclusions

- It appears that the CIF Board was surprised about the September 2004 write-down to CIF's investment portfolio, and were subsequently surprised about the potential for an additional reduction of value in the investment portfolio brought to their attention in November 2004. It is never a good sign when a Board is surprised by an event of this magnitude. It is possible, that had access to the Board by staff been encouraged, issues that are highlighted further in this report may have been brought to their attention sooner.
- Members of the Executive and Personnel Committee of the Board may have acted inappropriately when they discussed the potential sign-off of the draft 2005 prospectus by the former COO at an amount potentially higher than a realistic valuation.

4.2 INVESTMENT MANAGEMENT PROCESSES AND PROCEDURES

4.2.1 Summary of Investments Reviewed

As at September 30, 2004, CIF had 46 portfolio company investments with a total at-cost value of \$104.3 million at its fiscal year end. Of the 46 portfolio companies, 16 were reviewed in detail and are the basis for this report. Additional investments were also reviewed, and are commented upon within the body of this report.

Figure 3 reflects the totals associated with the 16 portfolio company investment files reviewed in detail.

FIGURE 3

Summary of Investment Portfolio Companies Reviewed (including an estimate of the potential impact of the write downs on the value of the investment portfolio) (\$000s)								
	Cost 9/30/04	%	Carrying Value 8/31/04	Initial Write Down	Carrying Value 9/30/04	Subsequent Write Down	Adjusted Carrying Value 9/30/04	Total Write Down
Investment Portfolio Reviewed (1)	\$ 50,657	48.6%	\$ 50,952	\$ 10,092	\$ 40,860	\$ 27,737	\$ 13,123	\$ 37,829
Investment Portfolio Not Reviewed (2)	53,602	51.4%	76,754	5,210	71,544	18,065	53,479	23,275
Total Investment Portfolio	\$104,259	100.0%	\$127,706	\$ 15,302	\$112,404	\$ 45,802	\$ 66,602	\$ 61,104
Write Down as a Percentage of August 31, 2004 Value				12.0%		35.9%		47.8%

Note 1: Guarantees on investments reviewed = \$8,856 (+ unlimited)

Note 2: Guarantees on investments not reviewed = \$10,063 (+ unlimited)

At September 30, 2004, these 16 investments represented \$50.7 million or 48.6% of the total at-cost value and \$40.9 million or 36.4% of the total carrying value of CIF's investment portfolio prior to the valuation adjustment of April 5, 2005. The September 30, 2004 draft consolidated financial statements were reviewed at CIF's Audit Committee on November 15, 2004, and included the adjustment of \$15.3 million approved by the Board on September 23, 2004.

Figure 3 reconciles the change in carrying values subsequent to August 31, 2004, including the \$45.8 million adjustment approved by the Board on April 5, 2005.

4.2.2 Overview

Valuation Adjustments

As at August 31, 2004, the venture investment portfolio of the Fund had a total carrying value of \$127.7 million. One month later at the Fund's fiscal year end date of September 30, 2004, the total carrying value of the portfolio was reduced by \$15.3 million or 12.0% percent to \$112.4 million. This significant reduction in total carrying value was the result of two to three months of work by a group of current employees within the CIF Investment Department.

On December 10, 2004, at the request of the Board and Senior Officers of the Fund, the MSC approved the halting of the issuance and redemption of CIF shares. Professional independent valuation firms were hired by the Fund to review the carrying values of 15 companies or 76.5% of the investment portfolio carrying value as at September 30, 2004. This work and other internal valuations resulted in a further proposed reduction in the carrying value of the venture investment portfolio of \$45.8 million, or 35.9% of the August 31, 2004 carrying value of the investment portfolio announced on April 5, 2005. This reflects a combined write-down of \$61.1 million or 47.8% of the August 31, 2004 carrying value of the investment portfolio.

Industry Context

By the end of February 2005, other LSIFs (as well as conventional venture capital funds across Canada) had been experiencing large carrying value reductions against their investment portfolios. The decline in net asset value per share (NAVPS) was attributed to the "science and technology investment bust" that began in March 2000. From that date on, the NASDAQ dropped from its high of 5,132 on March 10, 2000 to as low as 1,108 in September 2002 before rebounding to 2,002 more recently, which is still more than 150% lower than the 5,132 high-water mark.

The "bust" was important to venture investors in both Canada and the United States since the NASDAQ (and in Canada, the Toronto Stock Exchange) had been providing the majority of their exit opportunities for science and technology investments. Further, the "bust" affected not only the science and technology sectors. All exit opportunities were negatively affected as exit multiples decreased in almost every industry sector. As such, venture investors abandoned significant portions of their investment portfolios as they made triage decisions regarding which portfolio companies to support and provide more capital to, and which to no longer support.

As shown in **Figure 4**, CIF's return on investment reflects the September 2004 write-down of \$15.3 million but not the April 5, 2005 write-down of \$45.8 million. The greatest LSIF NAVPS reduction reflects a 34.06% loss over the past year. The most positive annual return for an LSIF was a 3.53% increase in NAVPS during that same period.

FIGURE 4

Return on Investment of Mature LSIFs with at least Eight Years of History As of March 31, 2005				
Fund Name	1 Year %	3 Year %	Incep. %	Incep. (mm/yy)
B.E.S.T. Discoveries I	3.53	-7.75	-1.63	12/96
Canadian Medical Discoveries	-15.52	-7.28	-1.76	12/94
Canadian Science and Tech Growth	-34.06	-25.08	-7.09	12/96
Capital Alliance Ventures	-21.36	-16.13	-.92	02/95
Centrefire Growth Fund Inc.	-11.09	-27.14	-8.47	03/97
Covington Fund I	-4.92	-10.17	-2.27	02/95
Crocus Investment Fund	-14.13	-7.91	.36	03/93
DGC Entertainment Ventures Corp.	-7.82	-2.78	1.12	03/94
Dynamic Venture Opport Series I	-2.98	1.11	.64	02/94
Dynamic Venture Opport Series II	-3.26	.99	.60	02/94
First Ontario LSIF Ltd.	-11.39	-8.39	-2.52	01/95
GrowthWorks Canadian	2.55	-4.44	-.52	02/90
Retrocom Growth	-7.39	-5.22	-.64	04/95
Triax Growth-I	-1.80	-15.94	-8.93	01/96
VenGrowth I Investment Fund Inc.	-12.53	-10.10	1.29	03/95
Workers Investment Fund Inc.	1.54	-.44	-.16	01/97
Working Opportunity Balanced Ser 1	-12.01	-8.69	3.61	04/92

Source: Globeinvestor.com

Out of 17 LSIFs across Canada that have been in business for at least 8 years, only 6 including CIF (prior to the proposed further write-down of \$45.8 million) had a positive annual compound rate of return by the end of March 2005. Even after the September write-down of \$15.3 million, CIF appeared to be among the best performing LSIFs in the country over the longer-term. With the recording of the April 5, 2005 reduction in carrying value of \$45.8 million, CIF will reflect a rate of return since inception that is among the worst.

The LSIF performance trend in **Figure 4** is largely the result of steadily mounting monthly write-downs for the majority of the funds over the three-year period shown. What is both unusual and unsettling about CIF's portfolio write-downs is that the write-down in September 2004 was not only significant; but that all information was not yet available at that date. A larger write-down of \$45.8 million was approved by the Board on April 5, 2005.

Overview Conclusions

In our opinion:

- The carrying value of the Fund's venture investment portfolio as at August 31, 2004 (and accordingly, the Fund's net asset value per share [NAVPS]) appears to have been overstated by up to \$61.1 million or 47.8%. Further, it is likely that the portfolio was overstated at earlier dates, based on specific observations in **Section 4.2**, (primarily the "Account Management and Monitoring" and "Valuation" sections). Accordingly, past monthly, quarterly and annual reporting disclosures including the Fund's consolidated statements of net assets, NAVPS, deficit and operations for the last year at a minimum, appear to have been significantly misstated.
- In spite of the general downward trend in LSIF performance in Canada, the need for two large one-time write-downs of the carrying value of an LSIF's investment portfolio is a highly unusual matter at this point in time. It certainly would not be classified as the

result of good investment management, and strongly suggests that certain write-downs of individual portfolio companies in CIF's venture investment portfolio should have been made much earlier and perhaps in prior fiscal periods.

- The large overstatements of CIF's venture investment portfolio and NAVPS both as at August 31 and September 30, 2004 indicate to us that the investment strategy and investment management processes and procedures had been wrong and had gone wrong.
- Based on our observations of significant deficiencies identified in this report, the Fund did not have in place the necessary leadership, the necessary structure, the necessary culture, and the necessary processes to handle the planning, growth, monitoring, and exiting of the investment portfolio. Further, we believe that:
 - the important issues were not addressed;
 - the appropriate information was not being produced;
 - the appropriate resources were not in place; and
 - when problems were identified, the Fund did not have the appropriate follow-through.
- Adequate investment management policies, processes and procedures were not established for governing and managing activities in the Investment Department. The Board should have ensured that such protocols were in place and should have actively monitored Senior Officers' performance. At a minimum, the Board should have ensured that policies and procedures were in place in the areas where they had previously expressed significant concerns. For example, the Board requested a report on the lessons learned from the failure of Company GG in 2001, and received the completed report in June 2002. It highlighted key process deficiencies in the Investment Department; however, the Board did not follow-through to ensure that these deficiencies were addressed.
- Responsibility for all of the foregoing resided with the Board of Directors and Senior Officers, namely the former CEO, the former CIO and the CFO. Ultimately, the Fund did not have the appropriate governance and the Board of Directors and Senior Officers did not fulfill their responsibilities to the Fund.

4.2.3 Investment Strategy

a) Cash Management Considerations

Investment strategy and management at an LSIF is usually based on, and is part of, an overall business strategy, plan and budget that includes an analysis of cash resources available for various needs throughout the period. A cash analysis for an LSIF would include at least the following categories:

- working capital requirements to operate the business of the fund;
- reserve requirements;
- redemptions;
- follow-on financing expectations and other committed funding obligations;
- possible calls on guarantees;
- debt and equity repayments;
- anticipated new subscriptions;
- fee and interest income;
- cash exits; and
- new investments.

Notwithstanding pacing requirements, which are a basic reality at an LSIF, cash available for new and follow-on investments is essentially what is left over after the other cash items and reserve requirements have been met.

OBSERVATIONS

- CIF did not have an investment strategy linked with cash and portfolio management practices.
- The Board did not identify the need to have an overall investment strategy for its portfolio.
- The investment choices made by CIF were not made within the context of an investment strategy developed using detailed cash analysis and cash flow information. As a result, investment decisions were made on an ad hoc basis.
- Deficient cash and inadequate portfolio management appear to have been the most important obstacles and issues impacting the future viability of the Fund's ongoing operations as far back as early 2002.
- Senior Officers and the Board were aware of a very challenging cash management problem at CIF that had been in existence since at least early 2002. Yet commitments to fund certain portfolio companies and sub-funds were still made. For example, the following recent investments were made:
 - In January 2004 a callable \$500,000 convertible note obligation;
 - In March 2004, a new investment of \$550,000 with a \$1.2 million guarantee;
 - In July 2004, a ten year \$3,000,000 partnership commitment; and
 - Also in July 2004, a further \$2,000,000 partnership commitment.
- Cash flow analyses that were prepared by CIF's Finance Department during fiscal 2002, 2003 and 2004 were prepared using information from the Investment Department that were not based on reasonable and realistic assumptions, and were not supported by sufficient detail in each of the categories noted previously.
- As per an Investment Department staff, *"It is important to note that the members of the investment department did provide projections and cash flow analyses during fiscal 2002, 2003 and 2004. These projections provided by the members of the investment department (after some fundamental analysis of the portfolio) were subsequently changed by the former CIO. The revised numbers were definitely more aggressive in nature and could be considered 'not based on reasonable and realistic assumptions'.... The distinction is that the numbers that were put forward to the Board were the creation of the former CIO despite the input from the investment department.*

Further, it could be said that there did not appear to be a concerted effort on behalf of the former CIO to manage to the business plans put forth to the Board or for the Company. There was a complete disconnect between certain of the department's stated objectives and the course of conduct portrayed by the former CIO."
- The Fund's Business Plan for Fiscal 2004 prepared for the Board of Directors in mid-2003, did not mention a cash flow or liquidity problem in either of the following two sections in the Introduction portion of that Plan: *"Threats in the External Business Environment"*; and *"Internal Weaknesses of Crocus Investment Fund"*. Also, neither the Investment nor the Finance and Administration portions of the Plan raised significant cash flow or liquidity concerns.

Conclusion

- As a result of the Fund not having a rigorous cash management discipline, the Fund took an undue risk that it would run out of money and not be able to meet its obligations.

b) Co-Investment

Co-investment is a common practice in the venture capital and private equity investment industry in Canada and the United States, and is considered to be a strong sign that an investment is viable both at initial funding and at follow-on financing milestones as the portfolio company continues to grow and develop.

Proven co-investors with significant capital provide much to improve the ultimate success of an investment. The value that can be added by a good co-investor includes:

- Aiding in the initial assessment of the viability of the investment;
- Validating whether or not follow-on financings are advisable;
- Sharing the financial risks – including follow-on financings – of the investment;
- Identification of other possible co-investors;
- Advising as to how to deal with the business risks of the investment;
- Helping with portfolio company account management and governance;
- Providing access to their network of contacts;
- From time-to-time, helping confirm the carrying value of the investment; and
- Identification of exit options and helping with the execution of the exit in order to monetize the value of the investment.

Particularly important for a regional fund like CIF, co-investors also provide an independent view of what is going on in the greater venture capital market, generally and specifically, including the latest in venture capital investment trends, techniques, processes and procedures.

OBSERVATIONS

- Many major portfolio company investments in CIF's portfolio at September 30, 2004 did not have proven substantial independent third party equity co-investors either involved or realistically targeted for investment in the portfolio company either at the time the investment was initially booked or when follow-on financings were made where it would affect value.
- As at September 30, 2004, CIF had 10 (out of 46) portfolio companies that were in excess of \$5 million at-cost making up 65.0% of the total cost of the investment portfolio. Out of the 10 investments reviewed, we noted that 4 did not have a proven, significant, equity co-investor and may have their carrying values entirely written off as a result of the recent work of the independent valuation firms. Three of the 10 are likely to have major carrying value write-downs. Three out of the 10 investments had co-investors, with one likely to have a value write-up due to the independent valuation work, one likely to have a valuation write down, and the other has not had an independent valuation done since it is considered to be a relatively recent investment.

Conclusions

- Too often when CIF was the lead investor in a portfolio company, co-investors were absent. This lack of partnering was a limiting factor in terms of receiving the benefits that a co-investor can bring to an investment. The proposed carrying value write-downs as a result of the independent valuation firm's work confirms that this lack of co-

investment was not a good thing. Co-investment appears to have been a positive influence where it existed within CIF's major portfolio companies.

- Co-investors would have enabled the Fund to leverage its capital in terms of bringing more investment dollars to Manitoba – an indirectly stated objective of the Fund.
- It may not have been an accident that CIF did not find co-investors for its investments. Co-investors may have been negatively influenced by practices such as:
 - The Fund's stated preference of not wanting to exit investments except to Manitoba-based buyers (see Exiting, **Section 4.2.14**);
 - The Fund's attitude regarding return on investment not necessarily being the most important objective in its investment philosophy; and
 - Seeking monies from portfolio companies for fees, interest and other income including the reimbursement of extravagant out-of-pocket expenses.

c) Use of Guarantees

Guarantees of bank and other debt represent absolute risk, since in most cases and by definition, they take the place of a direct financing. In the absence of a strong investment process including good internal reporting, a guarantee may provide false assurance about the true "cost" and performance of an investment especially if the guarantee remains outstanding for a long period of time.

Guarantees are best provided as a short term bridge to a defined event - such as banking that stands on its own without a guarantee, a significant co-investment, or an exit - that removes the guarantee. Guarantees are a poor cash management tool since a fund would be exposed to having to finance the guarantee amount if called.

The use of guarantees in arranging investments in LSIFs is not viewed as a positive investment approach.

OBSERVATIONS

- Guarantee amounts were tracked in various summaries in CIF's Finance and Investment Departments but only recently – in mid-2004, and thereafter – has all of the detail behind the Fund's total guarantee exposure been available on a single comprehensive schedule, prepared by Investment Department staff.
- It appears that guarantees were not considered by Senior Officers to be exposure totally at risk. That is, not the same in terms of risk as a direct financing to a portfolio company. The Board and its sub-committees did not, according to the minutes of their meetings, remark and follow-up on overall guarantee exposure in terms of it being a sign of potential problems for the Fund.
- The Fund's Business Plan Fiscal 2004 prepared in mid-2003 for the Board of Directors did not indicate that there was any significant risk related to the guarantees. The Plan provided the following un-alarming information:

"The Fund guarantees \$15 million for its portfolio companies. This amount is down from last year when the amount was \$17 million. A concerted effort was made to minimize the amount of guarantees provided to the Fund's portfolio companies and to implement more effective pricing on all guarantees provided".
- As at September 30, 2004, CIF had undertaken to provide loan guarantees, undertakings and letters-of-credit for its portfolio companies in amounts totaling approximately \$16.3 million. At the Fund's fiscal year end in 2003 and 2002 the amounts were \$14.9 million and \$16.0 million, respectively. The allowance for possible losses due to the guarantees

above were for the three year ends: 2004 - \$1.1 million; 2003 - \$0.0; and 2002 - \$1.75 million (see **Figure 5**).

FIGURE 5

Year Ending September 30	Total Guarantees, Undertakings and Letter of Credit for Portfolio Companies	Allowances as per CIF Annual Financial Statements
2002	\$16.0 million	\$1.75 million
2003	\$14.9 million	Nil
2004	\$16.3 million	\$1.1 million

Source: CIF

- The independent valuation firms have determined that, as part of the April 5, 2005 valuation, that the allowance should be \$5.8 million or \$4.7 million higher due to the guarantees signed for six portfolio companies.
- The Board did not receive, nor ask for, information that detailed the overall guarantee exposure of the Fund. We noted that this information only began to be provided to the Board when the recent change in investment management occurred.

Conclusions

- CIF routinely provided substantial loan guarantees to portfolio companies for long periods of time as an accommodation to the portfolio company. Guarantees were also one of CIF's cash management measures. In our view, the use of guarantees was excessive, and exposed the Fund to the risk of full payment against those guarantees.
- The allowance for possible losses due to guarantees was understated on CIF's books as at September 30, 2004. Given the above observations, we believe that the allowance as at the end of fiscal year 2003 and fiscal year 2002 are questionable.
- To ensure proper oversight of the Fund, the Board should have been provided with the total guarantee information in order to understand the overall risk exposure to the Fund.

d) Setting Formal Target Selling Prices

Industry practice involves the establishment of formal target selling prices for its share investments in publicly-listed companies. A target selling price is the market price that, if reached, would trigger a sale of all or part of the investment. For each investment, there could be target selling prices that are both above and below the present market price of the shares held.

OBSERVATION

- The Fund did not follow the practice of establishing formal target selling prices from time-to-time, for its share investments in publicly-listed companies.

Conclusion

- By not setting target selling prices, the decision as to whether or not to sell all or part of an investment may not be addressed in a timely manner, or in a manner that would be financially prudent for the Fund.

e) In-Kind Investment by Co-Investors

The acceptance of in-kind investments is not a recommended LSIF industry practice.

OBSERVATION

- In certain investments, CIF has allowed co-investors – sometimes key principals in the investment – to contribute assets instead of cash to the investment. This in-kind value may or may not have the same economic value as cash as at the funding of the transaction, and thereafter. In one case, a transfer of shares into the partnership occurred 4 ½ years after the commitment. The value of the shares had declined about 44% between the commitment date and the transfer date.

Conclusion

- An in-kind contribution of assets instead of cash by a co-investor and/or principal in an investment is not a usual venture capital industry practice because the value of those assets is always questionable. In-kind contributions may also leave the burden of ongoing cash financing requirements of the portfolio company entirely to CIF.

f) Involvement in the Canadian Venture Capital Association and the Association of Labour-Sponsored Investment Funds

Involvement in related professional organizations is very important in ensuring that business practices are aligned with industry practices. This also provides important networking opportunities.

OBSERVATIONS

- CIF Senior Officers did not involve themselves and fully participate in the Canadian Venture Capital Association (CVCA). While several of the Fund's other employees were CVCA members and attended the annual conference, CIF Senior Officers appeared to isolate themselves from the many opportunities to be involved with the leaders of the industry.
- Some Investment Department staff were involved in industry-related initiatives, including regular participation and review of industry surveys and research initiatives. In addition the Investment Department staff were all active members of the Association for Investment Management & Research (AIMR) and the Winnipeg Society of Financial Analysts. These associations are affiliated with the Certified Financial Analyst (CFA) program.
- CVCA Committees where involvement would have been beneficial to the leadership of the Fund include: the Statistics, Reporting & Valuation Committee which, since 1999, has worked to produce CVCA Valuation Guidelines for use by the entire Canadian venture capital and private equity industry; Marketing/Networking; Membership; Public Policy; Professional Development; Institutional; Regional Representation; and Code of Conduct.
- CIF was not a member of the Association of Labour-Sponsored Investment Funds. ENSIS Growth Fund Inc. is a member.

Conclusion

- There is much to learn and gain from associating with venture capital colleagues across Canada. Participation would have allowed the Fund to help frame the issues and develop the actions plans opposite the issues that face the Canadian investment fund industry,

generally and specifically. Other benefits such as co-investment partners for investment alongside CIF in Manitoba may have developed because of such involvement.

4.2.4 Portfolio Construction

A well constructed venture investment portfolio is not an accident.

Portfolio construction is an ongoing exercise that is particularly important at an LSIF because of the impact of eligibility, investment pacing, regional investing and other legislative requirements. As an integral part of cash management, there are a number of factors to consider when planning how a balanced and diversified venture investment portfolio is to be built and how it is expected to look at future points in time. These factors include:

- The size of individual investments;
- The size of companies to invest in;
- The number of investments to carry in the portfolio;
- Which industry sectors to invest in;
- What stages of development (early stage money-losing versus cash flow positive expansion/growth capital companies);
- What instruments or form of investment (debt or equity) to use;
- Location;
- Type (private or public); and
- Anticipated exit horizons.

The need for the appropriate human resources in the Investment Department to manage the portfolio during its build, throughout its development, and during its maturity to exit period is also a key component to portfolio construction.

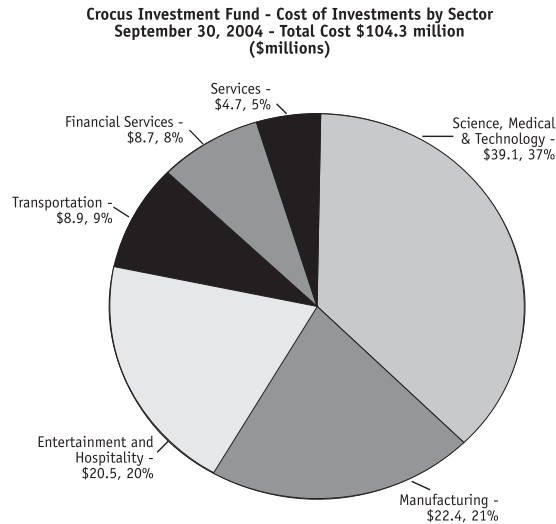
Fundamentally, portfolio planning must include a constant assessment about how individual portfolio companies are performing – including anticipated follow-on financing requirements - against the plan made for them at funding and their fit within the investment strategy and strategic plan for the fund at a given time.

The planning for new investments must be made in the light of a number of considerations including:

- A detailed assessment of present and future cash availability including follow-on financing requirements;
- Quality deal flow availability; sector issues – what's in and what's out; co-investment opportunities;
- Human resources considerations such as Investment Department expertise and experience; and
- What is going on in the exit markets for venture-backed companies since exit markets are both inconsistent and intermittent.

OBSERVATIONS

- There is little evidence that appropriate portfolio planning was done by the Fund on a comprehensive and ongoing basis. As a result, the investment portfolio at September 30, 2004 is over-weighted with portfolio companies with longer term exit horizons such as early stage, science, medical and technology investments, and certain other portfolio companies demanding more investment from CIF to continue operating.
- As at September 30, 2004 the portfolio (at cost) was comprised of:



- In the Fund's Business Plan Fiscal 2004 prepared in mid-2003, there is reference to the Investment Department having "recently conducted a review of the Fund's portfolio and estimated the potential sources and uses of cash from the portfolio company portfolio throughout the year". However, documentation to support that statement was not included in the Business Plan material. In terms of portfolio company problems existing and possible, there is no mention or exhibit of either specific or general risk. The section entitled "Portfolio Mix" is just a listing of sectors and percentages without a comment on whether the mix is good or bad and without any mention of a plan for the future. In fact, the Business Plan's "Portfolio Commentary" suggests a rather optimistic outlook for fiscal 2004:

"Generally, the portfolio has held up relatively well in the current depressed market environment and should be positioned well for value growth once the markets turn the corner. A number of the investments are relatively mature and would be available for divestiture in the next up market. Over the past year, considerable time and effort has gone into stabilizing distressed investments in the portfolio and minimizing the cash burden to Crocus of the portfolio. To this end, the Fund has been able to reduce the cash requirement from several companies through improved operating performance in the companies, sale of the company or attracting additional capital partners".

- Since the first step in portfolio planning is to understand what you have and what you can do with it, it is apparent that the first truly comprehensive and detailed analysis of the portfolio - including triage - was not begun until June/July of 2004 as a result of the efforts of the individual that was appointed CIO effective October 1, 2004. This comprehensive triage analysis of the portfolio should have been conducted at least two years earlier.

Conclusion

- Due to the lack of appropriate portfolio planning, over a period of some years CIF constructed an investment portfolio that is, at present, neither balanced nor diversified in a way that enables the Fund to conduct its ongoing business in a normal fashion including being able to meet all of its investment management obligations as they arise.

The lack of appropriate portfolio construction planning has contributed to the Fund's present cash management/liquidity problem.

4.2.5 Staffing Adequacy

Staffing adequacy with respect to the level and qualifications of staff in the investment area is very important for an LSIF. When staffing adequacy is not present, it demonstrates a lack of leadership and good management on the part of Executive Management, as well as a lack of oversight on the part of the Board of Directors.

OBSERVATIONS

- For most of the life of the Fund, the Investment Department was led by the former CIO who did not have a venture capital and private equity investment management background and track record. As set forth in the Fund's prospectus dated January 21, 2004, prior to CIF the former CIO was "a former director of a major Canadian securities dealer". This means the former CIO's experience was gained from "the sell-side of the street", as opposed to the "buy-side of the street" where investment funds such as CIF are located.
- There is a big difference in experience between the two sides of the street. The former is all about the selling of securities to investing institutions (the buy-side by definition) and/or to the public over a 3 - 9 month period. The sell-side gets compensated when the buy-side invests. All of the financial risks inherent in a transaction end for the sell-side when they get paid. This is coincident with the moment the buy-side buys. In contrast, the buy-side's 3 major risks – business, financial and exit - begin when they invest. The buy-side is all about making a return on investment over the long term which could be 3 - 9 years depending upon the industry sector and exit markets.
- The former CIO reported to the former CEO who had overseen the Fund since its inception and did not have an investment management background. As disclosed in the January 2004 prospectus, the former CEO *"had over fifteen years experience in the strategic development of employee ownership and related investment banking (the sell-side), business planning and legal structural design"*.
- In the last 10 years, a few experienced investment professionals were hired to reinforce the experience level in the Investment Department. None of these hires remained with the Fund for very long. As a result, during the 12 years since the Fund began in 1993, there has rarely been a person in the Investment Department, other than the former CIO, that had the experience of being closely involved with a portfolio company from start (deal selection) to finish (exit).
- When Investment Department people left the Fund, continuity regarding individual portfolio companies was lost and inexperienced people often took over responsibility for these files.
- Early on, for the most part junior and intermediate people were hired to work in the Investment Department - none of whom had significant venture investment experience.
- Although there were exceptions from time-to-time as certain people with professional experience were brought onto the investment staff, supervision and training of inexperienced Investment Department staff was on-the-job and largely dependent upon other relatively inexperienced staff. According to CIF staff interviewed, the former CIO

was not known as a strong manager and supervisor, and arranged little formal training of staff. For most staff, the venture capital investing business had to be learned on-the-job.

- Current and most former investment professionals of CIF had obtained or were candidates for the Chartered Financial Analyst (CFA) designation. In addition, some CIF analysts were completing their Certified Business Valuator (CBV) designation.
- The length and breadth of the on the job learning process for investment staff was neither planned nor thorough in any true sense. Most staff were inexperienced-hires and could gain true experience only in bits and pieces because the former CIO generally took it upon himself to do much of the following:
 - Screening investment opportunities including selecting which ones to decline and which to work on;
 - Performing major parts of due diligence including the vetting of the principals of the company being considered for investment;
 - Negotiating the terms and conditions of the deal including pricing (pre-and-post money valuations);
 - Presenting proposals to the Board to obtain an approval to book an investment;
 - Reviewing and signing the legal documents for an investment;
 - Account management and monitoring for many major portfolio company investments;
 - Handling and/or influencing of valuation changes for portfolio company investments;
 - Internal reporting regarding the progress of portfolio company investments including to the Board;
 - Trouble-shooting for portfolio company investments when they were not performing; and
 - Exiting portfolio company investments.
- As per CIF Investment Staff, *“the real issue is that the professional opinions of investment staff that were trained and knowledgeable about investment matters were routinely dismissed and overridden. This led to significant turnover in the Department during 2004”*.
- The former CIO was absent from the office much of the time, conducted key due diligence procedures on his own, did not usually document what he had done, did not write regular status memos regarding the progress of portfolio companies, did not maintain organized account management and monitoring files and records for the portfolio companies he managed, often attended key portfolio company meetings alone including Board meetings, did not document findings and follow-up action plans, and did the trouble-shooting for portfolio companies that he managed largely on his own without documenting – for the edification of others - the problems identified and remedial action(s) taken or to be taken.
- The former CIO did not set a particularly good example for investment staff to follow. It was communicated to us that he had a cavalier attitude towards whatever process and procedure did exist at any point in time (see **Section 4.2.11**).
- The former CEO did not challenge this approach to investment staff development.
- Despite attempts to formalize elements of process from time-to-time, strong investment management processes and procedures were not established to provide guidelines and govern and manage what went on in the Investment Department.
- The Fund has a corporate structure and legal framework that is not conventional in the venture capital and private equity business. Most such entities are partnerships with

experienced venture investors as general partners under a management company structure (the general partners' management company contracts to manage the assets of the fund usually on a long term basis). The majority of LSIFs in Canada have this conventional structure which, amongst other things, provides long term compensation incentives to attract and encourage the best people to remain with the fund and become partners.

- When Investment Department staff left the Fund, there is no evidence that it was seen as a danger sign by either Executive Management or the Board. Although turnover was high during 2004 when four staff left the Investment Department, there is no evidence that exit interviews were conducted by the former CEO to find out the underlying reasons for the departure.
- The former COO did request and obtain feedback from a departing analyst that indicated that he felt "that there is undue pressure in valuing companies upward as opposed to fairly. He felt that when there is a write-down required or not doing a write-up, that there is blame placed on the valuation personnel as opposed to dealing with the fact that there is a business issue within the portfolio company which needs addressing". The Board indicated to us that they were not aware of this.
- The Board had little knowledge of the qualifications of their investment staff and assumed they were appropriately trained and supervised by the former CIO. They did not consider that experts may be needed when making investments in specific sectors, such as technology.
- The current Investment Department staff and recent professional hires are now working in a more informed and learning environment under the new CIO. This group represents a core of capable people to face the job ahead which is expected to be largely one of portfolio management over the next 12 - 24 months.

Conclusions

- The lack of buy-side experience by the former CEO and former CIO led to the continuing situation where Investment Department staff were inadequately trained and supervised, where rigorous investment management discipline in terms of process and procedure were largely absent, and where practical experience gained by staff working on investments was intermittent and incomplete.
- The resources in, and of, the Investment Department were inadequate for the challenges at hand at most times during the last several years.
- The corporate structure related to CIF was not supportive of personal development and career advancement for Investment Department staff.

4.2.6 Initial Screening and Selectivity

OBSERVATIONS

- Most of the investment opportunities selected for due diligence, approval and funding were those chosen by the former CIO.
- As a result of this approach to selectivity, experienced Investment Department staff may have had the opportunity to work on a transaction but rarely had the opportunity to select and champion a deal on its merits on their own.

- Investment and valuation memoranda are written and approved by the Staff Investment and Valuation Committees respectively, before proceeding on to the Board Investment and Valuation Committees for final approval. Because there is rarely a name attached to the written document, all appear to be responsible rather than one individual being directly responsible – and accountable – for the document.
- As per Investment staff, valuation decisions were overridden by the former CEO and former CIO, and were frequently made after the Valuation Committee met.
- Although high estimates of return (i.e., 20% - 30%), were always cited on CIF investment memoranda, the rate of return in relation to the nature of the investment was not always the primary basis for investment selection. In the past three to four years, certain investments appear to have been chosen as a result of the Fund's objectives of promoting employee ownership and employee participation in corporate governance and management, of maintaining capital retention and economic stability in Manitoba, and promoting business continuity, job retention and creation and ownership of Manitoba businesses by Manitobans.

Conclusions

- By not always using rate of return as the primary screening objective, the Fund is at risk of making investment choices too heavily weighted on social objectives at the expense of return to shareholders and financial viability.
- By having one individual play such a predominant role in investment screening and selectivity, there is undue risk that selections may be heavily weighted on historic portfolio company relationships and personal bias.
- The staff committee approach to investment and valuation memoranda led to a lack of accountability on the part of investment staff, generally and specifically.
- CIF's approach to selectivity was not consistent with the best methods of promoting personal development and career advancement for investment staff. In order to properly develop experienced investment staff, the apprenticeship must include the ability to develop quality deal flow contacts and a reputation for being able to get a deal done. Accordingly, certain staff should have a mandate to identify investment opportunities and to pursue them until either declined or moved further along in the investment process.

4.2.7 Due Diligence

There are six fundamental areas of consideration that have to be examined in due diligence work when deciding whether or not to invest in a company:

- The people (by far the most important due diligence consideration);
- The technology, service or product;
- The present and/or future markets for that technology, service or product;
- The price to be paid to invest in the company (valuation work);
- The most likely exit options for the investment; and
- The financial accounting, planning and control functions of the target company.

Due diligence is usually customized to the company being examined, and a venture capital fund often uses more than one person to perform due diligence. Often when looking at an investment opportunity in the

science and technology sectors, an industry expert is hired to help with the work and the cost is shared with co-investors.

Simple reliance on due diligence work that a co-investor may or may not have done is not acceptable. There is no substitute for doing one's own work, and there is no better proof of what work has been performed than documentation.

OBSERVATIONS

- Due diligence performed by CIF to support initial investments in portfolio companies has been of inconsistent quality in terms of both the level of knowledge obtained and the thoroughness of documentation. Due diligence records supporting investments that were reviewed range from completely inadequate to acceptable.
- Most Board members, including those on the Investment Committee, did not have a clear understanding of the Fund's due diligence process. We were told that the Fund used social audits, as well as financial audits, as an important component of their due diligence process. However, we noted that the Investment Committee did not ensure that both were done for every investment. For example, only a partial social audit was conducted for Company A.² The former CIO conducted all due diligence in previous operations owned by Senior Management at Company A.
- Several examples of significant due diligence deficiencies were noted in five portfolio company files:
 1. In Company P, the due diligence work performed by CIF to support an initial investment and subsequent follow-on investments appears to be highly questionable. When CIF initially invested in Company P, it was in a cash crunch and out of working capital. It was not routinely able to produce reliable internal financial statements. It did not have a competent CFO. (During the social audit of Company P, it was recommended by CIF staff that he be removed because he was not competent. The former CIO stated to staff that CIF did not get involved in governance and ignored the staff recommendations.) It did not have valid financial projections going forward and had assets whose values were doubtful. Further, it appeared to be in breach of its loan covenant with a loan facility. Another venture capital fund devalued its investment significantly ahead of CIF. In the end, CIF's investment was written off.
 2. For Company O, CIF relied on a feasibility study that did not provide an independent look at the business, financial and exit risks associated with the proposed investment. The investment appears to have been made regardless of the risks. Due diligence at initial funding and during the life of the investment was questionable. In the end, CIF's investment was written off.
 3. For Company A, the due diligence effort at initial funding and ongoing for follow-on financings appears to have been materially deficient during most of the life of this investment.

Original due diligence files were not available for our review. The investment memorandum was written-up by an investment analyst, but the former CIO was the champion of the investment. Little documentation was maintained by the former CIO on the monitoring of this investment.

² Portfolio company names are not used in this report. Companies were given alpha references that are used for the same company consistently in the report. CIF's Board and Senior Officers were provided with detailed information for all alpha references.

Because it is now known that there are many problems with Company A, it is very difficult to separate hindsight from what was, and could have been, known at the time the investment was booked. Instead, one outstanding comment from the original Investment Memorandum is representative of the quality of thought and work that went into the due diligence done: – *“The upside potential of an investment in [this company] is contingent on the performance of the company”*. This is certainly not saying anything original or that couldn’t be said about any or all investments. Yet this statement formed part of the basis for approving the investment.

Although some of the major issues were documented by staff and brought to the attention of the former CIO, the former CIO did not communicate them to CIF’s Board. If the due diligence effort at the time of the initial investment and prior to the significant follow-on financing tranches that were made had been more thorough, it is possible that the Board may have raised more questions.

4. In the case of Company T, more than three years after an initial funding on an investment, CIF’s partner had not transferred their in-kind investment of shares into the partnership. This was an open due diligence point that should have been dealt with on or before initial funding.
5. In the case of Company U, CIF failed to record the value of shares held until over three years after an investment was made. This appears to have been the result of both incomplete due diligence and inadequate account management and monitoring of the investment.

Conclusions

- Due diligence is a fundamental building block of a good venture investment. Depending on the investment made, its timing, and which CIF investment staff worked on the investment, the quality of the due diligence work done was inconsistent and, in some cases, significantly deficient.
- The former CIO did not fulfill his responsibilities to ensure that the due diligence process operated effectively in the Investment Department.

4.2.8 Investment Approvals

Investment approval protocols can be an effective part of investment management processes and procedures. In order for approvals to be effective, the information provided to the approvers must be accurate, timely and complete.

Substance should be more important than form in seeking and obtaining approvals. Ultimately, approval protocols only work where there is good information available for the approvers and where approvals are given by knowledgeable readers of the material being approved.

OBSERVATIONS

- Prior to 2002, we noted that investment approval practices were rather informal.
- Formal protocols were put in place in 2002 following the significant write-off of CIF’s investment in Company GG of \$20.9 million in fiscal 2002. Largely as a result of this write-off, the Fund established definitive Investment Department protocols regarding approvals of new investments, follow-on investments and guarantees. In 2004, these were updated without material change.

- The major elements of the existing protocols follow:
 - Management will have authority to approve investments up to \$500,000 in any portfolio company, to an aggregate approval authority in any year of \$5 million. In managing this authority, management shall, as a courtesy to the Board Investment Committee, inform a member of the subcommittee of its investment decision before a cheque is written to the portfolio company.
 - The Board Investment Committee shall have the authority to approve investments of \$1 million or less.
 - 2% of investment assets at cost shall be the presumed maximum for initial investments. Initial investments greater than 2% of investment assets may only be made with approval of management, the Board Investment Committee, and the Board.
 - \$10 million at cost shall be the presumed maximum for aggregate investments in a portfolio company. An investment which results in the aggregate of all investments in a company exceeding \$10 million may only be made with the approval of management, the Board Investment Committee, and the Board. As noted in **Section 4.5.4** the Fund's By-laws have not been amended to reflect this.
 - Roll-ups shall be treated as a single investment for purposes of the aggregate investment maximums.
- For the 16 investments reviewed in detail in this report, the investment protocols were generally found to be followed. However, as indicated in the specific section of "Account Management and Monitoring", "Valuations", "Initial and Follow-On Financings" and other sections of this report, approval protocols were not supported by either strong investment processes and procedures or appropriate checks and balances. In other words, the information that the Board of Directors, Board Investment Committee and Senior Officers used to make approval decisions was often deficient in terms of being timely, accurate and complete.
- CIF has a number of problematic portfolio companies and transactions. In the case of Company D, the investment funded did not agree with the investment approved. A transaction was approved by the Board of Directors that included a significant co-investor in the transaction. CIF's funding was to be a convertible subordinated debenture. When the investment was completed, the investment was funded as common equity and the significant co-investor was not involved.

Conclusions

- The Fund's investment approval protocols, including approvals for follow-on investments, were generally followed. However, the information that the Board of Directors and the Board Investment Committee received on which to base their approvals, was often inadequate.
- The former CEO's and the former CIO's discretion to approve investments was too generous. Specifically, investment approval protocols were weak where portfolio companies were either not performing, were "watchlisted", or were otherwise worthy of more careful scrutiny (such as those which had potential conflict-of-interest situations).
- Particularly in light of the lessons learned from the Company GG debacle, and with the benefit of hindsight, the former CIO and the former CEO would appear to have been given

too much latitude in their ability to approve up to \$500,000 for any portfolio company and up to \$5,000,000 in any one year. As a result, follow-on investments were excessive both in number and amount in several investments where the Fund continued to fund, notwithstanding the problems of those particular portfolio companies.

- The actions of the former CIO with regard to approvals (i.e., not ensuring that the investment transaction that was approved by the Board of Directors was materially the same as the transaction that was ultimately booked by the Fund) demonstrated a cavalier attitude towards the Board approval process.

4.2.9 Initial and Follow-on Financings

The usual venture capital financing practice is to identify either an expected exit horizon or certain performance milestones to where initial investment amounts are fully-funded. Also, the usual venture capital practice is to have follow-on financing funding related to milestones or to a stage in the life of the investment before approval is obtained.

OBSERVATIONS

- Investment memoranda were prepared for approval recommending funding of certain initial investment amounts. These memoranda did not reflect any expectation of further future financing requirements and provided no indication as to the targeted amount of the investment (the long term cap on the investment). Nonetheless, a large number of follow-on financings are funded often on a monthly basis to keep portfolio companies alive.
- Follow-on financings were continued and guarantees were provided until certain investments became “all-or-nothing bets” that had to have continued follow-on investment and guarantees in order to stay in business. There was no indication in investment, valuation and other memoranda as to what event or situation, including deepening financial risk on the part of CIF, would lead to a decision to stop further investment in a troubled portfolio company.
- In the case of four investments, when added together, approval was given for initial investments of approximately \$3.7 million. After 151 follow-ons, the cost for these investments, (including \$3 million of guarantees) totaled \$36.2 million as at September 30, 2004. Individual portfolio company follow-on numbers were: Company A – 39 follow-ons; Company B – 40 follow-ons; Company C – 55 follow-ons; and Company D – 17 follow-ons.

Conclusions

- CIF’s practice regarding follow-on financings particularly at initial funding was not in line with common venture capital practice. At some point, a bad investment has to be recognized as such and follow-on financing and guarantees stopped.
- The large number of follow-on investments to some companies, together with the fact that they were made on an ad hoc basis rather than within a consistent overall investment strategy, should have raised red flags for Board members. While questions/concerns appear to have been raised with respect to follow-ons by a small number of Board members, it did not result in follow-ons being refused.

4.2.10 Documentation and the Use of Puts

There is no need for lenient legal documentation in venture capital investing.

In its simplest form, a put allows an investor to offer the shares that it owns back to the portfolio company for fair market value (which may be determined by an independent valuator). If the put cannot force the portfolio company to buy the shares, it is known as a “naked put”. A “hard put” is one that enables the investor, if the put is not honoured, to take control of the Board of directors, put the company up for sale, and execute an exit.

Puts are not usually enforced since it would most likely result in mutually assured destruction of the company. A put is, however, a useful structuring tool because it ensures that the principals of the company will not ignore the investor’s desire to exit the investment. A put gives the investor “power”.

OBSERVATIONS

- Legal documentation for booking a transaction to invest in a portfolio company was largely done by in-house counsel at CIF until early in 2000. After that, a law firm handled the Fund’s legal work.
- Legal documentation for investments in portfolio companies (a Unanimous Shareholders Agreement, Subscription Agreement and Debenture) did not normally incorporate a forced exit date, that is, a date when CIF as an investor could demand that its investment to be monetized by a sale of the portfolio company, a recapitalization or liquidation.
- The Fund’s external legal counsel has not been scheduled to hold training sessions for Investment Department staff to help them better understand the documentation used to invest in a portfolio company.
- Standard or “boilerplate documentation” that would be the starting point for legal documentation on a transaction cannot be found in CIF’s offices.

Conclusions

- A significant weakness in the Fund’s approach to the legal documentation of an investment transaction has been the lack of a way to force an exit at a certain point in time or upon the occurrence - or lack thereof - of certain events. Notwithstanding the Fund’s philosophical bias against exiting, generally and specifically as noted in the “Exiting” section of this report, additional legal information may have equipped investment staff with a better understanding of all the options available to strengthen the documentation on portfolio investments. This may have helped Investment Department staff deal with some of the more problematic portfolio companies over the past two - three years.
- Further, since CIF is a regional LSIF with limited competition, stronger legal provisions would appear to have been relatively easy to obtain on virtually all transactions where the Fund was the lead investor.

4.2.11 Account Management and Monitoring

a) Use of Specialists

Conventional venture capital practice is to employ investment professionals experienced in the type of investments that are being made. Even investment opportunities in industry sectors that are not either

science, medical or technology – entertainment, hospitality, real estate development, hogs - require experienced investment professionals to knowledgeably examine the merits of the investment.

OBSERVATIONS

- Particularly important in science, medical and technology investments, portfolio company investments made by CIF were often screened, selected, booked and managed by CIF investment professionals who did not have investment expertise in the relevant industry sector.
- For nine files reviewed of investments booked by the Investment Department, the individuals handling the files did not have relevant investment experience in the industry sector. These were in the area of science and biotechnology; film and sound; hospitality; real estate; and agriculture.
- Presently, the Investment Department has a reasonable amount of general investment experience and some developing sectoral expertise.

Conclusions

- CIF's practice has not been consistent with the conventional venture capital practice of employing investment professionals experienced in the type of investments that are being made.
- Generally and specifically, CIF's practice of having inexperienced investment professionals learning on-the-job presented additional risk regarding the potential for return on investment of its venture capital investments.

b) Fundamental Account Management and Monitoring

Investment and valuation memoranda should address and customize account management and monitoring considerations regarding each investment including the following matters:

- A thorough analysis of the key risks of the investment and what mitigating factors may exist;
- A description of what events may herald good progress on the part of the portfolio company and otherwise;
- Details regarding co-investment partners – names of individuals involved, staying power (cash to invest), and ability to add value to the investment;
- Follow-on financing expectations including what key milestones follow-ons may be tied to, and their expected timing in the portfolio company's development;
- The regular reporting regimen – internal financial statements and other reports – that will be obtained;
- Known conflict-of-interest issues and how they are to be handled;
- Proposed at-funding compensation packages and ongoing controls over the various forms of compensation regarding the principals of the portfolio company;
- The make-up and credentials of the Board of Directors and the checks and balances in place to protect CIF as a minority investor;
- An up-to-date capitalization table; and
- An assessment of the financial planning, control and accounting function including whether the portfolio company has a competent CFO.

OBSERVATIONS

- For all portfolio company investments reviewed, there was inadequate description in investment and valuation memoranda regarding the account management and monitoring plans for each investment.
- There was inadequate description in initial investment and subsequently written valuation memoranda regarding action plans to address the various problems and risks identified at the time the memos were prepared. The problems that later arose were due to fundamental account management and monitoring plan deficiencies usually regarding matters that were agreed, or should have been agreed to, by contract at the time of the initial funding of the investment.
- After initial funding, the problems were often identified and described but remedial action plans to correct the deficiencies were often not pursued, or were pursued without any sense of urgency, and often remained uncorrected for extended periods of time.
- In April 2000, the external audit firm for CIF conducted an “Internal Financial Process Review” that observed and recommended the following. We believe that this was an important issue that required resolution at the time it was raised:

“Investments should be monitored more closely to ensure timely receipt of investee information.....there is no process in place to ensure that investments are being monitored on a regular basis. If information is not being received from investees and analysts are not able to follow-up with investees on a timely basis to ensure that the information is received, Crocus may not be able to evaluate the investment on a regular basis to highlight matters of significance. These matters of significance may impact the value of the investment and hence Crocus’ share value.”

- In the meeting minutes of June, 2002 of the Investment Committee of the Board, the former CIO advised that many of the recommendations in the Company GG special report were “being practiced and are business practices as a whole”. It does not appear that many of those recommendations were implemented.
- Notwithstanding portfolio company problems that were identified and un-remedied, the Fund continued to finance and otherwise carry on business most times almost as if the problems did not exist. Coincidentally, these investments have been written-down as part of the latest external valuation review. Some examples are as follows:
 - For Company T, financial statements had not been received for three years and shares that were part of the contribution to the investment had not been transferred to the partnership. It took approximately four years before the shares were transferred.
 - Company A was primarily managed and monitored by the former CIO. His handling of this investment reflected a troubling approach to account management and monitoring and was representative of his relationship with his investment staff, the former CEO, and the Fund’s Board of Directors. He did not directly address problems noted and displayed a disregard for the concerns and views of the staff reporting to him, and he failed in his fundamental accountability to the Board for accurate, complete and timely reporting regarding this investment.

According to an internal email from an investment staff member to the former CIO about two years after initial funding of the investment, the final terms and conditions with regard to the pricing and valuation of part of CIF’s investment had not been settled. Approximately 50.0% of the funds invested in the company to that

date remained in question as to whether the investment was structured as debt or equity, what percentage of ownership would result, and whether or not the principals of Company A with shareholder loans would be converting their debt to equity. We found no evidence that the former CIO responded to this email.

One year later in September 2003, another member of CIF's investment staff learned that the principals of the company had repaid a material amount of shareholders' loans to themselves earlier in the year in contravention of contracted agreements with the Fund.

This was reported by email to the former CIO, along with the strong recommendation that the Company A investment should be put on the Fund's "Watchlist" and reported to the Board's Investment Committee. The former CIO disagreed by return email, and the matter was left in his hands.

Four months later, in January 2004, the investment staff member provided a five page comprehensive memo to the former CIO highlighting the significant issues with the Company A investment. Sub-headings of his memo were as follows:

- i) **Background** (Company A may need another \$5,000,000 in order to execute its business plans);
- ii) **Company Performance** in fiscal 2003 (significantly off budget and a very large operating loss);
- iii) **Holdco** (the principals holding company) shareholder loans;
- iv) **Investments In Related Companies** (Holdco holds interests in several different entities and makes loans and receives advances from them and Company A);
- v) **Strategic Partner** – Concern about the value of shares held by Company A received as consideration for product development;
- vi) **Continued Pattern of Making Commitments Without Cash Resources** (concern about the lack of cash to live up to agreements made by Company A to purchase equipment, and to invest in a foreign-based company and a foreign-based joint venture);
- vii) **Inability to Meet Commitments** (approximately \$2,500,000 advanced by CIF to Company A since April 2003 that was to be quickly repaid was not repaid);
- viii) **Poor Governance and Reporting** (timely financial reporting from Company A to CIF has "a long way to go");
- ix) **Goofy Transactions** (with another foreign-based company);
- x) **Inequitable Ownership and Investment Contributions** (CIF equity ownership of Company A should be higher based on funds advanced, and concern that the original Holdco shareholder loan of several million dollars had never actually been made since there is no record of an opening balance sheet.....); and
- xi) **Summary and Recommendation.**

The former CIO did not formally respond to this memo and it does not appear to have been forwarded to either the former CEO or to the Board for review. The Board has informed us that they did not receive this document.

In January 2004, the former CIO made a “first time” Watchlist report to the Board’s Investment Committee on this portfolio company. However, he also asked the Committee to approve a \$300,000 investment that had been previously advanced in excess of his yearly discretionary investment limit.

The written Watchlist was not very fulsome in its detail of the various shortcomings of the Company A investment. The entire report consisted of the following comment, *“Due to current financial performance this company has been added to the Watchlist”*. Minutes indicate that CIF had concerns regarding the Company’s financial reporting; the Company did not meet their previous year’s financial projections; the Company was in a cash squeeze; and the Company had expanded aggressively. The \$300,000 follow-on investment was approved.

A month later in February 2004, the Board’s Investment Committee again received a brief report from the former CIO regarding Company A which was described as having significant ongoing cash requirements and having failed to meet its business plan last year. He added that *“Crocus has concerns but they are concerns of opportunity”* and that there are also *“management concerns and (we) are working aggressively with them to grow slower”*. Then a \$300,000 investment was subsequently approved without notation of further discussion.

In March 2004, the Investment Department staff member again followed up with an email to the former CIO after a meeting held four days earlier. A number of concerns were tabled including that the principals of Company A were *“out of control”*, that the principals *“have once again over-spent and under-delivered”*, and that it may be time to stop funding the investment once and for all and to *“this time mean it”*.

The next day, the former CIO agreed with his staff member’s facts via email (copying the former CEO), but remained optimistic that co-investors would come into the investment and take the pressure off CIF to continue to fund. The former CIO then indicated that he would be recommending an immediate further investment in Company A in the amount of \$500,000.

Later that same day, the former CIO emailed the investment staff member indicating that he had *“received agreement to invest \$500,000 by way of secured loan to Company A from both the former CEO and the Chair of the Board Investment Committee. The former CIO added “Please let me know if there are any issues”*.

In April 2004, the former CIO reported to the Board’s Investment Committee that a short term loan or bridge financing in the amount of \$200,000 was required for Company A pending the closing and receipt of two third party financings. Without notation of further discussion, the Committee approved the investment of the \$200,000 on an *“as needed basis”* and on the condition that the funds would be *“immediately repaid out of the proceeds of the pending mortgage with...”*.

The next day, the former CIO emailed his staff member to report that the \$200,000 previously advanced would be repaid to CIF, shortly. The advance made was repaid from the mortgage proceeds two days later. However, a week later, the \$200,000 was re-invested into Company A. The former CIO had indicated that the authority to re-invest this \$200,000 was approved in April. This was misleading as in the end, the \$200,000 was not repaid.

There were various indications at various times of the significant deficiencies in the Company A investment that were not appropriately dealt with on a timely basis by

the former CIO. We were advised that he was both dismissive and manipulative of his staff member. He did not fully disclose all of Company A's account management and monitoring deficiencies to the Board. He did not identify any plans to remediate those problems.

The Investment Department staff member said it best: the investment in Company A was *"out of control"* and apparently in every possible way.

- For Company W, a co-fund managed by CIF, there were concerns about the poor financial reporting regarding the progress of the co-funds investments. Concerns were expressed about the expected exit horizon and conflict of interest issues. A number of investments in the co-fund were also direct investments of CIF.
- For Company B, the ownership of the intellectual property was in dispute for seven years.
- In the case of Company D, valuations were continually deferred on this company for two years. It was never put on the Fund's Watchlist report.

Conclusions

- The former CIO abdicated his responsibility to ensure sufficient fundamental account management and monitoring practices were in place and consistently followed. This contributed to the Fund investing, and continuing to invest, in companies where there were danger signs or identified problems. Further, investment problems that arose were not addressed by the former CIO on a timely basis.
- With respect to the Company B investment, the ownership of intellectual property should have been resolved when CIF initially funded the investment. Ownership of the intellectual property is a key component in the valuation of all science, medical and technology companies. An experienced investor would have either not booked such an investment with ownership in dispute, or forced remedial action on the portfolio company and/or the intellectual property owner if ownership remained in dispute for even a short period of time post-funding.
- Insufficient account management and monitoring contributed to internal valuation decision-making based on deficient information.
- The recent devaluations in the CIF investment portfolio are a reflection of inadequate fundamental account management and monitoring.
- The Board was not in all cases, provided with complete information on which to base its approvals. Based on the lack of sufficient information provided, it would have been reasonable for the Board to have denied approval until provided with appropriate, documented information.
- Existing information that was not made available to the Board regarding Companies A and D raise questions of impropriety.

4.2.12 Valuation

a) Review of the Valuation of Investments

There are many considerations to deal with in the valuation of a venture investment made by an LSIF such as CIF. These considerations are compounded when an entire portfolio has to be valued particularly when

the companies within the portfolio are not homogeneous, that is, not all in one industry sector where both investment and valuation expertise can be developed over a period of time. Such is the case with CIF.

Early stage investments – a venture capital staple – are more difficult to value than more mature companies with revenues and operating profits. In fact, one notable Canadian valuation expert – Ian R. Campbell – has indicated that the normal Chartered Business Valuator (CBV) approach to the valuation of an early stage company is not very reliable in terms of determining a realistic carrying value at any given point in time.

Added to the considerations that an LSIF has to face is the significant responsibility of having to self-price its own shares on a daily, weekly, semi-monthly or monthly basis. This is complicated by the fact that the venture capital industry – including LSIFs – has many valuation guidelines to choose from that are not consistent one-to-the-other and that are not enforceable by any governing body. The reasonableness of the carrying value of an LSIF's investment portfolio and the individual investments within it is left first to the management of the fund, and then to the fund's Board of directors, and finally to the fund's external auditors that usually employ CBV approaches to valuation.

There are a number of issues with the self-pricing of net asset value per share. Funds competing for the same investor's dollars may take a totally different approach to the valuation of identical investments with the result that the range of carrying values of portfolio companies in one fund compared to the others may be unreasonably wide. To date, and although it is a widely-known issue, the external auditors of the funds, the Association of Labour-Sponsored Investment Funds, and the respective Securities Commissions across Canada have not found a way to eliminate this anomaly. Regarding the Securities Commissions, it appears that prospectus disclosure is their preferred way of indicating that they have dealt with and handled the issue.

Accordingly, each LSIF has a great deal of discretion in placing a value on their portfolio companies and their portfolio taken as a whole. The challenge is not to choose between being either at the high-end or low-end of the valuation range, the difficult challenge is to value fairly and realistically – given all the information that investment professionals at the fund know and should know – in spite of competitive and other pressures that are at the very core of the LSIF business.

Lofty ideas aside and notwithstanding the foregoing, good practices for an LSIF regarding the valuation process would include the following:

- All portfolio companies in an LSIF's venture investment portfolio should be scheduled for mandatory valuation at least once a year. No deferrals, no exceptions.
- Due to the occurrence of valuation events, some portfolio companies may require either a formal or an updated valuation more than once annually.
- If key information, such as audited financial statements or recent interim financial results, is not available, the valuation should still be completed and the reason(s) underlying that lack of availability should weigh heavily on the ultimate carrying value of the particular portfolio company.
- Investment Department staff that manage and monitor portfolio companies should be capable of performing a valuation on those companies, perhaps with the assistance of an analyst. They know the portfolio companies the best.
- A qualified person or person(s) familiar with valuation methodology per se, such as a CBV, can then act as a valuation resource to help resolve valuation issues and as a reviewer (or check and balance) to ensure that portfolio companies are being valued consistently and appropriately across the portfolio.

- Valuation Reports should be addressed to the CEO and/or the CIO and to the Board Valuation Committee. Valuation reports should be signed by the investment staff that prepared them, and undersigned by the reviewing qualified valuation person.
- Quite aside from discount rates, multipliers and other elements of formal valuation methodology, a valuation template for use by investment staff should be developed to include and address the following valuation issues:
 - The business model of the company;
 - The track record, character and capabilities of management;
 - A summary of insurance on key management;
 - The market for the company's product, service or technology;
 - The quality of the financial accounting, reporting, planning and budgeting system;
 - Adjustments made to the audited financial statements in the past;
 - A summary of the historical financial performance with comments regarding how actual results compared to budgets;
 - Operating results and other milestones missed and yet to be met;
 - A summary of portfolio company problems and remedial action taken and to be taken;
 - All significant estimates made by the management;
 - Consideration of whether or not fraud factors exist;
 - Unusual transactions, if any;
 - Related party transactions that may indicate conflict-of-interest situations;
 - Unusual arrangements or special structures that may affect the quality of the valuation;
 - A capitalization table and a summary of the legal form of the fund's investment;
 - The value of the company according to co-investors, if any;
 - Expectations regarding follow-on investment requirements in the future; and
 - The exit plan.

Essentially, the very same considerations that make for a good investment are the drivers of a valuation.

It is often said that valuation is more of an art than a science. It is much more than just an academic exercise. The science – formal CBV-type valuation methodology – is the easy part. The art - valuing fairly and realistically – is the hard part. There is no LSIF in Canada today that has proven to be the model for the rest of the industry to follow.

OBSERVATIONS

- Based on our review of investment files and discussion with past and present investment staff, in general, the Fund's valuation process and use of valuation methodology has been indicative of an organizational culture that valued investments from the top-down versus the bottom-up in order to justify carrying values that were consistent with the hope that the portfolio companies would ultimately be successful. This appears to have contributed to investment carrying values that were, at many times, overly generous in the specific circumstances.
- Most Board members, including those on the Valuation Committee, did not have a clear understanding of the Fund's valuation protocols. They relied on the information provided by the Staff Valuation Committee and did not recognize that valuations routinely portrayed a positive approach, overly weighted to the "upside".

- Further, many of the Board members considered the limited review conducted by an external CBV (who also attended Valuation Committee meetings) to be an external valuation rather than strictly a concurrence report of limited scope.
- Based on the interviews we conducted with former and current staff and Board members, it appears that the former CEO, the former CIO and the Board were overly focused on managing value versus creating value in portfolio companies.
- The CIF Act and the 1995 Valuation By-laws indicate that all investments should be valued at each anniversary date on which the investment was acquired by the Fund. Section 15(4) of The Act adds that the Board shall cause a qualified person to prepare a report annually either as at the anniversary date of the acquisition of any particular investment asset, or, if at any time The Act so permits, and if applicable within six months following the end of the financial year of the entity which had issued any particular asset. The practice at CIF was that the quarter in which the Valuation Report was completed or deferred became the new anniversary date for valuation purposes. This practice was in non-compliance with The Act and the By-laws.
- In the spring of 2002, the external auditors raised the issue of the Valuation Department reporting directly to the former CIO. The auditors were concerned with the possibility of undue influence. The reporting relationship changed with the Valuation Department no longer reporting to the former CIO. Reporting was changed to the former CEO.
- An internal CIF memo in 2004 documented an exit interview with a CBV valuation analyst. He indicated the following “...feels that there is undue pressure in valuing companies upward as opposed to fairly”. He indicated that when there is a write-down required or not doing a write-up, that there is blame placed on the valuation personnel as opposed to dealing with the fact that there is a business issue within the portfolio company which needs addressing.
- Some examples of where an aggressive approach appears to have been taken with regard to individual portfolio company carrying values follow. It is important to note, that these examples are investments that have experienced significant valuation adjustments resulting from the adjustment in September 2004 and the subsequent more significant valuation adjustments in April 2005.
 - For Company V, the carrying value of the investment was doubled as a result of a small investment by another individual acknowledged not to be a sophisticated investor and the possibility of another potential investor, who had neither begun due diligence on the company nor provided an indicative term sheet. This write-up in carrying value is not in accordance with venture capital industry valuation standards regarding when to write-up the value of an emerging private company which indicates leaving the carrying value at cost unless there is a qualifying or significant third party investment.
 - Company U had an investment in Company V. As a result of the investment in Company V having its value doubled, the carrying value of CIF's investment in Company U was overstated.
 - For Company A, the internal valuation report prepared in December 2003, with a valuation date of August 31, 2003, did not include and did not refer to the interim financial results of the company. Past operating results were ignored. There was use of an aggressive multiple (too high for a money-losing-company in a mature

industry) and an overly optimistic discount rate (too low given the attendant risks of the investment). Nowhere in the report did it say that the investee's management team had never delivered on their promises of operating results. Instead, stale dated information and optimistic forecasts and assumptions were used to support the report's findings. This left the carrying value unrealistically in excess of cost as at that date, ignoring guarantees.

- For Company B, an investment was written up as a result of recent follow-on financings. However, the carrying value was largely based on new revenue forecasts using Discounted Cash Flow (DCF) and comparable multiple approaches to valuation, notwithstanding that the company had repeatedly missed its revenue targets in the past, had a current high cash burn rate, and was running out of money. Dismissed in the justification for the new carrying value was a recent term sheet provided by two well-known venture-investors, which implied a significantly lower value for the company, and accordingly, a need for a write-down in CIF's carrying value. The reason offered for not participating in the investment was that *"the transaction did not close because of the belief that the offer did not represent a fair valuation"*. Also dismissed by CIF was the inability of intermediaries to raise additional financing for the company – another sign that the carrying value was questionable.
- For Company C, three years after the initial investment, the carrying value was being maintained at a level slightly higher than cost despite the following comment in the Valuation Report indicating that the company had *"only achieved 16% of its projections for the year"*. This was dismissed by the comment *"it is not unreasonable to believe that the projections provided by management may be achieved by year-end"*. The optimistic valuation appears to have been a defensive effort to keep the carrying value up rather than to take a cold and hard look at the facts.
- The investment file for Company D was almost exclusively managed and monitored by the former CIO since the initial investment in 1997.
 - There was no valuation report done between September 2002 and September 2004.
 - A transaction occurred in March 2004, which is now understood to have been "an exit" which allowed for a distribution of proceeds to all equity shareholders, except for CIF, due to threatened litigation.
 - The evidential matter documenting the March 2004 transaction is scant. There is no evidence that the former CIO informed CIF's Board of the substance and form of the March 2004 transaction other than indicating that a certain amount of debt would be repaid.
 - Under a settlement agreement agreed to by the former CIO, CIF would have no rights to attempt to receive proceeds from this transaction until mid 2005.
 - There still remains unanswered questions on this file including: the nature and substance of the litigation threat and what parties were threatened; and why CIF would agree to allow other shareholders to exit (highly unusual), and also agree that the monies that would have gone as proceeds to CIF would end up in a new company to pursue a vague business plan.
 - It is unclear as to why the former CIO would attend a function in Las Vegas, Nevada to celebrate this transaction.

- It later became understood that CIF's potential proceeds from the above sale transaction are in a new start-up company which has virtually no assets except the proceeds which are due to CIF.
- Notwithstanding the March 2004 transaction, the August 31, 2004 carrying value had not been changed for 23 months.
- In September 2004, the carrying value was reduced based on work done by Investment Department staff.
- In November 2004, a new investment analyst has suggested that this investment be further reduced.
- The original and subsequent companies were never on the Fund's Watchlist.

Clearly, the carrying values of the investment in the original and latter companies, one of the largest investments in the portfolio, were overstated at various times during the September 2002 to September 2004 period. Valuations had not been performed on it during this period.

This investment indicates that there was failure on the part of the Board, the former CEO and the former CIO to have really learned from the lessons of the Company GG debacle, since many of the recommendations arising out of the special report on the debacle were not implemented including that *"there be reduced roles for any individual with respect to the monitoring and investment decision processes"*. There was failure by the former CIO to do his job properly including to keep people informed. There was failure on the part of the Board, and the former CEO to ensure that scheduled annual valuations were done.

During the 2002-04 period, the former CIO was asked specifically at a Valuation Committee meeting if there was a need to take a reserve allowance on the value of the holding due to the fact (at a minimum) the foreign exchange effect during that time period had decreased by 25+% (the investment was valued based on US dollar denominations). Even if the company had executed on its plan and was supporting the original valuation base (this was suspected not to be the case based on continual need to add money to the company), the exchange rate alone would have had a significant effect on value. We were told that the former CIO responded that a reserve allowance was not necessary.

It was not that investment processes and procedures were not working. When it came to the former CIO – process simply was not respected. This meant there often was no process.

- For Company R, in December 2003, the illiquid publicly-listed company's carrying value was raised to override the marked-to-market value by approximately 200% (three times the market price) based on an outside valuator's report. One month later, a follow-on convertible note investment was made by CIF at a price 65% below CIF's written-up- value (in other words equal to the market price previously overridden) and the convertible note investment was immediately revalued higher on an as-if-converted basis to reflect the intrinsic value price.

Overriding the market price has its shortcomings since it presumes the market to be wrong, and rarely represents the value that would be obtained if the investment were to be sold on the open market in a relatively short period of time.

- For Company P, in September 2002, when a co-investor carried their investment at 20% of cost, CIF still had the investment recorded at 100% of cost. Although an external valuation report regarding assets was available in draft, it was deferred by the Board Valuation Committee. In December 2002, two months after the Fund's fiscal year end, a write-down of 40% of cost was approved by the Board Valuation Committee leaving the carrying value at 60% of cost. In response to questions put forward by the Board Investment Committee, the Valuation Analyst indicated that a turnaround was expected at the portfolio company, a new CFO had been hired, that the former CIO was spending a lot of time on the investment and that this write-down was on the basis of a worst case scenario. The Valuation Analyst further indicated that a proper valuation could be done shortly. In June 2003, the balance of the equity investment was written-down. Debt advanced to the company during the period November 2002 to May 2003 remained on the books valued at cost until being fully written-off in September 2003. It appears that the Fund's carrying value of its investment was overstated at almost every date after the initial investment was made in July 2001.
- For Company N, the investing in and accounting for this investment over a period of years was both complicated and confusing. The investment appeared to have been increased in value in February 2004 by the recapitalization of prior period costs. The amount of the increase appeared to approximately match an amount reduced from the carrying value of the investment prior to fiscal 2004 when the Fund's auditors indicated that the amount was a prior period cost and that the investment value should not be increased. Notwithstanding, the unfinished job of sorting the investing and accounting details out, the absence of meaningful operating results and cash flow data of this relatively new enterprise, and considering the very high exit risks associated with this investment, Company N may have been carried approximately \$2.8 million in excess of what may be the appropriate carrying value during the period February to September 30, 2004.
- CIF did not operate in compliance with The Crocus Investment Fund Act (see **Appendix B**) as follows:
 - Section 15(1) with respect to a number of the companies reviewed by the OAG, for example: Company A, Company B, Company C, Company D, Company N, Company O, Company P, Company R, Company U, Company V;
 - Section 15(2)(b)(i) with respect to Company R;
 - Section 15(2)(d) with respect to Company A, Company D and Company P;
 - Section 15(4) with respect to Company A, Company D, and Company P and a number of other portfolio companies that had their valuation reports deferred;
 - Section 15(5) with respect to Company B; and
 - Section 15(6) with respect to all of the companies noted above regarding 15(1).

Conclusions

- Based on our review of specific investments, and the September 23, 2004 and April 5, 2005 carrying value adjustments, it appears highly probable that a number of significant portfolio company carrying values were overstated as at September 30, 2003 and 2004. These overstatements are material when taken together and may represent a misstatement of the consolidated net assets of the Fund on those same dates. It further appears that "managing" the carrying values of venture investment portfolio companies supported a higher NAVPS than would have otherwise existed. This positioned the Fund to improve, among other things, the Fund's capital raising capability.

- CIF's valuation process appears to have been long on methodology and short on common sense and rigorous analysis. Other than in very exceptional circumstances, the carrying values of early stage portfolio companies should be adjusted to new post-money value only upon the closing of a significant independent third party investment. Danger signs such as: poor portfolio company reporting to the Fund; weak coordination of the internal accounting and reporting system with the Investment Department (see **Section 4.2.13**); the inability to obtain information; disappointing operating results compared to budget year-after-year; cash/working capital problems (running out of money); and terms sheets from independent investors indicative of a lower value should not just be ignored, overridden or dismissed in favour of new highly optimistic forecasts. Unsupportable optimism and wishful thinking are not the basis for good valuation work.
- Limited scope valuation reviews such as those done by the CBV on retainer with the Fund are of questionable value. If the CBV was willing to agree with the write-up of an investment due to a possible third party investor that has not yet begun due diligence such as in the case of Company V, one would have thought that the CBV would also be supportive of a write-down in value in the case of Company B, where two other third parties indicated a lower carrying value and other possible co-investors could not be found by intermediaries.
- Based on our review of specific investments, it appears that CIF did not operate in compliance with respect to certain sub-sections within Section 15 of The Crocus Investment Fund Act regarding valuation practices.

b) Deferral of Valuations

OBSERVATIONS

- A schedule was drawn up from time-to-time by the Valuation Department indicating what portfolio companies were to undergo formal valuation work resulting in a Valuation Report as at a certain delivery date. Often, portfolio company valuations were deferred for various reasons including that the information necessary to perform the valuation was not available from the company in question.
- Formal Valuation Reports were normally prepared by Valuation Department staff and were reviewed on a limited desk-top basis by an outside valuator on retainer to the Fund. Certain portfolio companies had valuations prepared by independent outside valuation firms every three years.
- Based on a review of the minutes of the Board Valuation Committee, and a review of internal documentation, approximately twenty portfolio companies had their valuations deferred at various times, some more than once beginning in March 2002. We noted that certain valuations were deferred in 2002, 2003 and 2004.
- Many of the portfolio companies where there were deferrals are part of CIF's roster of investments that have gone wrong. Because the valuations on these companies were deferred, the progress and status of the companies was not available for the Board's view. However, the Board did not prompt timely follow-up.
- There were no Board Valuation Committee meetings held in the five months prior to the September 2004 \$15.3 million write-down.

Conclusions

- The Board and the former CEO and the former CIO failed in their responsibilities by permitting valuation deferrals.
- Valuation work that has to be deferred due to lack of information is a signal that something is amiss. It may be an indication that the planning for the valuation work was poor, that adequate resources were not available at CIF to get the job done, and/or that the portfolio companies are having problems. Such situations demand immediate attention and remedial action on the part of a CEO and a CIO and a Board in order to determine whether the lack of availability of required information is an indication of some impairment in the carrying value of the portfolio company. The lack of receipt of timely, accurate and reliable information and financial reporting from a portfolio company is one of the first signs that an investment is in trouble. This is a given in the venture capital and private equity business.

4.2.13 Internal Reporting within the Fund

One of the keys to successful operations in an LSIF is the coordination of information between the Investment Department and the Finance Department. The result is better information for use by investment and finance staff, Senior Officers, and ultimately for the Board of Directors and its various Committees.

Better information leads to better decision making by everyone involved. If the Finance Department acts as a support group for the Investment Department, the result is better information going to the Investment Department and the Board. Although the Investment Department is the source of much of the input information, the Finance Department should take control of the information in order to have better segregation of duties between those making the deals and those charged with the related financial reporting on the deals. It should be noted that the Finance Department usually operated with around 3.3 equivalent full-time employees, which included the CFO.

OBSERVATIONS

- The Finance and Investment Departments of CIF were not working together in an appropriate way. Investment Department staff did not always have timely or accurate information regarding the accounts that they were managing and monitoring. At times, the information they had was considered erroneous and cumbersome to work with. There was a recognized need for an integrated, real-time, fully accessible data base which could have alleviated a lot of reporting issues and confusion between the departments.
- After 12 years in business, the Fund has not developed a system capable of computing the rate of return on individual portfolio company investments, investments taken together as a sector or category such as life sciences, information technology and hospitality and entertainment, and for the investment portfolio taken as a whole. This is an observation pertinent to all portfolio investments in whole and in part.
- By working closely with the Investment Department, and by having quality and timely input information to work with, examples of information that the Finance Department could have improved upon or provided to Investment include:
 - Complete, timely and accurate portfolio company information regarding the cost and carrying value of portfolio companies including amounts advanced and received at every point during the life of the investment;

- Detailed information regarding contingencies including guarantees for each portfolio company and the portfolio taken as a whole. See “Use of Guarantees” in the Investment Strategy section of this report;
 - Better detailed cash flow information regarding portfolio company and all related investment matters – see “Cash Flow Considerations” in the Investment Strategy section of this report;
 - Accurate and timely monitoring reports regarding fee, and interest and other receivables from portfolio companies, and also maturity dates for debt repayments. When receivables are overdue, alerts should be sent out by Finance to Investment for immediate follow-up by the account manager for the portfolio company; and
 - Monthly detailed budget versus actual information for the Investment Department expense budget.
- Because internal documentation standards have not been rigorous in the Investment Department in the past, some standard LSIF information has not been routinely produced such as closing and exiting memos.
 - Until very recently, the Finance Department has not been a service and support centre for the Investment Department. The Finance Department was not always provided with quality input information from the Investment Department. In fact, much of the information and many reports used within the Investment Department had to be generated on their own without the coordination needed to confirm and reconcile facts and figures with Finance Department information.
 - As per the CFO, the former CIO would not support generating return on investment (ROI) calculations. We were told that *“the Finance Department was rarely provided with quality information as the Investment Department maintained a wall around its operation”*.
 - We were told that at one point *“The Fund had developed a very detailed system which tracked historical and forecast notes of return by investee company, but the CIO did not support the system and in fact was angry regarding accuracy. The CEO supported him”*.
 - We were told that *“the CIO and CEO together were too strong and influential and controlling of information on portfolio (investments) for the CFO to know there were gaps in valuation.... The investment portfolio was most controlled by (the) CIO who interfered with most major investments”*.

Conclusions

- Because the information within, and available to, the Finance and Investment Departments was deficient, the information provided to the Board was inadequate in terms of providing accurate and timely information regarding investment portfolio matters, generally and specifically.
- It is a fundamental venture capital industry practice to be able to know, at any given point in time, the rate of return on an individual investment, investments taken together as a group, and the investment portfolio taken as a whole. Rate of return – calculated on a basis standard in the industry (AIMR-based internal rate of return or “IRR” is the industry standard) – is a useful tool in performance determination and is a key building block in the ultimate rate of return that will be received by the shareholders of the Fund. Rate of return can also be used to judge the performance of Investment Department individuals.

4.2.14 Exiting

Exit Philosophy

As indicated at the beginning of **Section 4.2.7** on Due Diligence, one of the six basic areas of consideration that has to be examined when deciding whether or not to invest in a company is the most likely exit options for the investment. This is even more important for LSIFs than for conventional venture capital and private equity funds, because of the need for cash to serve redemptions and because raising capital is always uncertain.

By definition, the ultimate test of a venture capital investment and, indeed, of an entire fund, is how much money was invested and how much money was received upon exit. Because venture investing is affected by timing, circumstance, talent, hard work and luck over a relatively long period of time – a good investor is going to have some bad investments within a high performing portfolio. Alternatively, a poor investor can have some good investments in a badly performing portfolio.

Axiomatically, only an exit can truly test the validity of the carrying value of an investment. Only a fully exited portfolio can determine whether or not a venture capital investor has been successful.

OBSERVATIONS

- Investment memoranda invariably indicated that the investment in question would be exited by an initial public offering, sale to management or an employee group, or sale to a third party such as to another financial investor or a strategic buyer. Specific exit targets were not identified.
- Achieving an exit on an investment located in Manitoba can be more difficult than in other locations. There are less quality venture investment possibilities in the province – less selectivity – than many others. Other major investment organizations that could provide an exit, the public exit markets, top management and other human resources, markets for a portfolio company's product or service or technology, and competitors are all often located elsewhere.
- The Fund has a policy of wanting to keep capital and jobs in Manitoba. This often means that only a buyer located in Manitoba would be eligible to allow the Fund to exit an investment.
- The Fund has rarely had co-investors that could assist in the exit process including identifying good exit candidates via their own network of contacts.
- "Multiple bottom lines" were outlined in CIF's "Business Plan Fiscal 2004". These bottom lines included: economically-targeted investment or "ETI" (capital retention, employee ownership, participative management, local ownership); and socially-responsible investing or "SRI" (job creation and retention, ethical workplaces, business continuity). (See **Appendix B** - The Crocus Investment Fund Act.)
- The 2004 Plan, however, did comment on investment portfolio performance in its Corporate Performance Objectives section as follows, "*obtain a three-year return in the top quartile of LSIFs or in excess of 8%*".
- As indicated in the "Portfolio Construction" section of this report, certain investments in the investment portfolio that are not viewed as being problematic at this time in terms of carrying value and operations appear as if they may be difficult in terms of being able to execute a future exit. Along with certain of the science and technology investments, these portfolio companies include: hospitality and sporting, real estate and others.

- We were informed that CIF was managed on the assumption that legislative amendments that would ease their pacing requirements would be obtained. As such, less emphasis was placed on exiting because it was believed that shareholder investment capital would always be available. CIF was positioned to deal with the impact of redemptions by believing that it would be acceptable to deduct the amount of redemptions from new share sales in determining pacing requirements.
- The Fund's documentation put in place when an investment is booked is not strong in terms of being able to force an exit. See **Section 4.2.10**.

Conclusions

- The Fund did not have an appropriate exit strategy in place for its investments. Exiting in order to produce realized returns does not appear to have been a significant priority for the Board.
- CIF served many masters in terms of priorities including ETI and SRI which may have been a distraction and/or an obstacle in the way of pursuing exits. Accordingly, exiting – and as a result realized return on investment – appears to have been a compromised objective of the Fund.
- The Fund's desire for Manitoba-based buyers means that exit opportunities are reduced. Restricting exit candidates doesn't make the exiting process any easier.
- Good out-of-province co-investors may have improved the ability of CIF to exit certain of its investments.
- The 3-year return target of 8% as indicated in the Funds 2004 Business Plan was highly unlikely given the ongoing effects of the science and technology bust in the venture capital industry world-wide. This goal may have had a calming influence on the Board of Directors at the time. Further, it may be that members of the Board were unaware of venture capital industry returns – LSIFs included – as published by the Canadian Venture Capital Association since such return statistics were not included in the Fund's Business Plan Fiscal 2004.

4.3 CROCUS OPERATIONS

4.3.1 Financial Results

OBSERVATIONS

- **Figures 6 and 7** illustrate the audited financial results for CIF for the last five year period and for the unaudited September 30, 2004 figures. The September 30, 2004 figures are based on the CIF draft financial statements as at November 15, 2004 and do not reflect the April 2005 valuations adjustment (\$45.8 million), the Solidarity Transaction (**Section 4.3.3**), or any further adjustments to the September 30, 2004 statements that may be necessary.

FIGURE 6

Crocus Investment Fund Consolidated Statement of Income (Loss) For the Years Ended September 30, 1999 to 2004							
	(\$000s)						
	Total	1999	2000	2001	2002	2003	2004**
Revenue	25,099	3,086	3,526	4,863	3,278	5,590	4,756
Operating Expenses	38,020	4,272	5,528	6,290	6,793	7,071	8,066
Loss from operations	(12,921)	(1,186)	(2,002)	(1,427)	(3,515)	(1,481)	(3,310)
Realized gains on disposal of investments	10,760	217	10,543	-	-	-	-
Realized losses on disposal of investments	(32,566)	-	-	(5,824)	(16,141)	(2,499)	(8,102)
Realized gains (losses) on disposal of marketable securities	(132)	-	-	-	(132)	-	-
Unrealized appreciation (devaluation) in marketable securities	(122)	(523)	(106)	608	65	(74)	(92)
Unrealized appreciation (devaluation) in investments	(892)	7,673	(4,168)	(5,921)	9,833	(1,388)	(6,921)
Total realized and unrealized gains (losses)	(22,952)	7,367	6,269	(11,137)	(6,375)	(3,961)	(15,115)
Income (loss) before income taxes	(35,873)	6,181	4,267	(12,564)	(9,890)	(5,442)	(18,425)
Income taxes (recoveries)	566	279	143	87	72	(75)	60
Net income (loss)	(36,439)	5,902	4,124	(12,651)	(9,962)	(5,367)	(18,485)

* Reflects September 23, 2004 investment portfolio devaluation adjustment.

** Unaudited.

FIGURE 7

Crocus Investment Fund Consolidated Statement of Net Assets For the Years Ended September 30, 1999 to 2004						
	(\$000s)					
	1999	2000	2001	2002	2003	2004**
Net Assets						
Total Investment Assets	123,799	149,162	155,261	153,158	161,381	150,313
Total Other Assets	15,533	23,810	15,806	14,135	14,039	5,082
Total Assets	139,332	172,972	171,067	167,293	175,420	155,395
Total Liabilities	8,175	8,331	3,515	3,254	1,429	1,094
Net Assets	131,157	164,641	167,552	164,039	173,991	154,301
Shareholders' Equity						
Total Share Capital	115,110	146,392	164,074	172,844	190,417	189,107
Retained Earnings (Deficit)	16,047	18,249	3,478	(8,805)	(16,426)	(34,806)
Total Shareholders' Equity	131,157	164,641	167,552	164,039	173,991	154,301
Net Asset Value Per Share	\$14.62	\$14.93	\$13.67	\$12.72	\$12.09	\$10.61⁽¹⁾

(1) The 2004 value per share reflects the October 1, 2003 policy change regarding deferred sales charges. Deferred charges are no longer amortized over the 8 year hold period, and are now recorded as a charge to share capital in the year in which they are incurred. This resulted in a fully diluted Net Asset Value per share of \$10.09. However, the Fund has received authorization from the MSC to continue to defer and amortize sales charges for share pricing purposes only. For comparative purposes, the above Figure shows the "Pricing" Net Asset Value per share at September 30, 2004, prior to any additional adjustments resulting from the April 5, 2005 investment valuation write down.

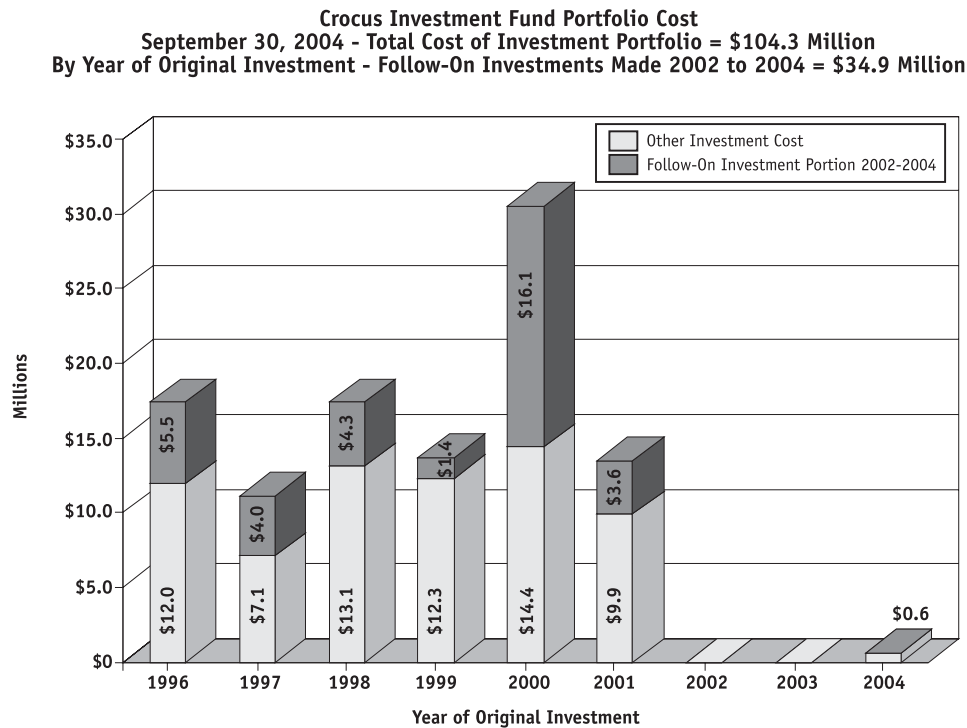
** Unaudited.

- Over this six year period the Fund:
 - Incurred net losses (after tax) in excess of \$36.4 million. Of this amount, \$12.9 million is related to operating losses. CIF was not generating sufficient operating revenue (i.e., interest, dividends, management fees, etc.) to cover its operating expenses.
 - Earned gains on disposal of investments totaling \$10.8 million, while incurring losses on disposal of investments totaling \$32.6 million. For 2001 to 2004 disposals (exits) overall were not contributing monies to cover operating losses.
 - CIF had recorded a net write-down for unrealized losses in its portfolio of only \$892,000. The unrealized appreciation of investments in 2002 of \$9.8 million was related to companies included in the write-down of investment assets approved by the Board on April 5, 2005. This write-down significantly reduced the carrying values of these companies.
 - Increased operating expenses by 88.8% from \$4.3 million in 1999 to \$8.1 million in 2004 (or 63% when excluding approximately \$1.0 million in selling costs recorded as a result of a change in GAAP). CIF had a salary band increase on September 30, 2002 under a new collective agreement. This involved a reclassification of many employees into new salary bands. Further, during this period of time, when CIF was unable to cover its operating costs, discretionary spending occurred or was planned that had a negative impact or a potential negative impact on cash flow. Some examples include:
 - Significant travel and other costs associated with portfolio companies;
 - Donations and sponsorships;
 - Costs associated with other CIF initiatives;
 - The pursuit of a proposal to implement a Supplementary Executive Retirement Plan (SERP) with the Executive and Personnel Committee in the summer of 2004; and
 - Initiating Board compensation.

We were informed that the CFO counseled the need for cost controls in the organization, but did not always receive the necessary internal support.

- Increased annual revenues by 54.1% from \$3.1 million in 1999 to \$4.8 million in 2004, with some variation over the years. This is significantly less than the increase in expenses. Internal controls over the completeness of revenue (interest, dividends, management fees) were weak and negatively impacted by the lack of coordination between the Investment Department and the Finance Department. As well, internal controls over the billings for expenses recoverable from investees were weak. CIF placed considerable reliance on a strategy of generating fees from the management of funds. These revenues did not materialize to the extent anticipated.
- CIF's retained earnings (deficit) decreased by \$50.9 million from September 30, 1999 to the unaudited figures of September 30, 2004, prior to any further adjustment as a result of the April 5, 2005 write-down of investment assets approved by the Board.
- While share capital was increased from the sale of shares, the investment portfolio did not grow in the same proportion. Share price decreased by 27.4% (from \$14.62 in 1999 to \$10.61 as at September 30, 2004). The share price of CIF declined as a consequence of share capital being used to fund operating losses and the net loss recognized on the disposal of investments in the last three years.

- With the exception of \$625,000 of monies invested into one fund and one portfolio company, CIF did not enter into and fund any other new investments for the years ending September 2002, 2003 and 2004 (**Figure 8**). Follow-on monies provided to existing portfolio companies totaled \$34.9 million for the same three year period and are reflected in the year of the original investment.

FIGURE 8


- Although the former CEO was aware that CIF was facing cash liquidity issues in early 2002, the major strategy to address this was the establishment of sub-funds. It does not appear that alternative portfolio management and divestiture strategies were seriously contemplated. The former CEO did not pursue the divestiture of companies and advocated that pacing legislation be changed to alleviate the need to sell investments. As well, expense levels in the organization continued to increase, without measures being put into place to reduce the risk of potential liquidity issues in the future.
- With respect to valuations and investments, the CFO indicated, *"I have never been responsible for valuations or investments. I always relied on the experts, both external and internal for information I reported"*. Notwithstanding this, a CFO in any organization has primary responsibility for the fair presentation of financial information.
- A Research Report by the CICA entitled "Financial Reporting by Investment Funds" states:

"that financial statements should include a statement of portfolio investments that reports summarized data on all of an investment fund's securities investments at the end of the accounting period on a comparative basis".
- CIF's Consolidated Statements of Investment Portfolio complied with this recommendation for fiscal years up until 2002. Beginning with the 2002 financial

statements, CIF's Consolidated Statements of Investment Portfolio were not presented comparatively. As a result, users were not being provided with adequate information to determine investments and divestitures made by CIF during the year. Our review of the financial statements of a number of other LSIFs in Canada confirmed that the statement of portfolio investments is typically presented with comparative information.

Conclusions

- Given that the LSIF industry was experiencing write-downs over this period of time, and given the significant investment portfolio write-down that will be recorded, it appears highly probable that Senior Officers were aggressive in their positive valuation of the investment portfolio. Further, the above analysis illustrates the Fund's practice of investing, and providing follow-ons to maintain investment value.
- The decline in share value (price) over the last few years was not due to a significant downward valuation of the portfolio, but rather can be mainly attributed to realized losses on investments and operating losses, thus eroding shareholder value. Further, funds raised from new shareholders were needed to cover redemptions. The rising number of outstanding shares meant that net assets were being spread over more investors.
- By not managing nor addressing its operating losses (otherwise known as a run-rate gap) on a timely basis, CIF was heading for financial difficulties and non-compliance with its legislated liquidity requirements. This in turn, necessitated the Solidarity transaction (Section 4.3.3).
- Additional comparative disclosure on the financial statements would provide fuller information on the impact of investments and divestitures on the CIF portfolio.

4.3.2 Share Pricing

An investment fund offers its shares or units of ownership for sale to various investors. The price at which the shares of mutual funds are sold or redeemed is the net asset value per share (NAVPS). NAVPS is determined by dividing the net assets of the fund by the number of its shares or units outstanding.

The determination of a fund's NAVPS is of critical importance because it is the value at which the fund transacts with its investors. If the NAVPS per share is misstated, investors who purchase or dispose of their shares in the fund are affected. An investment fund's policies with respect to pricing errors should be clearly documented and approved by the fund's governing body.³

Determination of the NAVPS is typically performed by the accounting staff of a fund and requires the accurate, complete and timely recording of the following:

- investment transactions, usually on the day following the trade date (trade date plus one);
- share sales and redemptions;
- the weekly accrual of interest income and expenses;
- dividend income on the ex-dividend date;
- the weekly accrual of other income and expenses; and
- investments at "current value" (market price or fair value where a quoted market price is not available).⁴

³ Adapted from CICA - Assessing Risks and Controls of Investment Funds

⁴ Ibid

Materiality of share price adjustments could be viewed as follows: The Investment Funds Institute of Canada, an association whose members are involved in the investment funds industry, has issued a bulletin to provide voluntary guidance regarding the correction of errors in NAVPS calculations. The bulletin states that a fund should be made whole at or above a threshold of 0.5% of NAVPS. Individual investor accounts should be adjusted, if the error is at or above the threshold of 0.5% of NAVPS, unless the total effect on the individual account is less than \$50.

OBSERVATIONS

Calculation of Share Price

- The MSC has designated CIF to be a mutual fund. The MSC defines net asset value as the current value of the total assets of the investment fund less the current value of the total liabilities of the investment fund, as at a specific date. The net asset value of an investment fund must be calculated in accordance with Canadian Generally Accepted Accounting Principles (GAAP).⁵ The Accounting Handbook of the CICA defines Canadian GAAP.
- However, for pricing purposes only, MSC has permitted CIF to defer expensing the commissions related to the sale of their common shares and to amortize the sales commissions to the deficit on a straight-line basis over eight years (the period during which the CIF shares cannot be transferred or redeemed, except in limited circumstances). This share pricing treatment is not consistent with GAAP treatment for financial reporting purposes. MSC noted that they accepted this treatment at their December 10, 2003 meeting.

Transition from Monthly to Weekly Pricing

- CIF was calculating its NAVPS monthly until September 17, 2001 when weekly calculations began to be prepared pursuant to an amendment to the July 13, 2001 prospectus. The net asset value is calculated on the last business day of each week, normally each Friday, as at the close of business on the previous day (Thursday).
- Subsection 15(1) of The Crocus Investment Fund Act specifies that the Board shall determine the fair value of the Class "A" Common Shares of CIF at each valuation date. **Appendix I** summarizes the calculation of NAV specified in The Crocus Investment Fund Act, the most recent prospectus issued by CIF, and the valuation policies of CIF.
- In addition, the Act, prospectus, and valuation policies specify that the Board shall have a qualified person report on the suitability of the manner in which NAVPS is calculated assuming the valuation rules have been followed. The Board is required to fulfill this obligation at every valuation date, but has the discretion to dispense with the report when there has been no change in the assets or liabilities that could materially affect the manner of calculating the value of the common shares.

Review of CIF Weekly Pricing Process

- In general, the procedures for calculating NAV and NAVPS are not documented. Detailed income recognition policies are not defined.
- CIF calculates NAV and NAVPS in a manner that complies with its own Act, prospectus, and policies, as well as the requirements of the MSC, assuming asset valuation figures are appropriately determined.

⁵ National Instrument 81-106 Investment Fund Continuous Disclosure - Section 14

- CIF calculates weekly NAVPS using the following formula:
 - Actual net assets from the previous month end
Add: Weekly estimated net income
Proceeds from Common Shares and Class I Series 2 Shares issued.
 - Deduct: Weekly estimated net loss
Weekly accrued dividend to Solidarity
Cost of share redemptions
Value of Class L and Class I Series 3 (Solidarity) shares.
 - This result equals the estimated value of net assets for Class I Series 2 and Common shares.
 - This result is then divided by the total number of Class I Series 2 and Common shares outstanding at the end of the week.
 - This final result equals the NAVPS.
- In 1993, 1994 and again in 1999, a professional services firm assessed that the manner of calculation of the common share fair value was in accordance with the CIF By-law that established valuation policies. The firm assessed the manner of calculating common share value when CIF was calculating the value only at month-end. No such assessment has been made since the change to weekly pricing.
- When CIF changed from a monthly pricing protocol to a weekly pricing protocol, they did not commission a review to confirm the reasonableness of their weekly pricing model. The prospectuses of January 2004 and prior stated, *"To assist in determining the fair value of a Common Share at a valuation date, the Board of Directors will have an independent qualified person (the 'valuator') prepare a report setting out an opinion as to the manner in which the fair value of a Common Share should be calculated by the Fund's internal accountants as at such date. Presently, the valuator retained for this purpose is KPMG, LLP. Such report is to be prepared at each Valuation Date, unless the Board of Directors determines that since the preceding Valuation Date there has been no change in the assets or liabilities of the Fund, which could have a material effect on the manner of calculating the fair value of a Common Share, in which case the preparation of the report may be dispensed with for such Valuation Date and the calculation determining the value of the Common Shares as at such Valuation Date shall be done by the internal accountants of the Fund in accordance with the previous report."*
- Further, Section 15(7) of The Crocus Investment Fund Act (**Appendix B**) indicates that a similar process to that indicated in the prospectus should be followed.
- Since 1999, two significant events that should have triggered a review occurred. On September 17, 2001, CIF changed from monthly to weekly prices and in November 2002, the Fund issued Series Three Class I, Special Shares to Solidarity for consideration of \$10 million.
- In reviewing the pricing in February 20, 2004, we noted that a general upward adjustment in value of \$2.0 million had been used in the calculation of the weekly share price. This general reserve was not directly attributable to any specific portfolio company, but was rationalized as reflecting an adjustment that would enable CIF *"to meet our requirements for fair valuation at all time"*. We further noted that a write-down of

\$2.0 million had been taken on Company C for the same period. The adjustment upward negated the impact of the write-down on share price.

- In discussions with Investment Department staff, we noted that information factored into the calculation of share price may have contained errors during the past few years. However, the incidence and materiality of these errors cannot be determined or quantified. In 2005, CIF began using a standard form titled, "Crocus Receipt of Cash," to ensure the proper recording of funds received from organizations in which CIF has invested.
- The Valuation Department does not explicitly review and approve the current value of investment assets to be used in the weekly calculation of NAV.
- CIF uses a commercial accounting software product, rather than a portfolio management software product, to record transactions for its investment portfolio. The accounting software does not track information regarding investment assets, such as whether it is debt or equity, number of units, terms regarding the investment, or original cost. To compensate, in-house developed database tables and application routines import transactions from the accounting software to serve as a portfolio ledger and reporting system. However, accounting staff must review and revise the transactions to classify and record needed information.
- The Investment Department advised that the CIF information systems do not provide reports that meet the needs of the Investment Department.

Board Approval of Weekly Share Price

- The Board was required to sign off on the weekly share price. This was delegated to two Board members, usually the Chair and Vice-Chair. In our discussions, it was evident that they were not familiar with the process for calculating the weekly share price. We were told that they simply signed the share valuation certificate that was faxed or mailed to them, and returned it to the Fund. The weekly share price was not approved prior to the calculation being publicly released. In essence, the Board approval was viewed as a formality, generally done after the fact.
- Periodically, copies of the certificates are mailed to the MSC. The MSC indicated to us that CIF did not have any obligation to file these certificates with the MSC.
- On the February 17, 2004 meeting of the Board Valuation Committee, a policy for valuation reserves was approved as follows:

"At times when material, known changes of value surface between meetings of the Valuation Sub-Committee, those who have internal signing authority over valuation reports may, at their discretion, incorporate these changes into the next weekly share price. The Valuation Sub-Committee will be made aware of any reserve taken in this manner by e-mail. Documentation will be brought forward to the next sub-committee meeting for formal approval. Should approval not be granted, the reserve would be reversed at the next share valuation date".

- The Board Valuation Committee did not meet between April 20, 2004 and September 14, 2004. This reduced the Board's ability to reasonably assess whether any potential valuation adjustments to the investment portfolio should have impacted the weekly share price during that period of time.

Conclusions

- The Board should have commissioned a review of the weekly pricing as required under its prospectus and The Crocus Investment Fund Act.
- The lack of appreciation of the significance of Board sign-off on weekly valuations exposed the Fund to considerable risk of misstating the weekly share price. Given the importance of the valuation processes on weekly share prices, the Board should have called for Valuation Committee meetings between April 20, 2004 and September 14, 2004. Further, given the significant impact of the overstatement of the investment portfolio as discussed in **Section 4.2**, it is highly likely that the Fund's NAVPS has been significantly overstated over the last year, at a minimum.
- The Board sign-off on the weekly share price added no assurance as to the accuracy and reliability of the weekly share price. Board members placed considerable reliance on CIF staff.
- Further, the accounting system at CIF does not effectively support a weekly pricing protocol.

4.3.3 Liquidity, Cash Flow, and the Solidarity Transaction

Under The Crocus Investment Fund Act, the Fund is required to maintain a reserve account equal to the greater of:

- 15% of the fair market value of its investment assets; and
- 50% of the total of its outstanding guarantees.

If the Fund falls below its minimum reserve requirements for a period of more than 60 days, the Minister could declare the Common Shares of CIF ineligible for tax credits. If this happened, it would seriously impair the ability of the Fund to raise additional capital and would affect its long term viability.

The funds for the reserve account can only be invested in bonds or treasury bills issued by the Government of Canada or a province, debt obligations of Canadian corporations with a minimum R1-mid rating, and an interest in a mutual fund that invests in only government bonds, or Canadian corporation rated R1-mid or higher.

The Fund maintains its minimum reserve requirements by balancing cash inflows from mainly selling shares and liquidating investment holdings with cash outflows for redeeming shares, making investments, and paying operating expenses. If the Fund expends more on redeeming shares, making new investments, and paying operating expenses than it raises through selling shares, and liquidating investment holdings, the Fund runs the risk of falling below its minimum reserve requirements.

The Solidarity Transaction

OBSERVATIONS

The Liquidity Situation that Prompted the Solidarity Transaction

- At September 30, 2004 the unaudited financial statements showed CIF had \$39.2 million in liquid reserves or 26.1% of investment assets of \$150.3 million. The Fund's minimum reserve requirement was \$22.5 million and according to the financial statements, the Fund exceeded this by \$16.6 million.
- In 2002, the Fund prepared an internal cash flow projection analysis covering the period July 2002 to September 2004. This analysis showed that without significant additional

capital, the Fund could fall short of its minimum reserve requirement by October 2002 and would stay below its minimum requirement until December 2002 – a 90 day period.

- In order to prevent a shortfall in its minimum reserve requirements, the Fund negotiated a short term institutional investment of \$10 million from the Fonds de Solidarité FTQ (Solidarity), a Quebec-based LSIF.
- A subsequent analysis prepared by the Fund of its actual minimum reserve requirements compared to the actual liquid reserve balance maintained since October 2002 showed that in October 2002, prior to receiving the \$10 million investment from Solidarity, the Fund exceeded its minimum reserve requirement by only \$630,000.
- With the receipt of the \$10 million proceeds from Solidarity in November 2002, the Fund was able to report substantial excess reserve requirements ranging from \$5.6 million to \$16.9 million for the period November 2002 to November 2004.
- Had the \$10 million not been used by CIF to determine whether the minimum reserve requirement was met, and had they not generated any additional monies, the above noted analysis showed that the Fund would have fallen below their minimum reserve requirements for three 60 day periods:
 - November 2002 to January 2003;
 - June 2003 to August 2003; and
 - December 2003 to January 2004.

Initiating the Solidarity Transaction

- In early July 2002, the former Chair of CIF approached Solidarity to indicate that CIF would be interested in negotiating the terms of a short-term investment by Solidarity to CIF.
- On August 1, 2002, the former CEO formally requested Solidarity to make a \$10 million investment in institutional shares (Class I) of CIF. The former CEO proposed a term of 18 months with a cumulative annual dividend of greater than 7%. He also offered to *“segregate the \$10 million and retain it in a money market account”*. At the end of the term, the shares would be redeemed from that account *“even if the consequences of the redemption would place us offside our regulatory requirements regarding Reserve Funds”*.
- As part of the request, the former CEO commented that *“we presently face a short term liquidity challenge”* and *“are very concerned that our normal operating expenses and the requirements of our existing portfolio companies will cause us to be offside the 15% Reserve Requirement before the next RRSP season”*. The former CEO noted the following reasons for Crocus’s reserve problems:
 - Lower than expected net sales during the 2002 RRSP season;
 - Pacing requirements to invest 70% of all new money raised in eligible investments; and
 - A reluctance to sell positions in portfolio companies to non-Manitoban investors.
- The former CEO further noted that there had been extensive discussions at the Executive and Personnel Committee and the Board regarding CIF’s liquidity challenges and that they were committed to addressing this problem as their highest priority. The Fund was concerned that they would be out of compliance with their reserve requirement before they could fully operationalize a divestiture strategy.

- On September 6, 2002 a letter from Solidarity confirmed their interest in considering a \$10 million transaction with CIF. The letter documented the main terms to be included and also required that CIF pay a \$107,000 non-refundable study fee and \$136,500 for all legal and closing costs.
- On September 9, 2002, CIF indicated their acceptance of the terms by returning a duly executed copy of the letter to Solidarity.
- On November 15, 2002, a final agreement was signed for the issuance of 790,513.83 Series Three Class I special shares for consideration of \$10 million (\$12.65 per share). The shares carried a 10% guaranteed annual dividend rate (i.e., \$1 million per year). CIF could redeem the shares any time after November 15, 2003 (12 months). In addition, Solidarity could require CIF to purchase all or any part of the shares after May 15, 2004 (18 months) and CIF was required to purchase any remaining outstanding shares at November 15, 2004 (24 months). The Agreement provided for a 10% penalty (in addition to the annual dividend) on any share outstanding after November 15, 2004, and 10% interest on any unpaid dividends.

Significant Terms of the Agreement

- The Agreement contained covenants that made this a virtually risk free transaction for Solidarity, including the requirements that CIF:
 - Use the \$10 million subscription proceeds for the sole purpose of maintaining the cash reserve account by investing in Treasury Bills with a maturity not longer than 90 days.
 - Obtain all necessary consents from other shareholders to give Solidarity priority for the payment of dividends and in the case of liquidation, dissolution or wind-up.
 - Notify Solidarity of the time and place of all Board meetings. Solidarity was entitled to have an authorized representative at these meetings, and could address the meeting, but could not vote.
 - Provide Solidarity with detailed monthly financial and non-financial information regarding the Fund's operations including certification from an Officer confirming that CIF is in compliance with the Agreement.
- Under the Agreement CIF was prohibited from:
 - Investing any amount in excess of \$3 million without first divesting of one or more investments and using the proceeds, dollar for dollar, for the new investment, without first obtaining written permission from Solidarity;
 - Issuing any other Series Three Shares without written permission from Solidarity; and
 - Declaring any dividends on Series One or Series Two Class I Shares, or purchasing any Series Two Class I shares from the holders, or initiating any redemption of Series One Class I shares.
- If CIF breached any of the provisions in the agreement, CIF was required to purchase all of the shares upon 30 days written notice. In addition, if CIF achieved negative net sales, effective March 1, 2003, they would have until June 17, 2003 to liquidate sufficient portfolio investments to obtain \$15 million in proceeds to be applied as follows:

- The amount required to restore its 15% reserve account; and
- The balance to purchase Series Three shares from Solidarity.

Any failure to comply with this provision would constitute a default that would require the immediate redemption of all Series Three shares.

- At the time of redemption, Solidarity would receive the greater of either the original share price paid (\$12.65 per share) or the NAVPS at the time of redemption, less any dividends previously paid on the Series Three Class I shares. In this way, Solidarity would share equally with Common Shareholders if the value of the Fund increased.
- Information on the Solidarity transaction was provided by Fund legal counsel to Fund auditors.

Inappropriate Balance Sheet Presentation

- The September 30, 2003 audited consolidated financial statements reflected the proceeds received from Solidarity as Shareholders' Equity on the Balance Sheet. This classification of the investment as equity did not follow Section 3860 – Financial Instruments - of the CICA Handbook that states:

“In classifying a preferred share as a liability or equity, an entity assesses the particular rights attaching to the share to determine whether it exhibits the fundamental characteristics of a financial liability. For example, a preferred share that provides for redemption on a specific date or at the option of the holder meets the definition of a financial liability if the issuer has an obligation to transfer financial assets to the holder of the share”.

- Based on this definition, the investment by Solidarity had the following fundamental characteristics of a financial liability:
 - The shares were retractable by the holder (Solidarity) commencing June 15, 2004;
 - The Fund was required to redeem all outstanding shares by November 15, 2004; and
 - The Fund was required to pay cash (a financial asset) for the redemption of the shares.
- Other fundamental characteristics of equity and liabilities include:
 - For equity, dividends are discretionary and are declared by a company's board. Payment is made out of a company's current or retained earnings. If a board does not declare a dividend, the event does not constitute a default.
 - For liabilities, interest payments are not discretionary and must be paid even if a company is in a loss or deficit position. If an interest payment is missed, the event constitutes a default, and a lender can take immediate action to collect both the principal and interest owed.

Under the Agreement between the Fund and Solidarity, Solidarity had a guaranteed right to the dividend payment – it was not discretionary and the Board did not declare the dividend payments made to Solidarity. In addition, the payments were made even though the Fund was in a loss and deficit position. If the Fund had not paid the dividend, the event would have constituted a default under the Agreement and Solidarity could have taken action to collect the principle investment amount, outstanding dividends, and any interest penalties from the Fund. These characteristics are fundamental characteristics of a liability.

- By incorrectly reporting the investment from Solidarity as equity on the Balance Sheet, the liabilities reported on the September 30, 2003 audited consolidated financial statements were understated by \$10 million, and Shareholders' Equity was overstated by \$10 million. This resulted in a \$10 million overstatement of Net Assets on the Balance Sheet. Because of this, the Fund appeared to be in a stronger financial position than it actually was.
- In addition, because the guaranteed 10% return (dividend) payment on Solidarity's investment was recorded as a dividend payment and not interest, it was shown as a direct reduction of Retained Earnings (Deficit) on the Balance Sheet. As a result, the payment was not reflected as an expense on the Consolidated Statement of Deficit and the reported loss for the year ended September 30, 2003 was understated by \$875,000 or 16%. This also means that MER was understated.

Inadequate Financial Statement Note Disclosure

- Note 5 of the September 30, 2003 audited consolidated financial statements described the issued share capital of the Fund. The Series Three Class "I" Special Series issued to Solidarity are described as follows:

"Series Three Class 'I' Special Shares - entitled to a minimum cash dividend equal to 10% per annum, retractable by the holder commencing June 15, 2004, or earlier in limited circumstances and redeemable by the Fund after November 15, 2003. The redemption amount is equal to the greater of the net asset value per Class 'A' Common Share and Series Two Class 'I' Special Share less dividends paid on the Series Three Class 'I' Special Shares or the subscription price of the Series Three Class 'I' Special Shares. After November 15, 2004, the Series Three Class 'I' Special Shares contain other preferential redemption and dividend privileges which are fully described in the Fund's prospectus".
- The above description appropriately discloses the dividend rate and basis for calculating the dividend. However, other important features of these shares are not disclosed in this or other Notes to the statements. As the financial statements refer the reader to the Fund's prospectus for additional information, a reader would require a copy of the prospectus in order to understand the Fund's obligations for these shares.
- Significant information regarding the Series Three Class I shares not disclosed in the audited statements includes:
 - The 30 day call provision for any breach of the provisions in the Agreement;
 - The requirement for the Fund to purchase all outstanding shares by November 15, 2004 and the related 10% penalty on any outstanding shares at that time;
 - The requirement to liquidate investment assets if negative net sales occur;
 - The priority given to these shares over all other shares in case of liquidation, dissolution or wind-up;
 - The restrictions on CIF's ability to invest more than \$3 million without the prior written approval of Solidarity or divesting dollar-for-dollar for the new investment; and
 - The need to maintain the \$10 million in proceeds from Solidarity in short term Treasury Bills for the sole purpose of maintaining CIF's reserve account.

Inadequate and Misleading Disclosure of the Solidarity Transaction in the Prospectus

- The January 23, 2003 prospectus and the January 21, 2004 prospectus, both disclosed some information regarding the Series Three Class I Preferred Shares issued to Solidarity. Significant information regarding the Series Three Class I Share disclosed includes:
 - The 12, 18, and 24 month redemption/retraction covenants.
 - The dividend rate and payment dates, including the additional 10% dividend on shares outstanding at November 15, 2004, and the interest at 10% per annum, compounded monthly, on any unpaid dividends.
 - The calculation of the redemption amount.
 - The priority status of the Series Three Class I Shares over all other shareholders to the property of the Fund on a liquidation, dissolution or winding-up of Fund operations.
- However, significant information regarding the Series Three Class I Share that was not disclosed includes that:
 - Solidarity's right is to require repayment upon 30 days written notice if the Fund breaches any provisions in the Agreement.
 - CIF is required to liquidate sufficient portfolio investments to obtain \$15 million in proceeds if negative net sales occur. The proceeds will be applied to first restore the Fund's 15% reserve account and the balance will be used to purchase the Series Three shares from Solidarity.
 - CIF is prohibited from investing any amount in excess of \$3 million without first divesting of one or more investments and using the proceeds, dollar for dollar, for the new investment without the prior written approval of Solidarity.
 - CIF is required to provide notice to Solidarity of all Board meetings or any other meeting of any of the Board members where the status of the reserve fund, pacing requirements, or the ability of CIF to meet its obligations under the agreement are discussed. Solidarity is entitled to have an authorized representative at these meetings, and can address the meeting, but cannot vote.
 - CIF is prohibited from issuing any other Series Three Shares without Solidarity's written permission and cannot issue any other Class I shares without providing Solidarity with the consents and subordination of any future proposed holders.
 - CIF must use the subscription proceeds for the sole purpose of maintaining its reserve account and shall invest such funds only in liquid marketable securities.
- The January 23, 2003 prospectus stated, *"The Fund raised \$10 million by selling 790,513.83 Series Three Shares to Fonds on November 15, 2002"*. This statement implies that Solidarity had made a capital investment in the shares of the Fund. However, as previously noted, the fundamental characteristics of this transaction were those of a liability and not equity.

Misleading Public Statements

- On December 3, 2002, prior to the 2003 RRSP selling season, CIF issued a press release entitled, "Crocus attracts \$10 million institutional investment" (**Appendix F**). As noted in **Figure 9**, a number of the statements made by the former CEO and the former CIO in this press release were a misrepresentation of the nature of the Agreement with Solidarity.

FIGURE 9

Statement made December 3, 2002	Concerns with the Statement
<i>"This is tremendous news for businesses in Manitoba and a strong signal to other local and national institutional investors that Manitoba has a strong economy and is a great place to invest", (former CEO).</i>	- The Solidarity transaction was not a "signal" to other institutional investors or a reflection of Manitoba's economy. Effectively, the transaction was a short term loan. - To ensure that the proceeds were not used for other purposes, CIF was required to invest the proceeds in Treasury Bills with a term not to exceed 90 days. Because of this, the proceeds were not available to investment in Manitoba businesses.
<i>"This is a strong endorsement of the Crocus management team and the Crocus Fund's investment portfolio", (former CEO).</i>	- This transaction was not an endorsement of the management team or investment portfolio. The Agreement contained covenants to control or limit the investment activities of CIF's management team and the proceeds could not be used to support the investment portfolio.
<i>"The investment by Solidarite supplements funds from our retail investors and gives us extra flexibility to take advantage of growth opportunities in the current portfolio. It will also allow us to respond more aggressively to new opportunities that may be available at very attractive prices in this economy", (former CIO).</i>	- As the proceeds could only be invested in short term Treasury Bills, they could not be used as a source of capital for new or existing investments in portfolio companies. - The Agreement limited CIF's investment activities to no more than \$3 million. If CIF wanted to invest more than this, they were required to first divest dollar for dollar to provide the additional capital required.

- Both the former CEO and the former CIO made similar comments regarding the transaction with Solidarity to shareholders who attended the May 10, 2003 Annual General Meeting of the Fund. The complete presentation made to the shareholders is posted on the Fund's website. The specific comments related to the Solidarity transaction are summarized below:

- Remarks made by the former CEO:

"A second highlight has been our ability to create a combined total of more than \$30 million in liquid capital available for new investment. In addition to the \$9.4 million in net sales from retail investors, the Fund attracted a \$10 million institutional investment from the Solidarity Fund, a Quebec-based Labour-Sponsored Investment Fund. As the Fund investments mature we have also continued to divest portfolio companies when financial and non-financial objectives can be achieved. Our total divestiture thus far this year exceeds \$10 million.

When combined with the new capital from retail sales, institutional investment and divestiture, the Fund has significantly increased its ability to make add on investments in the current portfolio or to make new investments. This increased investment capacity is especially significant because investments can be made at very attractive prices in the current economy. We see this as a positive endorsement of the Crocus portfolio and the Fund's management team, and a signal that Manitoba is a great place to invest."

- Remarks made by the former CIO:

"We have also focused a significant amount of time on attracting new institutional capital to the Fund. As ...indicated, our objective is to earn new revenues for Crocus from management fees and to create a source of new capital for future co-investment or as an investment partner for businesses in the current portfolio. These new institutional capital pools are also potential buyers, providing Crocus with another way to exit current investments. ... Over the next five years our

objective is to have at least \$150 million in institutional capital under management earning significant net new revenue for Crocus.

We also concluded a transaction that resulted in the Solidarity Fund, the largest labour fund in Canada, investing \$10 million in Crocus. We did this to ensure we could take full advantage of strategic buying opportunities that we expect to arise in what we characterize as a buyer's market. As noted in our prospectus the terms of this investment provide Solidarity Fund with a floor rate of return of 10%, although consistent with other venture investments they expect to earn a stronger return as a result of growth in the value of the portfolio, and their share price will track the same value as our Class A shares.

We have also predefined a series of milestones in the agreement. These check-in points are common for this type of strategic partnership but the intent of both parties is for this arrangement to be a long term relationship similar to our existing partnership in the Manitoba Science & Technology Fund and in BioCapital Fund."

- These remarks are consistent with those made in the Press Release, and with the information presented in both the Audited September 30, 2003 consolidated financial statements and the January 23, 2003 prospectus – that the funds received from Solidarity were an equity investment similar to other institutional investors with the Fund.
- On July 22, 2004, at the Annual Meeting and Special Meeting of the shareholders of the CIF as recorded in the draft minutes, we noted that a shareholder questioned the nature of the investment made by Solidarity in November 2002. The draft minutes of the annual meeting note that the former CIO "...responded giving the details of the investment, namely that the Fonds (Solidarity) was receiving a 10% rate of return and that the investment of \$10 million would be dealt with in November 2004 at which time the Fonds was to be entitled to be repaid. No decision had been made by the Fund as to whether it would request the extension for repayment of the Fonds \$10 million investment".
- The same shareholder also made a statement that the Solidarity transaction appeared to have been entered into with little publicity and the Fund's shareholders had not been advised of the transaction. The former CIO "...responded firmly that the Fonds transaction had been announced in the Winnipeg Free Press at the time the transaction was concluded". In addition, the former CIO "...referred to the minutes of the 11th Annual Meeting of shareholders of the Fund (last year's minutes) held on May 10, 2003 in which the terms of the Fonds investment were clearly communicated to the shareholders". The former CIO "...confirmed that full disclosure had been made to the shareholders about the Fonds investment". The former CIO "...then went on to describe the long term relationship with the Fonds and described the investment entered into by the Fund with the Fonds in November".

Conclusions

- The Fund misled investors in a significant way by failing to properly disclose and publicly communicate the essence of the Solidarity transaction. This is an unacceptable practice. The "spin" provided by the press releases and the comments made by the former CEO and former CIO to shareholders regarding the investment from Solidarity helped to conceal the liquidity challenges confronting the Fund. The former CEO and former CIO painted the picture of a financially strong company – one that was able to attract a significant

equity investment from a Quebec LSIF on the strength of the Fund's management team and investment portfolio. However, the actual nature of the transaction, as a loan, was not fully disclosed to shareholders or the public.

- The audited September 30, 2003 financial statements significantly misrepresented the fundamental characteristics of the investment from Solidarity as an equity investment. This resulted in an understatement of liabilities and an overstatement of Shareholders' Equity on the Balance Sheet. In addition, the loss for the year ended September 2003 was understated by \$875,000 or 16%. Combined, these misrepresentations present a better financial picture of the Fund than actually existed.
- The Notes to the financial statements did not fully disclose all of the significant covenants of the Agreement between Solidarity and the Fund. As a result, readers were not provided with sufficient information to be able to assess the nature of the transaction between Solidarity and the Fund.
- The prospectuses issued by the Fund in 2003 and 2004 did not fully disclose all of the significant covenants of the Agreement between Solidarity and the Fund. The transaction was misrepresented in the prospectuses as an equity investment while the fundamental characteristics were those of a liability. Because of these factors, a reader of the prospectuses would not have been able to adequately assess the risk of investing in the shares of the Fund.
- CIF highlights the misleading nature of its recording of this transaction by treating it as both equity and liability depending on the circumstances. It is treated as equity in its financial statements and in the calculation of MER and as a liability in calculating NAV and NAVPS.

4.3.4 Employee Travel and Other Expenses

We reviewed expenses greater than \$100 for all corporate credit card and expense reports from October 1, 2000 to September 30, 2004. We were not able to examine November 2001 and April 2002 credit card reports. The Fund was not able to locate the files for these two months.

OBSERVATIONS

- The Fund established an Employee Expense and Travel Policy in August 2000 (see **Appendix C**).
- Employees of CIF used corporate credit cards for charging travel and other expenses, or were reimbursed for expenses by submitting expense reports.
- As per an Internal Financial Process Review Report dated April 2000 prepared by CIF's external auditors, prior to April 2000, CIF did not require employees to submit receipts for charges made on their corporate credit card. The corporate credit card statement was viewed as the receipt. As well, expense reports were not being reviewed for propriety on a consistent and regular basis.
- The amount incurred by employees for travel and other costs totaled approximately \$2.55 million for the period October 1, 2000 to September 30, 2004 (**Figure 10**). This was comprised of \$200,000 charged to employee expense accounts and \$2.35 million charged by employees to their corporate credit cards. In many cases, travel and other expenses were incurred and identified as being chargeable to portfolio companies in either a recoverable or non-recoverable expense category.

FIGURE 10

Travel and Other Costs For the Period October 1, 2000 to September 30, 2004	
Expense Account Category	Amount
Portfolio Company Charges - Recoverable	\$ 890,000
Portfolio Company Charges - Non-recoverable	90,000
Staff Development	301,000
Corporate Image	113,000
Meals	112,000
Perquisites	113,000
Dues and Memberships	92,000
Other Travel	75,000
Books and Subscriptions	65,000
Employee Receivables	90,000
Costs Associated with Creation of an International Sub-Fund	31,000
Other Credit Card Categories	578,000
Total	\$2,550,000*

* Includes approximately \$1.8 million in Travel, Accommodations, Meals and Entertainment.

- The former CIO incurred the largest amount of credit card and other expenses. He charged approximately \$1.1 million in travel and other expenses or 44% of the \$2.55 million from October 1, 2000 to September 30, 2004. Of these expenses, approximately \$635,000 was considered recoverable from portfolio companies. Remaining costs were charged to other categories such as: staff development; corporate image; other travel; meals; perquisites; and employee receivables and other accounts.
- The Fund permitted first class travel if an employee traveled in excess of 15 roundtrips the previous year.
- The Fund incurred approximately \$830,000 in international travel costs over the four year period. The former CIO incurred approximately \$660,000 or 79% of such costs, often traveling to many locations in a single month. Destinations included Dublin, New York City, London, Denver, Aspen, Florida, Munich, Paris, Cancun, Las Vegas and many other cities. In many cases, the reason for the travel was not documented. There are travel costs of \$90,000 where we could not determine the destination.
- Over the four year period, \$100,000 in event tickets were purchased by the former CIO and other members of CIF.
- We noted the following violations of the Fund's Expense and Travel Policy:
 - Expense reports and analysis of corporate credit card charges were not completed and submitted on a timely basis. Many employees did not submit expense reports on a monthly basis. The former CIO and another Vice-President were consistently delinquent in their filing of complete expense information. In 2004, the former CIO was eight months behind in submitting corporate VISA reports. The former CIO's response to the CFO when asked for expense information in 10 days, after numerous requests for expense documentation was as follows, *"I do not respond well to timelines imposed by you in this fashion. While this is an important issue to both of us I do not report to you and have significantly more seniority in this company than*

you do. Therefore I request that you refrain from this type of tactic and put it to you that this would be in both of our best interests. As indicated I will complete the reports as soon as I can”.

- Although policy indicates that corporate credit card reports submitted after three months may result in card cancellation or other corrective action, abuse of privileges by the former CIO were allowed to continue. We noted numerous e-mails from the CFO to the former CIO and former CEO regarding the abuse of corporate credit card privileges by the former CIO. The CFO warned the former CIO that his corporate credit card would be cancelled. However, such action, although recommended by the CFO, was not enforced by the former CEO.
- Many of the corporate credit card reports and expense reports for staff were not approved, including the former CEO's reports. In cases where the former CEO's reports were approved, they were approved by the CFO and not the Board.
- Corporate credit card reports and expense reports for the former CIO were generally reviewed and approved by the former CEO in 2003 and 2004, with some exceptions. However, we did not note any formal approvals for the reports in 2001 and 2002.
- Although the former CEO and the CFO expressed in writing ongoing concerns regarding the former CIO's corporate credit card expenses, no remedial action, other than setting up receivables from the former CIO, was taken. In addition to tardiness in filing corporate credit card and expense reports, other concerns dealt with the lack of appropriate documentation for expenses, the large amount of personal expenses being charged, excessive amounts of non-recoverable meals and entertainment, promotion, corporate image expenses, and excessive travel and related expenses.
- In as early as 2000, it was noted that the former CIO claimed and was paid approximately \$20,000 for nine flights that he cancelled. Upon this situation being drawn to his attention by the CFO, he reimbursed the Fund.
- Although the former CIO did not follow CIF policies on many occasions, no significant remedial action was taken. We were told that the former CEO acted as though the former CIO was so essential to operations that it was too risky to take timely, serious action on expense account abuse. Internal documentation from 2004 confirmed that the former CEO recognized that the CIO had *“significant weaknesses that created risk for CIF and was prepared to move him out as soon as we had an adequate replacement”*.
- As per the CIF policy, expenses submitted three months after the later of the expense date or billing date, could be considered stale-dated and reimbursement would not be provided. However, reimbursement was provided.
- Expenses were reimbursed in some cases without receipts or original receipts. CIF policy indicates that reimbursement would not occur without receipts. We noted over \$230,000 of transactions with no receipts that were reimbursed by the Fund. Of this total approximately \$150,000 was related to expenses of the CIO. In one case, there was a charge of \$2,477 to the Alberta Motor Association. There were no receipts and the explanation provided on Fund records indicated the charge was for “miscellaneous travel due to change in Honolulu trip”. In another case, the former CIO attended a wedding in California. There was no airfare, but \$4,149 was charged to corporate image. This amount included \$3,535 for accommodation which was not supported by a receipt.

- Corporate credit cards were used for personal expenses without timely reimbursement of the personal portion. Over \$50,000 in personal expenses over four years were charged on corporate credit cards and had to be collected from employees. Corporate policy indicates that “NO personal expenses are to be charged on credit cards”. The former CIO and three individuals purchased a wedding gift for the California wedding noted above. The three individuals reimbursed CIF for their portion of the gift. The former CIO’s portion (\$1,272) was charged to corporate image. There was no receipt for the gift.
- Corporate credit cards were also used to pay for family members to attend events and the costs were recorded as CIF expense. In one case, airfare of \$1,884 was paid on behalf of a spouse of a staff member to attend an event in Las Vegas.
- There were numerous instances of cash advances being charged on corporate credit cards mainly by the former CIO. The advances exceeded the maximum allowed under CIF’s policy. As per CIF Policy, employees were discouraged from using cash advances to pay for business travel expenses. Cash advances were only to be incurred under emergency situations and should not have exceeded \$100 per day for domestic travel or \$200 per day for other international travel, including travel to the United States. Cash advances require receipts to confirm amounts spent. Many cash advances did not have supporting receipts or had incomplete receipts.
- There were instances where business development expenses were incurred (particularly meals and entertainment tickets) where the individual participants covered by the expense claim were not identified and the specific business topic was not identified.
- The corporate policy requires staff to book the most economical fare. It also notes that generally, the earlier a ticket is booked, the greater the chance of a discount. The former CIO often booked flights only a few days prior to the departure date. The resulting fares were very high. Three such examples involve travel to Frankfurt at a cost of \$12,800, travel to Australia at a cost of \$13,200 and travel to Toronto at a cost of \$1,955.
- We noted numerous trips made by the former CIO that were made on behalf of portfolio companies that were coded as non-recoverable. The reasons for the trips were not generally documented. An example includes a trip to Frankfurt, Germany for airfare of \$8,351.
- We noted many expenses of the former CIO that were extravagant. For instance:
 - Air Travel to Berlin, Germany for \$9,405 coded as staff development. No further details were provided.
 - Two cash withdrawals of \$473 each on consecutive days from Casino Cash in Las Vegas. Both were coded as “One % Agency” expense. The supporting receipts were incomplete. However, the expense report noted a bar bill of \$260 U.S, but there were no receipts;
 - Jaguar rental of \$467 while in Toronto;
 - Spa/tennis charges of \$405 while in Banff, Alberta;
 - A charge of \$265 at a health spa in Honolulu;

- A charge of \$954 for bringing a relative and an acquaintance to meet him in Las Vegas on an Easter weekend. The amount was described as emergency travel;
- Walt Disney World charges of \$1,496;
- One night accommodation and room charges at the Four Seasons Hotel in New York City of \$1,354;
- Numerous parking tickets totaling over \$1,000 were paid and charged as a Fund expense;
- Charges of \$3,975 for a portfolio company's Board meeting at a restaurant in Winnipeg;
- Meal and entertainment charges of \$1,412 for three people at a Winnipeg restaurant; and
- The purchase of many event tickets over the course of four years, including \$1,729 for Avril Lavigne concert tickets. Tickets were also purchased for Celine Dion in Las Vegas for a family member and charged to an employee receivable account.
- Prior to his departure from the Fund the former CIO owed an amount of \$36,000 to the Fund for personal expenses paid on his behalf. Upon his departure, \$16,000 of this amount was forgiven by the former CEO and was not reimbursed to the Fund.

Conclusions

- There was significant abuse of the Fund's Expense and Travel Policy between October 1, 2000 and September 30, 2004.
- There were instances when accurate and complete expense records were not maintained.
- Many expenses of the former CIO were extravagant and inappropriate given the responsibilities associated with managing an Investment Department. With a significant amount of these expenses being charged back to portfolio companies, both the companies and ultimately the shareholders funded the CIO's extensive travel to international destinations.
- These expenditures, where uncollected from portfolio companies, contributed to an increasing Management Expense Ratio (MER).

4.3.5 Recovery of Costs from Portfolio Companies

According to several venture capital and private equity funds contacted including other LSIFs, and except for reasonable travel and accommodation expenses related to Board meetings, the practice of routinely billing portfolio companies for out-of-pocket expenses is unusual and if done at all, would be on an exception basis only. Normally, out-of-pocket expenses incurred to benefit individual portfolio companies would be reimbursed by a fund to the fund's representative as a cost of doing business and reflected in the Management Expense Ratio (MER).

Simply put, the funds advanced by a venture investor to a portfolio company are to help grow the investment. The funds are not advanced to then cover extensive travel costs of fund executives.

OBSERVATIONS

- CIF has a policy of recovering costs incurred, when conducting due diligence and monitoring, from portfolio companies.

- As disclosed in the Fund's January 2004 prospectus, *"travel and other related expenses incurred by CIF and its representatives are paid by the portfolio company"*. This is not a common industry practice, especially to the extent practiced by CIF.
- Expenses considered recoverable from portfolio companies were generally incurred through corporate credit cards, expense claims, or invoices and recorded as receivables in the general ledger. Portfolio companies were not billed on a regular basis for recoveries of expenses. For many expenses coded as recoverable, we found large time lapses between the time the cost was incurred and the time an invoice was issued to the portfolio companies (where an invoice was sent out). Finance Department staff indicated that invoices were generally issued when the Investment Department staff advised them to do so. They also advised us that some receivables were recorded as potential recoveries from portfolio companies, but were completely offset by allowances for doubtful accounts.
- Although there are more situations of non-billing, three examples are as follows:
 - In the case of Company J, although \$52,000 was recorded as recoverable, no invoices were ever sent out;
 - In the second case, there were approximately \$31,000 of costs incurred on behalf of Company B between December 2003 and September 2004 that were not billed; and
 - In the third case, approximately \$48,000 of costs were not billed to Company C.
- There was no accounts receivable sub-ledger of invoices (aged or otherwise) issued that agrees with the general ledger account balance for Investee's Receivable. Accounts receivable statements were sent out on an infrequent basis. When payments were received from portfolio companies, they were not specifically matched to the invoice.
- The Fund also has a practice of charging some of its costs incurred on behalf of the portfolio company directly to expense – non-recoverable costs.
- Fund staff were unable to provide a documented policy providing guidance on what costs are recoverable and what costs are not recoverable. We were advised that the decision for recovery/non-recovery of costs was at the discretion of the Investment Officer responsible for the investment.
- The former CIO routinely followed a practice of recording costs as recoverable from portfolio companies for various and sundry out-of-pocket expenses - including travel, accommodation, meals and entertainment.
- We analyzed the receivable accounts to determine the amounts billed to and recovered from portfolio companies for the 2001 to the 2004 fiscal years. See **Figure 11** for the analysis.
- The total of charges to the Investees Receivable Account over that period was approximately \$2.6 million. Adding the opening receivable balance of \$617,000, the total receivable from portfolio companies over that period was \$3.2 million. Actual payments received against this receivable over the same period totaled \$1.7 million or 52.5%.
- Approximately 77% or \$2.0 million of these expenses were recorded as recoverable charges from 10 portfolio companies and one sub-fund.
- The Fund wrote off approximately \$500,000 of the Investees Receivable Account and provided an allowance of \$800,000 for potential uncollectible accounts. Consequently,

\$1.3 million, or 40.6%, of the \$3.2 million costs charged to portfolio companies were considered as uncollectible.

- The current allowance as at September 30, 2004 for uncollectible recovery receivables was \$721,000. This comprises the majority of the \$888,000 receivable balance that was outstanding at September 30, 2004.

FIGURE 11

Analysis of the Portfolio Company Receivable Account for Recoverable Costs from October 1, 2000 to September 30, 2004	
Opening Balance - October 1, 2000	\$ 617,000
Charges Between 2001 and 2004	
Employee travel and other expenses	\$ 890,000
Legal costs	1,294,000
Guarantee/line of credit fees	123,000
Consulting	207,000
Operating costs for a Portfolio Company	54,000
Other costs/credits	27,000
	2,595,000
Opening Balances plus Charges Between 2001 and 2004	3,212,000
Conversion of receivable to shares	(90,000)
Payments received for recoveries	(1,734,000)
Write-off costs	(500,000)
Closing Balance - September 30, 2004	\$ 888,000
Allowance for Uncollectible Accounts	\$ 721,000
Closing Balance - September 30, 2004	
Net	\$ 167,000

Source: CIF General Ledger

- In addition to the costs billed to the portfolio companies, the Fund also incurred \$280,000 in costs for portfolio companies that were considered as non-recoverable and recorded directly as expenses. Write-offs of uncollectible portfolio company receivables and the allowance for the potential uncollectible receivable accounts were eventually recorded in this expense account as non-recoverable. **Figure 12** analyzes the amounts recorded in this expense account for the 2001 to 2004 fiscal years.

FIGURE 12

Analysis of Amounts Recorded in the Non-Recoverable Expense Accounts from 2001 to 2004	
Employee travel and other costs	\$ 90,000
Legal	182,000
Consulting	8,000
Total additional costs incurred regarding investments	280,000
Miscellaneous	(25,000)
Write-offs and provisions for uncollectible accounts	1,340,000
Total Expense	\$1,595,000

Source: CIF General Ledger

- The Fund incurred a total of approximately \$2,875,000 of costs referenced to portfolio companies - \$2,595,000 million recorded as recoverable and \$280,000 recorded as non-recoverable between 2001 to 2004. Of this total, approximately \$1.0 million was for employee travel and other costs. Legal costs incurred were approximately \$1.5 million. Of the total costs of \$2,875,000, over \$700,000 were incurred by the former CIO.

Conclusions

- Costs charged back to portfolio companies, particularly in travel and other costs, assessed in consideration of the high write-offs were excessive. The Fund's practice of requesting portfolio companies to reimburse for expenses, may place the Fund and/or its representative in a conflict-of-interest situation since a portfolio company seeking to arrange further financing from the Fund may find it difficult to refuse expenses that it might otherwise deem to be of questionable value. Such a practice could lead to abuse, and could very well discourage potential co-investors.
- Because significant write-offs of accounts recoverable from portfolio companies and because of the poor compilation of the accounting records, it is impractical for us to determine the nature of the expense recoverable being written-off.
- Because of CIF's practice of funding follow-on amounts to portfolio companies that were short of operating capital on virtually a monthly basis (including portfolio companies whose carrying values were written down in September 2004 and April 2005), the Fund was effectively charging back expenses and then funding the portfolio company enabling it to reimburse those same expenses. In essence, CIF capitalized its own operating costs by making follow-on financings that were later written-off. In our opinion, the greater majority of the charged back expenses (during fiscal 2001 to 2004) should have been period costs of the Fund. Accordingly, the Fund's MER was understated during those periods.

4.3.6 Management Expense Ratio

The Management Expense Ratio (MER) of a mutual fund is calculated by dividing the total expense of the mutual fund for the financial year, as shown on its audited statement of operations, by the average net asset value of the mutual fund for the financial year. This is then multiplied by 100 to express MER as a percentage.

The Canadian Securities Administrators (CSA) has established rules for mutual funds when publicly disclosing its MER. The MSC is a member of the CSA.

CSA National Instrument 81-102 includes a section which sets out the method to be used by a mutual fund in calculating its MER. The requirements are applicable in all circumstances in which a mutual fund calculates and discloses an MER. This includes disclosure in a sales communication, a simplified prospectus, an annual information form, financial statements or in a report to shareholders. The mutual fund is required to use its total expenses for a financial year as shown on its financial statements as the basis for the MER calculation. Total expenses are to include interest charges and taxes of all types, including sales taxes and GST, payable by the mutual fund. The total expenses are then divided by the average net asset value of the mutual fund for the financial year to arrive at the MER for the year.

The MER can be a useful measurement tool for a board and management to monitor operating expense trends and to assess a fund's overall performance. The board and management of a fund with growing net

assets should expect to see an MER that is declining. An increasing MER in a mature fund would be a red flag and explanations should be sought by a board.

OBSERVATIONS

- On April 19, 2001, the Fund's external auditors provided the CFO with a copy of the method of calculating MER as prescribed by the National Instrument 81-101 Mutual Fund Prospectus Disclosure. They indicated that CIF's current method of calculating its MER complies with this regulation.
- CIF discloses its MER on its prospectus, its annual audited financial statements and other promotional documentation.
- In its prospectus dated January 21, 2004, CIF reported its MER as 4.04% for the financial year ended September 30, 2003.
- In its annual report for the year ended September 30, 2003, CIF reported an MER of 4.04%. By comparison, the average MER for all LSIF's in Canada is 4.10% as reported by Globefund in the 15-year Mutual Fund Report dated November 4, 2003.
- In **Section 4.3.3** of this report we discuss the Solidarity transaction. Under the terms of an agreement, dated November 15, 2002, CIF issued 790,513.83 Series Three Class I special shares to Solidarity for consideration of \$10.0 million. By incorrectly recording the amount from Solidarity as equity rather than debt, in our opinion, the liabilities reported on the audited financial statements of CIF for the year ended September 30, 2003 were understated by \$10 million and share capital was overstated by this amount. As a result, the net asset value used for calculating MER was overstated by \$10 million. CIF treated the \$10 million as a liability for calculating net asset value per share contrary to the logic used in computing MER.
- In addition, we believe that the \$875,000 and \$1.0 million payments to Solidarity during the year ended September 30, 2003 and September 30, 2004 respectively, should have been recorded as an expense rather than as a dividend. As a result, the reported loss for the year was understated by \$875,000 and \$1.0 million in the respective years on CIF's statement of operations included in its audited financial statements for 2003 and in its unissued draft financial statements for 2004.
- Also, CIF was required to pay a \$100,000 non-refundable study fee and all legal and closing costs under the terms of the agreement with Solidarity in order to obtain financing of \$10 million. These costs amounted to \$121,463 and \$68,558 and were charged directly to Retained Earnings during the years ended September 30, 2003 and 2004. The charging of these expenses directly to Retained Earnings is consistent with how the Fund charges the amortization of deferred selling costs associated with the offering of Class "A" Common Shares. However, we believe that the study fee, legal and closing costs were not for the purpose of selling shares but were incurred to obtain needed financing and therefore should have been reported as operating expenses on CIF's statement of operations.
- In **Section 4.3.5** of this report we discussed CIF's practice of billing staff travel costs and other expenses to certain of its portfolio companies. As per LSIF's industry practice, these expenses would normally have been reported as operating expenses on a fund's statement of operations rather than billed to portfolio companies. Over the four year period from September 30, 2001 to September 30, 2004 we estimate that CIF operating expenses for MER purposes have been understated by approximately \$1,383,000.

- CIF's MER calculation does not include expenses for its wholly-owned subsidiaries, Scitech Management Inc. and Crocus Capital Inc. In our opinion, the expenses of the subsidiary companies, which are included in CIF's consolidated financial statements, should be included when the Fund calculates its MER.
- The revised MER, after adjusting for the impact of issues identified, is shown on **Figure 13**.

FIGURE 13

Crocus Investment Fund Management Expense Ratio				
	2001	2002	2003	2004
CIF total expenses per MER worksheet	\$ 6,289,856	\$ 6,781,168	\$ 7,062,340	\$ 8,035,269
CIF average net assets per MER worksheet	\$167,950,889	\$168,279,807	\$174,647,395	\$177,021,477
MER per CIF annual financial statements	3.75%	4.03%	4.04%	4.54%
<i>Impact of Solidarity transaction on MER:</i>				
Interest expense recorded as dividends	\$ -	\$ -	\$ 875,000	\$ 1,000,000
I Shares - legal and other costs	-	-	121,463	68,558
Total expenses including Solidarity adjustment	\$ 6,289,856	\$ 6,781,168	\$ 8,058,803	\$ 9,103,827
Average net assets including Solidarity adjustment	\$167,950,889	\$168,279,807	\$165,480,729 ¹	\$167,021,477 ¹
Revised MER including the Solidarity transaction	3.75%	4.03%	4.87%	5.45%
<i>Impact of Other Expenses on MER:</i>				
Expenses billed to portfolio companies	\$ 505,029	\$ 459,952	\$ 213,713	\$ 204,313
Wholly-owned subsidiary expenses	-	12,158	11,118	31,002
Total expenses including Solidarity and other expense adjustments	\$ 6,794,885	\$ 7,253,278	\$ 8,283,634	\$ 9,339,142
Average net assets including Solidarity adjustment	\$167,950,889	\$168,279,807	\$165,480,729 ¹	\$167,021,477 ¹
Revised MER including the Solidarity and the other expense transactions	4.05%	4.31%	5.01%	5.59%

Note 1: Adjusted CIF's average net asset calculation downwards for the \$10,000,000 amount received from Solidarity in November 2002.

Note: The above calculations are before any write-down in the valuation of the CIF Investments that should have been booked on or before September 30, 2004.

Conclusions

- The impact of incorrectly recording the Solidarity transaction in the annual financial statements for the year ended September 30, 2003 and the unfinalized draft statements for the year ended September 30, 2004, significantly contributed to the understatement of the MER, including that disclosed in the January 2004 prospectus.
- The treatment of billing back of expenses to portfolio companies and not including wholly-owned subsidiary expenses in the MER calculation, also contributed to the ability to reflect a lower MER as reported in the annual financial statements for the years ended September 30, 2001, 2002, 2003 and in the initial draft statements for the year ended September 30, 2004. This treatment also contributed to the ability to reflect a lower MER in the January 2002, January 2003 and January 2004 prospectuses.

4.3.7 Cash Receipt and Payment Processes

OBSERVATIONS

Cash Receipts Process

We reviewed how CIF processes receipts of funds regarding investment assets and related income. We noted the following:

- In general, CIF has not documented procedures for processing receipts, including the cut-off procedures for ensuring that receipts are recorded in the proper financial period.
- Detailed income recognition policies are not defined. Various receivables are not recorded.
- In particular, dividend income, other profit distributions (referred to as management fees), and director fees are not anticipated and recorded as receivables but are recorded on the cash basis.
- Prior to 2002, CIF did not prepare cash flow forecasts. In the summer of 2002, the Finance Department began to prepare an overall cash flow forecast called "Cash Flow Requirements to September 2004". This was developed to monitor CIF liquidity.
- Although the Finance Department prepared cash flow budgets, they were dependent on information from the Investment Department. Up until recently, this information was deficient.
- There is no evidence that the Finance Department compares actual receipts with expected receipts so as to be able to identify and investigate variances.
- Aged accounts receivable schedules are not prepared.
- Operating bank account reconciliations are prepared by the same individual responsible for preparing and recording cheques and deposits, as well as receiving the bank statements and processed cheques.
- Although we were advised that the bank reconciliations were reviewed by the Controller, this review is not evidenced.
- Cheques received in mail may be forwarded in unopened envelopes to CIF personnel and not to the Finance Department for deposit to the bank account.
- Although management letter points were received from the Fund's external auditors, it does not appear that all recommendations were acted on in a timely manner.

Cash Payments Process

We reviewed how CIF processes payments regarding investment assets and related expenses. We noted the following:

- In general, CIF has not documented procedures for processing payments, including the cut-off procedures for ensuring that payments are recorded in the proper financial period.
- There was no clear evidence, such as an initial, indicating that the Finance Department compares actual payments with expected payments so as to be able to identify and investigate variances.
- Operating bank account reconciliations are prepared by the same individual responsible for preparing and recording cheques and deposits, as well as receiving the bank statements and processed cheques.

- Although we were advised that the bank reconciliations were reviewed by the Controller, this review is not evidenced.

Conclusions

- Internal controls over the processing of receipts and the completeness of revenue are weak.
- Internal controls over the processing of payments can be improved.

4.3.8 Executive Compensation

OBSERVATIONS

- Compensation for Senior Officers of the Fund consisted of:
 - Base salary;
 - Perquisites up to \$22,000 per year (The perquisite policy provided for reimbursement of costs incurred for transportation, memberships, personal and family services and health and family protection);
 - Additional pension contributions equal to 7.5% of their salary over the Revenue Canada pension cap; and
 - Annual distribution of CIF shares under the Employee Share Ownership Plan (ESOP).
- This was the same for all employees with the exception of perquisites.
- Senior Officers believed that executive compensation levels of the Fund were less than other similar organizations. In the 1998 fiscal year, they took two steps to improve the competitiveness of executive compensation levels.
- The first step was to move the Officers to the higher end of the salary range established in 1996 (\$155,000 to \$180,000). The salary range has since been revised to be \$138,550 to \$271,400. Individual salaries are set by evaluating the position against specific factors for the organization.
- The second step was to establish a formal management perquisite policy with a cap of \$22,000 per Senior Officer. The policy was also extended to certain Non-Officer Vice-Presidents with a cap of \$12,000 per individual. See Appendix E for the Perquisite Policy. The policy entitles reimbursement for the following:
 - Transportation
 - Car allowance (lease and operating expenses)
 - Vehicles leased or purchased under this benefit must be union made in North America
 - Memberships
 - Professional associations
 - Business luncheon club
 - Recreation club
 - Personal and family services
 - Daycare and eldercare
 - Personal services
 - Health and family protection
 - Life insurance (term)
 - Health and wellness services

- In addition, all employees of the Fund received additional compensation as part of the pension plan equal to 7.5% of their salary over the Revenue Canada pension cap. All employees also receive an annual distribution for purchase of Fund shares under the Employee Share Ownership Plan (ESOP).
- Annual base salaries for the former CEO, former CIO and the CFO increased as indicated in **Figure 14**.

FIGURE 14

	September 30, 2004 Gross Annual Salary (excluding perquisites)	Annual Salary 1997 - 2004	
		Total % Increase	Average Annual % Increase
Former CEO	\$247,700	78.4%	9.8%
Former CIO	\$240,200	73.8%	9.3%
CFO (1998 - 2004)	\$162,900	95.1%*	13.6%*

Source: CIF

* Employee started employment in 1998. Title was Director of Finance (1998 to Oct. 2000), which was the most senior position in the Finance Department. Title changed to Vice-President and CFO in October 2000.

- We reviewed the total annual perquisite charges by Officer for the four fiscal years 2001 to 2004. The maximum was exceeded in five separate occasions by the following amounts:
 - \$800 by a former COO in the 2001 fiscal year;
 - \$3,400 by the former CIO in 2004 fiscal year;
 - \$6,100 by a former COO in the 2003 fiscal year;
 - \$8,600 by the former CIO in 2001; and
 - \$16,600 by the former CIO in 2002.
- The \$16,600 overage by the former CIO in 2002 was recorded as a receivable in the 2003 fiscal year.
- We reviewed the individual charges in the perquisite accounts. The individual amounts generally met the policy. However, we noted two instances where accommodation and meals totaling \$7,000 were charged to perquisites by a former COO in the 2003 fiscal year. This is not in accordance with the policy.
- We noted that the lease for the former CEO's 2003 Ford Explorer had a \$21,000 reduction in the lease value. This reduction was agreed to as part of CIF's investment in a portfolio company. The \$21,000 was to be charged to the former CEO's perquisite account at \$7,000 a year over a three year period. The \$7,000 amount was correctly charged the first year, but was not charged to the remaining two years. When we brought this to the Fund's attention, we were informed that this will be corrected.
- Annual distributions by employee for the purchase of Crocus Shares under the Employee Share Ownership Plan (ESOP) from 2001 to 2004 were: \$912.92; \$915.62; \$1,070.17; and \$1,103.11 for employees employed for the entire year. A proportionate amount was allocated for those employees on staff for less than the year.

- Perquisite amounts for automobile expenses, pensions and Employee Share Ownership Plan were included on the employees' Canada Revenue Agency T4s. However, perquisite amounts for life insurance, income tax preparation fees, and accommodation/meal expenses were not included on the T4s. The Canadian Tax Act and interpretations require these amounts to be included on T4s.
- We reviewed the amounts recorded in the prospectuses disclosed as the aggregate remuneration paid to Senior Officers. The Senior Officers included in the prospectus were the CEO, CIO, COO and CFO. In the January 2004 prospectus, the Vice President of Labour was also included as a Senior Officer. We noted only small errors in the amounts disclosed. However, the total amount in the January 2003 prospectus was understated by \$30,200.
- We also noted that amounts for the ESOP were not included in the prospectus disclosure.

Conclusions

- It appears that the compensation levels for the former CEO, the former CIO and the CFO have increased significantly in recent years.
- CIF management has failed to ensure that the perquisite policy was effectively managed. As a result, the perquisite policy has been exceeded on a number of occasions; the perquisite policy was not followed in a number of instances; amounts were improperly omitted from the perquisite accounts; and perquisite amounts for life insurance, income tax preparation fees, and accommodation and meal expenses were not included on the employee T4s.
- ESOP distributions for Senior Officers were not accurately disclosed on the prospectuses.

4.3.9 Director Fees from Portfolio Companies

Organizations may or may not pay director fees. Normally, an LSIF employee who sits as a director on a portfolio company board would not receive a director fee. This supports the logic that an LSIF provides monies to the portfolio company to grow the business and requesting director fees would be reducing the financial support provided.

Where public companies are involved and fees have to be paid, any director fees received by LSIF employees would be revenue of the LSIF for depositing and would not be retained by an LSIF employee. In cases where an LSIF may collect director fees from their portfolio companies, this practice may be in place for cash management and cash flow purposes of the LSIF.

OBSERVATIONS

- During the last four years, director fees received and recorded in the general ledger by CIF were as follows:
 - Year ending September 30, 2001 - \$9,000
 - Year ending September 30, 2002 - \$15,400
 - Year ending September 30, 2003 - \$32,600
 - Year ending September 30, 2004 - \$28,100

- There is no standard communication provided to portfolio companies regarding the payment or non-payment of director fees to CIF or prohibiting the payment of director fees to CIF employees.
- CIF did not have controls in place to ensure the completeness of director fees received by CIF in situations where portfolio companies arranged to pay director fees to CIF for having a representative on their board.
- A master listing of portfolio companies was not available identifying which portfolio companies would be paying director fees.
- CIF did not have controls in place to ensure that director fees are not being directly received and retained by CIF representatives sitting on portfolio company boards.
- Where CIF representatives sit on boards of public portfolio companies, there are no controls in place to ensure director fees are paid to CIF.
- We found no evidence in CIF records, that CIF employees attending past portfolio companies board meetings were receiving director fees personally.

Conclusions

- Given the nature of CIF's investment portfolio, the requirement of a portfolio company to pay director fees does not seem reasonable, unless the objective is to obtain cash flow.
- The lack of completeness controls contributes to the undue risk that not all monies were received.

4.3.10 Income from Portfolio Companies

As a means of generating cash flow to help cover the operating expenses of the Fund, debt and preferred share instruments of portfolio companies were routinely used. Often, pure common equity investments were made coincident with the debt. Debt investments obtained at the outset, were sometimes converted to common equity later in the life of the investment depending upon the status and progress of the individual portfolio companies concerned.

In order to forecast future cash inflows and also properly manage the receipt of revenue from interest, dividend, management fees and other income, a venture investment fund must maintain a completely documented summary of what investment instruments are contained in its investment portfolio at all times. This is true with respect to common equity, preferred share and debt investments. Without complete and current information, decision-making regarding cash flow forecasting is compromised and deficient.

OBSERVATIONS

- **Figure 15** summarizes recorded income from portfolio companies by type, for the fiscal years ending September 30th.

FIGURE 15

Income Type	2000/01	2001/02	2002/03	2003/04	Total
Interest income - Investee	\$1,670,864	\$1,498,510	\$3,112,806	\$1,914,378	\$ 8,196,558
Dividend income	637,849	650,980	968,068	1,142,605	3,399,502
Line of credit and guarantee fees	-	-	14,301	501,169	515,470
Management and director fee income	425,526	504,122	836,248	617,614	2,383,510
Total	\$2,734,239	\$2,653,612	\$4,931,423	\$4,175,766	\$14,495,040

Source: CIF General Ledger

- CIF earns interest income on loans provided to portfolio companies based on the terms and conditions specified in the loan agreements. CIF also earns dividends, management fees, director fees, and fees for letters-of-credit and guarantees from portfolio companies based on the various terms and conditions of the other legal agreements made on each investment.
- A wholly owned subsidiary of CIF, Scitech, is the general partner for the Manitoba Science and Technology (MS&T) Fund. Scitech receives management fees from the MS&T Fund based on a set percentage of MS&T's invested capital. These management fees are accrued on a quarterly basis and consolidated in CIF's financial statements. CIF earned \$570,000 in management fees from MS&T in the four year period under review.
- Dividends, management fees (excluding MS&T), director fees, letter-of-credit fees and fees for providing guarantees are recorded only when cheques are received or the Finance Department is advised of a receivable.
- Bonus payments or profit distributions to CIF as an investor, other than dividends or payments for employment, are to be paid as management fees, plus an amount for GST. Most equity investments do not result in management fees. CIF earned \$1.8 million in other management and director fees in the four year period under review.
- A key concern of the current CIO was the lack of complete documented information on the Fund's debt portfolio. On November 12, 2004, the current CIO and his staff prepared an analysis of yield and terms of the debt portfolio. From this analysis they noted the following:
 - "At the time of this analysis, and as a % of original investment costs, debt accounted for 32%.
 - CIF had invested \$34 million (excluding capitalized costs or \$36 million including capitalized costs), into debt which had a carrying value of \$25 million at November at the time of the analysis.
 - In Fiscal 2004, CIF collected interest at a rate of 1.97% of debt cost (excluding capitalized costs). The rate projected for Fiscal 2005 is 1.37% of debt (excluding capitalized costs).
 - A debt quality and contingent liability assessment had recommended that a \$22 million reserve be taken leaving the carrying value of the debt at \$3 million. As \$463,000 of interest was projected to be received for Fiscal 2005, on the recommended reduced carrying value, this would then represent a collection rate of approximately 15%.

- *Interest receipts were noted as decreasing and that the receipt of interest payments would be an insignificant source of cash inflows to CIF.*
- *Only 13 instruments had regular payment terms for their interest owing.*
- *At the time of this analysis, CIF had 95 debt instruments (68 accruing interest, 27 not accruing interest). Only 12 portfolio companies had made an interest payment in fiscal 2004.*
- *Not only were cash receipts for interest expected to be lower in Fiscal 2005, the number of companies forecasted to make interest payments was also expected to decrease over 2004 numbers.*
- *CIF has a debt instrument in 26 portfolio companies. This represents 53% of portfolio companies.*
- *At the time of the analysis, \$2.3 million of debt had come due, but had not been repaid.*
- *When principal would come due, new debt instruments were created and due dates were pushed into the future.*
- *It now appears that many portfolio companies do not have the cash flows to repay principal or interest. Debt was advanced to portfolio companies to cover operating losses and to companies who had an inability to pay interest or repay principal at the time of advance."*
- CIF accrued interest income monthly or based on the payment cycle in the loan agreements. However, interest was not being accrued on some debentures if the loan was considered a shareholder loan or if the interest was considered uncollectible. As per the current CIO's analysis noted above, of the \$25 million carrying value in loans outstanding as at September 30, 2004, interest income was not being accrued on \$10 million in loans.
- During the four fiscal year periods from 2001 to 2004, CIF recorded interest income from portfolio companies of \$8.2 million. Of this income, CIF wrote-off \$460,000 to expense and provided an additional allowance of \$370,000 for uncollectible amounts. The total write-offs and allowance for uncollectible accounts - \$830,000 - was 10.1% of the recorded interest income during this period.
- Interest rates attached to debt instruments range from prime to 20%. Over 10 debt instruments had been given at prime. CIF By-laws state that:
 - *"The Fund will make debt placements with the objective of achieving market interest rates and amortizing principal repayment over a commercially reasonable period.*
 - *...desirable investment opportunities must provide an opportunity for a return on the Fund's investment that is commensurate with the perceived risk."*

Conclusions

- The risk-reward relationship is not evident in the structure of CIF's investments. That is, there is neither a link nor a quantitative justification between the terms and conditions within the legal instruments used to document the investment and the risks of the investment.
 - For example, providing a loan to a very early stage technology company with a relatively high risk profile, and accordingly, a high reward target (internal rate of

return) above 40%, makes little sense on its own since the company may be many years away from being able to produce enough income to service the debt. In essence, a loan to such a company represents pure equity risk notwithstanding the loan structure. However, a debt instrument such as a convertible subordinated loan, plus an appropriate common equity interest in the company, may together represent the right balance against the risks of the investment. At any rate, the risk-reward ratio should be evident and justified – analyzed quantitatively and documented – in every case. However, CIF does not follow this practice. This justification should also be done each time a valuation is performed and a follow-on investment is considered.

- The past management of CIF's debt portfolio (funds provided to portfolio companies in the form of debt instruments), including documentation management had been deficient. The collection of interest income had been inconsistent. The creation of new debt instruments, when previous debt instruments matured, may have been used to defer the recognition of the debt as uncollectible. The current CIO has improved this situation and the write-down of some of this debt has been taken.

4.3.11 Conflict of Interest and Interwoven Roles of Individuals

OBSERVATIONS

- On June 24, 1998, the CIF Board approved a Conflict of Interest Policy that applies to directors and officers. This policy intentionally did not reference other employees. It covers director and officer interests in investments, as well as, director and officer interests in contracts, that CIF would need to consider. The Crocus Investment Fund Act provides that the conflict of interest provisions in The Corporations Act apply to the Fund. The intent of this Conflict of Interest Policy was to reflect a combination of the conflict of interest provisions in The Corporations Act and the conflict of interest provisions that already exist in the Fund's investment By-law.
- This Board-approved policy does not address general issues of conflict of interest.
- As of March 2005, an employee conflict of interest policy was still not in place. A draft of the "Workplace Conflict of Interest and Confidentiality Policy" (**Appendix D**) is presently under consideration. This draft addresses general issues of conflict of interest and highlights acceptable and unacceptable conduct. The purpose of this draft policy *"...is to establish clear guidelines for the duties and obligations of Crocus employees in the context of avoiding actual or potential conflicts of interest. It is essential that all employees of Crocus avoid any situation or interest that might interfere with his/her judgment or responsibilities to Crocus"*.
- We were advised by CIF Senior Officers and Board members that a conflict of interest policy has not been put in place as a result of not being able to reach an agreement with the bargaining agent of unionized staff.
- The Crocus Investment Fund Act refers to conflict of interest in relation to a person who is a member of the Investment Advisory Committee and states the following:

"9.1(3) A member of the investment advisory committee who has a material interest in a proposed investment by the Fund that is under consideration by the committee

 - a) shall disclose the nature and extent of his or her interest in writing to the committee*
 - i) at or before the meeting of the committee at which the proposed investment is first considered,*

- ii) *if the member did not then have an interest in the proposed investment, at the first meeting after he or she becomes interested in it, or*
 - iii) *if the member had an interest in the proposed investment before becoming a member, at the first meeting after he or she becomes a member at which the proposed investment is considered; and*
- b) *thereafter shall not participate in the committee's deliberations or advice to the Board regarding the proposed investment."*
- We were informed that the onus for declaring a conflict rested with the individual Board member, who would excuse themselves from the meeting when that issue was disclosed, or abstain from voting on an issue if a potential of conflict could be perceived to exist. The Fund's Corporate Secretary confirmed that this was recorded in the minutes when it occurred. Although most Board members did not express concerns with how their fellow Board members handled conflicts of interest, our review did note, for example, a situation where a Board member was involved in all discussions and voted on decisions related to an investment where their organization was also an interested partner.
- The representative of the Class G shares is appointed by the Province, usually a senior employee of IEDM. Between June 2000 and July 2001, the Province's representative on the CIF Board was a Deputy Minister. This was subsequently filled by an Assistant Deputy Minister, who later became a Deputy Minister of another government department. In July 2004, he was replaced by an employee of IEDM. While it was made clear that their fiduciary responsibility as a Board member was to the Fund rather than to government, our interviews confirmed that having a senior government official from IEDM as a Board member raised a potential for conflict due to IEDM's monitoring role. This may have placed these Board members in awkward positions.
- The Fund has a number of connections and overlapping relationships with certain individuals and portfolio companies.
- During our examination of CIF, we noted many situations of interwoven relationships that may or may not be actual or perceived conflicts of interest, but raised troubling questions about the governance and management of the Fund. Some examples were as follows:
 - The former Chair of the Workers Compensation Board of Manitoba (WCB) served on the Board of CIF and was Chair of CIF's Investment Committee as well as its Investment Advisory Committee. At the same time, the Fund's former CEO was an advisor to the WCB's Investment Committee. We noted that when the CIF Board discussed co-investing with the WCB, the former Chair of the WCB did not excuse himself from the discussions.
 - A Board member of CIF was also a Board member of the Teachers Retirement Allowances Fund (TRAF). In this case the Board member excused herself from the TRAF Board discussion around co-investments with CIF.
 - The CIF consultant on Company F was also the consultant for WCB on investing in Company F.
 - CIF's Chair is the President of the Manitoba Government Employees Union (MGEU). The employees in CIF are members of the MGEU.
 - The former CIO, as part of his severance package, became a part-time contract employee of a portfolio company, Company D, at an annual salary of approximately

\$87,000 USD along with a benefit package and a significant incentive package based on the Company obtaining certain milestones.

- The former CIO had extensive involvement on a social level with key owners of portfolio companies. This may have created a perception that investee corporations either received preferential investing treatment and/or may have felt compelled to cover costs incurred by the CIO.
- The former CIO indicated that when he sat on the Board of portfolio companies, he viewed his responsibility firstly to the portfolio company and did not believe that he was serving a monitoring role. As a consequence, he conveyed that it was other Investment Department staff's responsibility for monitoring the portfolio company.
- The lead broker for the sale of CIF shares is also a portfolio company.
- We noted in correspondence that, *"In exchange for lowering the interest rate, Crocus is to receive a \$5,000 [product] credit from an investee company annually until the loans in question are paid in full"*. Prior to our bringing this transaction to their attention, current Investment Department staff had no knowledge of this arrangement; no record of it was included in any of the Department files. However, the original memo where the credit was mentioned was located in an investment directory folder of an analyst who had left the Fund. The loan agreements with Company X and related companies had been renegotiated on September 1, 2003 and the interest rate had been reduced to prime. However, these loan agreements made no reference to the \$5,000 [product] credit. Current investment staff told us that, given the risk profile for this group of companies, they would have expected the negotiated interest rate to have been significantly higher. On further follow-up, we noted that the \$5,000 [product] credit was then applied against an invoice that was paid on behalf of another portfolio company, Company E, for a function held by it and sponsored by the Fund.
- In July 2000, CIF signed an agreement with Company HH. Included in that agreement was the following paragraph:

"At all times while any amount is owing to Crocus under the Debenture or any debt instrument substituted therefore, or while any subsequent investment by Crocus in the Corporation is outstanding. Company HH will [provide] to Crocus two vehicles for use by Crocus' chief executive officer and chief investment officer. In respect of each such [provision], Company HH will either provide Crocus with a credit (if the vehicles are [provided] by Company HH) or pay on behalf of Crocus (if the vehicles are used by Company HH to be [provided] to Crocus) the sum of \$750 per month per vehicle towards the payments under such [arrangements]."

Conclusions

- Interwoven relationships can be advantageous to the portfolio companies within a venture investment fund. However, conflict of interest situations can develop because what is in the best interest of a fund may not always be in the best interest of the portfolio companies and their principals. Such "off the books" transactions as the \$5,000 credit and the vehicle benefit do not demonstrate appropriate business practices, and significantly increases an organization's risk of abuse. Even if the amounts are not significant, we are concerned with the corporate ethics of such "off the books"

transactions. Shareholders and others have no way of knowing whether or not it was in their best interests, nor the total amount of Fund income that was forfeited.

- The former CIO sat on various portfolio company boards because of his position with CIF. It would have been appropriate and beneficial for CIF had he used the position to act as a monitor for CIF.
- Having a CIF Board member who is a representative of the government department responsible for monitoring the Fund may have created a perception of conflict, regardless of whether it existed in practice.

4.3.12 Donations

OBSERVATIONS

- CIF does not have a documented policy regarding donations.
- CIF provided donations to sponsor various events such as golf tournaments, marathons, fundraisers, etc. Donations were also made for portfolio company events.

FIGURE 16

	Year Ending September 30				Total
	2001	2002	2003	2004	
Charitable Donations	\$118,000	\$104,000	\$114,000	\$112,000	\$448,000
Political Donations (Federal)	\$4,000	\$2,000	\$3,000	\$9,000	\$18,000

CONCLUSIONS

- Given that CIF is a shareholder fund, we do not believe that it was appropriate to provide charitable and political donations.

4.3.13 Other CIF Initiatives

OBSERVATIONS

Community Ownership Solutions Inc.

- Community Ownership Solutions Inc. (COS) is a registered charitable, not-for-profit organization founded by CIF in 1999. Its mission is to create quality jobs for Winnipeg's low-income community through enterprise creation and enterprise transformation activities.
- There is no formal operating agreement in place between CIF and COS which sets out the services each party is to provide the other and the costs associated with these services.
- From October 1999 to December 2004, CIF contributed a total of approximately \$472,500 to COS. (In 1999, a contribution of \$22,500 was made; for the years 2000 – 2004, \$90,000 per year was contributed.)
- From 1999 to 2001, COS was economically dependent on CIF to operate. Over this period CIF's contribution to COS represented between 60 – 70% of COS's total revenue. This

changed in 2002 when COS secured additional sources of funding, including \$250,000 over a four year period from the Province. Other funding sources include Western Economic Diversification Fund and local Foundations. According to the audited financial statements of COS for the year ended December 31, 2003, total revenues were \$538,115 of which \$90,000 (17%) was from CIF.

- CIF's annual contribution to COS of \$90,000 is non-cash in nature in the form of seconded staff and the provision of office space and parking.
- CIF staff perform certain accounting and administrative services for COS, however, there is no estimate of the costs for these services provided by CIF to COS. Consequently, CIF does not record any amounts related to these donated services in its records.
- CIF does not disclose the nature and extent of its donated services to COS, for either its annual contribution of \$90,000 or for the accounting and administrative services which are not quantified, in its annual financial statements. Although the amounts involved are not material to the CIF financial statements, the extent and nature of these non-core business activities would be of interest to readers of CIF's financial statements.

Manitoba Centre for Labour Capital Inc.

- The Manitoba Centre for Labour Capital Inc. (MCLC) is a not-for-profit entity that was incorporated on September 5, 2003. Its purpose is to provide education and training primarily for union-based pension fund trustees. MCLC was created by the MFL, the Manitoba Government, the MGEU, the Canadian Union of Public Employees, the United Food and Commercial Workers, the Manitoba Teachers Society, the Manitoba Building Trades Council, and CIF.
- With respect to considering creation of the MCLC, CIF material indicated, *"...Crocus takes its labour sponsorship seriously and while already structuring its internal governance systems around the importance of labour's strategic oversight as sponsor, is always looking for ways to assure that its core business undertakings are relevant to the changing environment and needs of its sponsor – particularly its sponsors needs related to capital and economically targeted development"*.
- CIF set up an account in its general ledger in 2002/03 for recording MCLC transactions. This account was set up by CIF because MCLC, at the time, did not have its own bank account to process transactions.
- Prior to opening its own bank account, two deposits of \$5,000 each from the MFL and the Manitoba Teachers Society were deposited in the CIF bank account in 2002/03 on behalf of MCLC and credited to the 'Due from MCLC' account.
- A review of the 'Due from MCLC' account for 2003/04 indicates that the amount owing from MCLC as at September 30, 2004 was \$138,790. As at March 18, 2005, this amount was still outstanding.
- MCLC has yet to finalize its financial statements for its first fiscal year ended September 30, 2004.
- Our review of MCLC's draft financial statements indicates that the Province provided funding to MCLC in the amount of \$162,500. MCLC's total revenue was \$282,633 in the year. Other significant sources of funding were CIF - \$52,193, Western Diversification Canada - \$47,673 and Labour Groups - \$20,000.

- According to the notes to the draft financial statements of MCLC, CIF does not charge interest to MCLC on the amount owing to CIF.
- Also, MCLC's draft financial statements and CIF's records indicate that the \$52,193 CIF contributed to MCLC was in the form of seconded staff (\$40,171) and paid for office space for MCLC at the Union Centre (\$12,022).
- CIF has not recorded the \$52,193 amount contributed to MCLC in its 'Due from MCLC' account or as a donation/contribution to MCLC.
- In October 2004, CIF hired their former Chair to be the General Manager (GM) of MCLC and to serve as the Vice President, Labour Relations for CIF. At that time, it was anticipated that the salary allocation would be split equally between CIF and MCLC. However, to date all of the salary being paid is charged to CIF salary expense, the amount being approximately \$160,000 annually. According to the GM of MCLC, approximately 95% of his time to date is being spent on CIF related activities.
- There is no formal operating agreement in place between CIF and MCLC which sets out the services each party is to provide the other, the costs associated with these services, how the costs, such as the salary of the GM of MCLC will be allocated, and how the amount owing to CIF from MCLC will be repaid.

Centre for Employee Ownership

- The Asper Centre for Entrepreneurship of the University of Manitoba opened the Centre for Employee Ownership (Centre) in October 2003. The Centre's focus is on programs supporting employee ownership and participative management.
- The Certificate Program in Participative Management is a fully certified 10 month program provided through the Centre. This program is specifically designed to give managers the opportunity to learn practical participative management skills that can be applied to their own organizations. CIF indicated that several of their staff have attended the program offered by the Centre.
- We examined CIF documentation which indicates that the former CEO of the Fund was seeking funding commitments for the Centre from a number of organizations including portfolio companies. The correspondence also indicated that funding from CIF would enable the Centre to reach its annual minimum requirement over the next three years.
- The Centre's website lists its program sponsors. This includes CIF and three of its portfolio companies, as well as two organizations related to former Board members.
- Based on our discussions with CIF, there have been no payments made to the Centre from CIF to date. While a CIF cheque was processed to the Centre in January 2005, it was not forwarded due to the present circumstances at the Fund.

Extent of CIF Contributions to Other Initiatives

- CIF has not disclosed the extent and nature of its non-core business activities to the readers of its financial statements.
- **Figure 17** provides an estimate of the CIF funds expended on the COS and MCLC initiatives for the years ended September 30, 2000 to September 30, 2004.

FIGURE 17

	2000	2001	2002	2003	2004	Total
COS*						
Seconded staff, Office space and parking costs	\$ 90,000	\$ 90,000	\$ 90,000	\$ 90,000	\$ 90,000	\$450,000
OAG estimate of other staff costs	5,000	5,000	5,000	5,000	5,000	25,000
	\$ 95,000	\$ 95,000	\$ 95,000	\$ 95,000	\$ 95,000	\$475,000
MCLC**						
Salaries and Office costs	\$ -	\$ -	\$ -	\$ -	\$ 52,193	\$ 52,193
Amount due to CIF***	-	-	-	-	138,790	138,790
	\$ -	\$ -	\$ -	\$ -	\$190,983	\$190,983
Total	\$ 95,000	\$ 95,000	\$ 95,000	\$ 95,000	\$285,983	\$665,983

* Source: COS and CIF records.

** Source: MCLC and CIF records.

*** This amount may be reduced by future payments from MCLC to CIF.

Conclusions

- CIF funds were utilized for the creation and operation of COS and MCLC. In our opinion, shareholder funds were used for non-core initiatives that will not provide any return for the shareholders of CIF. It is unfair to shareholders to have resources directed to such initiatives without full disclosure provided in the financial statements and prospectuses.
- Soliciting funds from portfolio companies creates the potential for a conflict of interest situation given the dependency of portfolio companies on funding from CIF.

4.3.14 External Reporting

External reporting is intended to provide the public and stakeholders with information that enables them to draw conclusions on whether performance is stable, improving, or declining. An organization's performance information should communicate shareholder benefits and demonstrate how the organization's activities and results add value.

To determine the quality and transparency of the Fund's accountability reporting to the public, we compared the information in CIF's prospectuses with the information presented in their Management Discussion and Analysis (MD&A) included with their 2003 Financial Statements. As well, we examined whether the Fund's MD&A is consistent with the CICA Standards and Guidance on MD&A.

OBSERVATIONS

Comparison of MD&A to Prospectuses

- For the years 1999 to 2002 inclusive, annual reporting by CIF consisted of financial statements without an MD&A (as the latter was only issued by CICA in November 2002) and an annually updated prospectus.
- In 2003, the Fund added an MD&A to its financial statements as per the new guidance of the CICA.
- Findings from a comparison of the information in the Fund's 2003 MD&A in the financial statements to the 2003 prospectus is presented in **Figure 18**.

FIGURE 18

Comparison Between 2003 MD&A and 2003 Prospectus	
Key Topics Covered	Fund's MD&A - 2003
Identifying CIF's Objectives	Compared to the 2003 prospectus, the MD&A communicates a partially complete picture of CIF's objectives – i.e., the MD&A does not identify CIF's aim of providing competitive financial and non-financial rewards for its shareholders through investments in socially responsible Manitoba businesses that operate in accordance with ethical policies with respect to employment practices, workplace safety, environmental suitability and other matters. (2003 prospectus, p. 1)
Explanation of Tax Credits and Financial Benefits	Compared to the 2003 prospectus, the MD&A communicates a partially complete picture– i.e., the MD&A does not explain that the tax credits will effectively reduce the purchaser's cost of Common Shares by 30% of the aggregate purchase price paid provided that the Manitoba and Federal income tax payable by the purchaser is equal to or greater than the respective tax credits. (2003 prospectus, cover page.)
Investment Approach	Compared to the 2003 prospectus, the MD&A communicates a partially complete picture – i.e., the MD&A does not explain what it means when it states that <i>"before investing CIF undertakes extensive financial due diligence"</i> (2003 MD&A, p. 3). By contrast, the 2003 prospectus explains CIF's investment policies, its criteria for selection of business investments, and investment restrictions (2003 prospectus, Section 4, pp. 25-33).
Relationship with Portfolio Companies	Compared to the 2003 prospectus, the MD&A communicates a partially complete picture – i.e., the MD&A does not explain CIF's aim for the various activities it undertakes to assist portfolio companies. According to its 2003 prospectus, CIF undertakes these activities to <i>"enhance their profitability and to encourage the evolution of employee ownership and employee participation in management and governance, important components of the Fund's mandate"</i> (2003 prospectus, p. 37). As well, the MD&A does not mention: the CEO Roundtable (regular meetings initiated by the Fund with CEOs from each of the portfolio companies); the annual trade show organized by CIF for its portfolio companies; and the course that CIF offers in conjunction with the University of Manitoba's Continuing Education on participatory management for representatives of its portfolio companies and others (2003 prospectus, p. 37).
Risk	The MD&A does not identify the risks associated with investing in CIF. By comparison, the 2003 prospectus details the risks associated with investing in the Fund (2003 prospectus p. 9 and pp. 76-81). However, MD&A indicates how it attempts to manage risk: <i>"Crocus tries to control non-systemic business risk (company risk) by buying businesses we understand, and diversifying across industries to minimize exposure to industry cycles"</i> (2003 MD&A, p. 3).
Management Expense Ratio	The ratio in the MD&A is consistent with the one presented in the 2003 prospectus.

- The 2003 prospectus contains information on a number of key topics that are not included in the 2003 MD&A such as:
 - CIF's organizational structure and main features of how it operates including its Board of Directors, its committees, and its management;
 - The role of the Investment Committee in making "Add-On" Investments;
 - The different classes of shares and the rights attached to each class in the event of liquidation, dissolution or winding up of CIF;
 - That there is no market for the Common shares;
 - The Fund's ESOP established by the Fund for its employees;
 - Eligibility of CIF investments to be held in a retirement savings plan;
 - Limits on redemption of shares; and
 - That neither government nor its agencies nor the Manitoba Securities Commission assume any liability or obligation to any investor in the Fund.

Conclusion

- The information presented in the MD&A of CIF's 2003 financial statements is not sufficiently consistent with the content of the 2003 CIF prospectus. The MD&A downplays the risks associated with investing in the Fund and does not indicate that common shareholders cannot redeem their shares for eight years except under limited circumstances. Moreover, the MD&A provides very limited information with respect to the basis upon which CIF selects its investments. As well, the MD&A does not explain to readers the way in which CIF is governed and managed.

OBSERVATIONS

Comparison of MD&A to CICA Standards and Guidance

- In the Fund's 2003 MD&A, it states that *"currently, there is no requirement for Management Discussion and Analysis (MD&A) but the Fund's policy is to include MD&A in all financial reporting"*, (p. 6).
- Findings from a comparison of the content of the 2003 MD&A and CICA Standards and Guidance on the content of MD&A is presented in **Figure 19**.
- The notes to the financial statements would help readers to have a better understanding of the Fund and should therefore also be disclosed in non-technical language in the MD&A. Such information includes: how the investments are valued; the Federal contribution of \$2 million repayable at a rate of \$200,000 per year only in years following a year in which net income of the Fund, not including unrealized gains, exceeds \$1 million (which according to the financial statements did not occur in 2003); restrictions pertaining to the reserve fund; and limits on amounts that can be invested in any business.

Conclusion

- The information presented in the MD&A of CIF's 2003 Financial Statements does not adequately meet CICA Standards and Guidance on the content of MD&A. The information that CIF presents in its MD&A does not satisfy CICA intent that the MD&A and the financial statements together comprise a stand-alone disclosure package. A reader could not rely on the Fund's MD&A and the financial statements to form a clear picture of CIF. To gain a more complete picture of CIF, a reader would also need to review its prospectuses.

FIGURE 19

Comparison of 2003 MD&A and CICA Standards and Guidance	
CICA MD&A Standards and Guidance	Fund's MD&A - 2003
Disclosure Framework Analysis of past results and discussion of future prospects should be framed within the context of the following elements: - the company's vision, core businesses and strategy; - key performance drivers; - capabilities (capital and other resources) to achieve desired results; - results - historical and prospective analysis; and - the risks that may shape and/or affect the achievement of results.	- The MD&A presents the main objectives of the Fund and identifies a couple of its strategies in very general terms – portfolio diversification (p. 3) and risk control (p. 2). However, the MD&A does not present the Fund's vision, and its presentation of strategies is limited. - Does not present its operating context/environment – i.e., performance drivers. There is passing reference to “market conditions” impacting the investment portfolio (p. 4). - No discussion of capabilities. - Presents results through historical comparisons – e.g., indicates that rate of return has been above average for seven out of the past nine years; compares net loss in 2002 with 2003; compares sales to the local and national industry trends (pp. 4-5). Prospective analysis is limited - indicates that growth in the Manitoba economy is forecasted at 3.3% for 2004 (p.4). - No discussion of the risks associated with investing in the Fund.
Principle 1 - Through the Eyes of Management - Disclosure of appropriate elements of information used by management for internal purposes. There is a need for greater alignment of external and internal reporting and providing contextual and prospective information that financial statements do not provide.	- The MD&A does not provide the reader with sufficiently appropriate information. For instance, while the MD&A provides an overview and captures information on its performance in terms of revenues, expenses, sales, and investment amounts, it does not provide readers with information on how CIF is managed, its decision-making process, whether it has a strategic/business plan, the basis on which it selects investments, what strategies it takes to achieve each of its legislated objectives and what results it has achieved in relation to each of those objectives.
Principle 2 - Integration with Financial Statements - Disclosure should explain the conditions and events that shaped the information contained in the financial statements and help the reader understand how past conditions and events may give rise to future financial consequences.	- The MD&A does not refer to the financial statements; it does not make observations in the narrative that link and integrate financial information with the MD&A.
Principle 3 - Completeness and Materiality - Information reported should be complete, fair and balanced. Management should communicate the quantitative and qualitative information necessary for users to understand and evaluate the company's nature, risks and prospects. Information reported should include “good news” and “bad news”.	- The MD&A reports some information that communicates shortcomings – e.g., the 5% decline in net asset value per share; and continued trend of net loss on the portfolio (pp. 4-5). However, the information presented is not complete and does not focus sufficiently on what is material or relevant. For instance, the MD&A does not present performance information relative to legislated objectives of the Fund – e.g., increase in level of employee participation in corporate governance and management; increase in capital retention and economic stability; making investments in businesses that operate in accordance with ethical policies, with respect to employment practices, workplace safety, and environmental suitability. Another example is that the MD&A does not disclose the Fund's liquidity challenges. Overall, the MD&A does not provide the reader with sufficient information on how CIF operates, the challenges it faces, and its priorities.
Principle 4 - Forward-looking Orientation - MD&A should describe anticipated future events and risks that management considers likely to materially impact future prospects as well as management's vision, strategy and key performance drivers.	- The MD&A does not provide this.
Principle 5 - Strategic Perspective - The focus in MD&A should be on management's strategy for generating value for investors over time. Discussion of performance will serve to communicate milestones that show progress towards achievement of longer-term goals.	- The MD&A does not identify the Fund's strategic perspective. In order to communicate the achievement of milestones the MD&A needs to share with the reader the performance targets that CIF has set for itself and to report performance in relation to expected/targeted results. In that way, the reader would be able to draw conclusions on whether performance has remained static, is declining, or improving. Without the benefit of knowing CIF's planned results for 2003, a reader cannot draw any conclusion on performance based on the type of information reported in the MD&A such as: that gross sales of Common Shares Class “A” was \$29 million; that sales in Class “I” were \$10.1 million; and that \$14.8 million was invested in Manitoba businesses (pp. 3-4).

Comparison of 2003 MD&A and CICA Standards and Guidance	
CICA MD&A Standards and Guidance	Fund's MD&A - 2003
Principle 6 - Usefulness - To be useful, MD&A should be written in plain language, without exaggeration and should embody the qualities of understandability, relevance, comparability and consistency over reporting periods.	- The MD&A is largely written in a way that assumes the reader has knowledge of technical concepts and terminology. For instance, no explanation or definition is given of the terms "pacing" (p. 4); gross sales (p. 3); and net sales (p.4). The RBC Financial Group is referred to in relation to forecasted data on economic growth without explanation of what makes them a reliable source for economic forecasting (p. 4); there is reference to CIF's "Corporate Development Strategy" with no explanation of its main elements (p. 4); the term "add-on investments" is used without explanation (p.5).
Integrity of Disclosure - MD&A should include a statement about the responsibility of management for the existence of appropriate information systems, procedures and controls to ensure that information used and disclosed is complete and reliable.	- Management does not include a statement on the integrity of disclosure.

4.4 BOARD GOVERNANCE

Corporate governance can be most straightforwardly defined as "the system by which an organization is directed and controlled."⁶ Corporate governance practices relate to how a governing body (most often, a Board of Directors) leads and oversees an organization. Regardless of the type of organization, all governing bodies are comprised of a group of people who have been elected or appointed to provide direction and control to the organization on behalf of others.

Effective corporate governance is built upon four pillars:

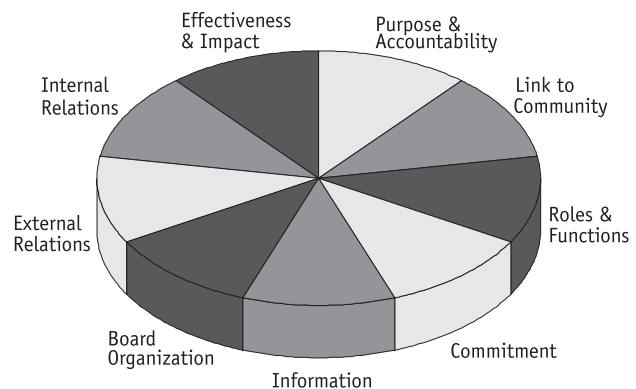
1. **Stewardship** - As stewards, Boards act on behalf of others, and are trustees of an organization's mandate and its resources. A Board is therefore given the ultimate authority for the actions of its organization. As a result of this stewardship, a Board needs to honour the trust that has been placed in it.
2. **Leadership** - A Board fulfils a leadership role and as leaders, Board members are expected to reflect the priorities and values of the stakeholders which they represent and from which they are drawn. Leadership is about the relationship between the governors and those governed. Therefore, a Board needs to develop positive relationships with all stakeholders, ensure respect between parties, and build a sense of commitment.
3. **Responsibility** - Having been given a fiduciary responsibility, Boards are expected to manage the resources of the organization efficiently and effectively to accomplish the desired aims. Board members are expected to be reliable, and to allow appropriate factors and considerations to influence their judgment, including consideration of the effect of their decisions on others. They are also expected to devote the personal time and energy to ensure that governance is appropriate and adequate.
4. **Accountability** - Boards are ultimately accountable for the actions of their organization. Accountability is the requirement to answer for the discharge of responsibilities that have been conferred on and that affect others in important ways. It requires that Boards understand who is responsible for what, what performance is to be achieved, and what information is required to ensure appropriate decision-making.

⁶ Report of the Committee on the Financial Aspects of Corporate Governance ('Cadbury Report'), UK, 1992

Effective governance requires appropriate mechanisms be established by the Board to enable effective decision making, ensure clear accountability, and provide for regular review and assessment of management and operations. Although the specific practices, functions and activities of a Board will, and are expected to, differ based on the particulars of the organization, a Board's work must ensure that the key governance elements of setting strategic direction and providing corporate oversight (control) are performed.

Drawing on this, and based upon a review of leading research, perspectives and practices of Board governance, the OAG has identified a set of attributes that operationalize each of the four pillars. Incorporating both a structural and behavioural perspective to Board governance, the attributes of our Model⁷ represent the attributes of an effective Board (see diagram). We believe that, in general, the more a Board fulfils each of these attributes, the more effective it is. These attributes are generally found in all Board governance frameworks, regardless of the specific Board structure and governance approach/practices adopted by a Board. The attributes of our Model have been assessed in a number of public sector reviews, revealing a strong endorsement from governance practitioners that these attributes represent reasonable criteria for effective Board governance.

Attributes of an Effective Board



CIF BOARD OF DIRECTORS ⁸

Board Composition

Responsibility for the management of the business and affairs of the Fund rests with the Board of Directors. The Board of Directors must consist of not less than three and not more than 11 directors. Holders of Common Shares are entitled to elect two directors; the Province as the holder of Class G Shares is entitled to elect one director; holders of Class I Shares are entitled to elect one director; the Board of Directors may appoint an independent director; and the MFL as the holder of Class L Shares is entitled to elect four directors, plus one director for each director elected by holders of Class I Shares or appointed by the Board of Directors, for a maximum of six directors.

Holders of Common Shares do not participate directly in the management of the Fund, but are entitled to receive financial statements of the Fund, to attend meetings of shareholders of the Fund and to vote on matters requiring the approval of shareholders such as the appointment of auditors, approval of By-laws or changes to By-laws, which would include the Investment Policies, Valuation Policies and any increase in the Hold Period. Holders of Common Shares have the right to vote, as a group, for the election of two persons to the Board of Directors.

All Board members of the Fund are elected at the annual general meeting to serve for a term of one year or until their successors are elected.

Notwithstanding ownership of more than 10% of the class or series of a class, each shareholder of each class has one vote, and only one vote, regardless of the number of shares owned. Each class, however, has different rights with respect to the election of representative directors.

⁷ Detailed information on the OAG's Model of Governance can be obtained from previously issued reports, available on our website (www.oag.mb.ca)

⁸ Information for entire section is quoted from CIF's January 2004 prospectus

Responsibilities

The Fund's prospectus specifies the responsibilities of the Board of Directors' as:

- selecting and evaluating management of the Fund;
- establishing operational policies, including the Investment Policies and the Valuation Policies; and
- approving the acquisition and divestiture of Eligible Investments.

The Board of Directors ultimately is responsible for the Fund's compliance with all legislation applicable to the Fund.

The Board of Directors has delegated responsibility for the day-to-day management of the Fund to its Senior Officers.

Board Remuneration

In 2003, the Fund implemented an honorarium system for directors of the Fund. The provincial appointed representative to the Board is excluded. Directors receive \$600 per month, Committee Chairs receive \$700 per month and the Chairman of the Board receives \$800 per month. The Fund also reimburses directors for expenses incurred by them in acting as directors.

Investment Advisory Committee

As mandated by The Act, the Fund has appointed the Investment Advisory Committee to assist the Fund in carrying out its investment policies and to advise the Board of Directors regarding the financial merits of proposed acquisitions of Eligible Investments. Members of the Investment Advisory Committee have been selected for their experience and expertise in particular business sectors or in the management of investments. Members of the Investment Advisory Committee do not attend and do not vote at meetings of the Board of Directors and their views need not be followed by the Board of Directors. However, The Act provides that before approving the acquisition of an Eligible Investment, the Board of Directors must consider the Investment Advisory Committee's advice regarding the investment. Members of the Investment Advisory Committee do not receive any remuneration from the Fund other than reimbursement for expenses.

Sub-Committees of the Board

The Board of Directors has also established the following sub-committees of the Board:

1. **Investment Committee:** The Investment Committee was established to review and approve smaller investments which are of a time sensitive nature. Its mandate includes to review and recommend to the Board, new investments recommended by the Staff Investment Committee; to review and approve new investments or "add-on" investments which are less than \$1.0 million; to review trends in the economy and challenges and opportunities for investment; to recommend new members for the Investment Advisory Committee; and to regularly review and update the Fund's investment policies as requested.
2. **Corporate Development Committee:** This Committee reviews corporate development initiatives conceptualized and developed by a corporate development working group consisting of the CEO, the CIO, and other officers, staff and advisors as needed.
3. **Executive and Personnel Committee:** This Committee is comprised of three members of the Board of Directors and primary responsibilities include evaluating the Fund's governance structure, serving as the nominating committee, and evaluating the performance of the President and CEO and establishing CEO compensation. The committee also provides advice and direction to the CEO on personnel matters from time to time.

4. **Labour Affairs Committee:** This Committee provides advice and direction to the Board and the Fund on matters related to the labour movement in Manitoba, and serves to ensure the broad objectives of the Fund's sponsor, Manitoba Federation of Labour, are achieved.
5. **Finance and Audit Committee:** The Committee works closely with the Fund's Vice-President Finance/CFO and Controller and approves non-routine redemptions, reviews and reports to the Board on all matters related to finance and audit including review of the monthly and quarterly financial statements, the annual financial plan, and all activities associated with the audit requirements of the Fund.
6. **Valuation Committee:** The Committee is comprised of three voting members of the Board and is supported by an external Chartered Business Valuator (CBV), and Fund staff. The Committee reviews all valuations coming forward from the Staff Valuation Committee and provides recommendations to the Board for their consideration.

As one aspect of our review, we examined the board governance practices of the Fund's Board of Directors (the Board). Our work consisted of a review of Board By-laws, Board minutes, and Board policies and procedures. We examined over four years of Board activity, from May 2000 to December 2004. Interviews were held with both current and past Board members who were on the Board during that time period, as well as the Corporate Secretary (total of 15 interviews). Issues of governance also formed a part of our discussions when we interviewed current and former Senior Officers of the Fund.

OBSERVATIONS

Board Composition and Representation

- The composition of the Board in April 2005 was eight Directors, comprised of six MFL representatives, one government representative, and one representative of common shareholders. We note that there was considerable change to the Board's composition after September 2004, including the retirement of the Chair in October 2004, the appointment of three new Directors in October 2004 (two of whom represent the MFL and one independent Director who was appointed by the Board), and the resignation of one of the common shareholder representatives in November 2004. Further, in December 2004, the institutional shareholder representative and the independent Director who had been recently appointed also resigned.
- Prior to September 2004 and for the majority of the period under review by the OAG, the Board was comprised of nine Directors: five elected by the MFL, one by institutional shareholders, one by government, and two by common shareholders. With the exception of the government representative who was newly appointed at the Fund's Annual General Meeting (AGM) in July 2004, all other Directors had served longer than five years and several were long-standing members of the Board, with over a decade of service. We note that while all Directors are re-elected annually at the AGM, the Fund's prospectus does not specify a limit to the number of terms that a Director may serve on the Board.
- The MFL, by virtue of its ownership of Class L Shares, has the right to elect a majority of the Board of Directors. Further, we noted that representatives elected by the MFL act in both the Chair and Vice-Chair positions.
- Regardless of the share class from which they are appointed, all Board members noted clearly that their fiduciary responsibility was first and foremost to the Fund. Further, all

Board members indicated that their primary accountability was to all shareholders of the Fund, not just to the particular share class that they were elected to represent.

- In our discussion with the government representatives, it was noted that they were on the Board to represent all shareholders and their fiduciary duty was to the Fund, not to government. The Board had a documented discussion to ensure all Board members had a common understanding of this issue.
- It was evident from our discussions that all Board members are highly committed to the Fund, and to its social objectives.

Background and Training

- The majority of Board members did not have specific knowledge or expertise in venture capital, investment or financial management. One Board member has a financial accounting background, and one recent Board member has banking experience. With the exception of the independently appointed Board member who has since resigned, only one former Board member brought private sector business experience to the Board.
- It is evident from a review of minutes, that the Board itself recognized that they did not have sufficient expertise on the Board, and several discussions were held about the need to attract and recruit new Board members from the business community. Several recruiting attempts were made, but it was not until October 2004 that such a Board member was appointed. As noted above, this Board member resigned in December 2004.
- Board members indicated that no formal orientation process was provided to them when they joined the Board to assist them in becoming familiar with the Fund and its governance practices. Some Board members indicated they had met informally with the former CEO prior to their appointment to the Board. Others indicated they were only provided with relevant documentation such as the Act, the Fund's prospectus, etc. We noted that no specific governance/Board policy manual has been developed.
- Board members were not routinely provided with any ongoing training and development opportunities, related to venture capital, financial management and/or corporate governance. Individual Board members were left to take their own initiative on these types of matters.

Board Sub-Committees

- Until January 2002, Board meetings were generally held on a monthly basis. All issues for decision were brought forward by management to the entire Board. Until 2002, the Finance and Audit Committee was the only Board Sub-Committee. It met twice each year – once prior to the annual audit to review the audit plan, and once after the audit to approve the audited financial statements.
- In February 2002, the Board established a Sub-Committee structure and five new Committees were added to the Board (as previously described). Committees met monthly (or as required), and full Board meetings were reduced to every second month. We were told by some Board members that the rationale for this change was that Board meetings had become overly long and that because members would often have to leave, the Board was not getting through the full agenda and information package. Other Board members noted that the Sub-Committee structure was established as the Board had recognized the need to become more actively engaged in investment, valuation and other key discussions.

- Board members informed us that the Sub-Committees were given specific mandates and that the detailed discussion and review of a particular issue was done at the Committee level. The Committees' recommendations for decisions were then ratified by the full Board at the subsequent Board meeting. Given the time delay until the next Board meeting, Committees were given delegated authority to approve some decisions prior to the Board meeting (for example, the Investment Committee had the authority to approve follow-on investments up to \$1 million).
- At the full Board meeting, a verbal report was provided by the Committee Chair and the Board package included copies of Committee minutes. We were told that discussions at the full Board meeting with respect to the Committee's recommendations were dealt with at a high-level. While we were told that questions were asked and discussed, the Board in almost all instances simply ratified a Committee's recommendations with no substantive changes.
- A recurring theme among Board members was that they relied on the work/decisions of the Committee members and that if they were not on a particular Committee, they did not know the details around the issues or the work of that Committee. For example, members who were not part of the Executive & Personnel Committee claimed they had little knowledge of decisions with respect to CEO compensation and personnel matters; members who were not part of the Finance and Audit Committee never met with the external auditors and claimed they had little knowledge of issues raised in management letters or that Committee's actions to ensure these were addressed by management.
- While some Board members did indicate that the change to a Committee structure in 2002 enhanced the Board's governance, a few Board members noted that the full Board meetings became secondary to the Committee meetings and that the detailed discussion and "real work" was done at the Committee level. This was especially true since the Board meetings were held less frequently.
- After 2002, the Finance and Audit Committee met four times per year. Under its new charter, its roles and responsibilities were expanded to include: internal control; financial reporting; annual financial statements; external audit; and compliance with laws and regulations; etc. However, our review noted that the Finance and Audit Committee did not:
 - Follow up to ensure that issues raised by external auditors in the management letters were fully addressed by management;
 - Did not review the monthly and quarterly financial statements as identified as a responsibility in the prospectus;
 - Perform detailed reviews of budgets, cash flow forecasts, cost variance analysis, or monitoring of operational expenses;
 - Did not request nor review information on legislative compliance issues including pricing requirements; and
 - Although the Committee asked questions on internal controls, they did not follow-through to ensure internal controls were implemented.
- In recent years, the role and value of the Investment Advisory Committee was questioned by its members. As well, the frequency of, and attendance at, meetings had diminished substantially. Once the Board formed its Investment Committee, the meetings/activities of the Investment Advisory Committee were combined with the Board's Investment

Committee. When new, eligible investments were considered, Investment Advisory Committee members were invited to attend that portion of the Investment Committee meeting. They were not involved in discussions regarding ineligible investments, nor follow-on investments.

Strategic Planning

- Annually, the Board held a one day retreat to focus on discussions of strategic direction and corporate governance. We were informed that documented minutes of these Board retreats were not maintained. We were told that the Board would receive a strategic planning document and presentation from Fund management, which was discussed. Some Board members noted that other than this, the Board's involvement in strategic planning was relatively minor and that only slight wording modifications were made to management's strategic plan prior to Board approval.

Board Processes

- The majority of Board members told us that the Board was collegial and functioned well together as a team. We were told that the former Chair did a good job in facilitating meetings. Almost all Board members indicated that there was good participation at meetings, and that they felt all Board members were comfortable raising an opposing view should they have one. A couple of Board members did raise a concern of the Board being perhaps too collegial and not as challenging as it could have been.
- Board members told us they were generally satisfied with the information they received and rarely felt they had to ask for additional information in making their decisions. Many noted that they received a large quantity of information in their Board packages, which was generally supplemented by a verbal report at meetings. However, our review of the Board packages and Board minutes noted that much of the information provided to the Board did not facilitate effective decision making by the Board. Formal written reports, containing an analysis of alternative options and their financial consequences, as well as overall financial information highlighting risk, cash flow, overall guarantee exposure, and overall expense categories were not generally provided to the Board. Board meetings did not focus on the condition of the investment portfolio as a whole, or a review of investment portfolio returns.
- In December 2002, the Board, which had served voluntarily since inception of the Fund, unanimously approved a pay structure providing a monthly honorarium to all Board members except the government representative. The honorarium came into effect January 2003. Some Board members noted that the remuneration was put in place due to the increasing time commitment required by Board members; some reported that there was a view that Board members from the private sector would not be attracted to serve on the Board without being paid. The Chair was paid \$800 per month, Committee Chairs were paid \$700 per month, and Board members were paid \$600 per month, regardless of their attendance or the number of meetings that were held. As it was not until October 2004 that a new private sector Board member was recruited, the Board's decision, rather than attract qualified Board members, simply resulted in the Fund paying the same members who had previously fulfilled their governance role voluntarily.

Relationship with Senior Officers

- The Fund's CEO is directly accountable to the Board, while all other Senior Officers are accountable to the CEO.
- The majority of Board members indicated that the Board had a good working relationship with the Fund's Senior Officers and that they had been generally satisfied with management's performance prior to September 2004. Many Board members told us that they felt they had not had reason to question the performance of Senior Officers until September 2004.
- The Board had little involvement in human resource issues, even with respect to the former CEO, until the creation of the Executive & Personnel Committee. The only performance evaluation of the former CEO was conducted by the Executive and Personnel Committee in 2003. We were told that this performance evaluation was completed informally through the Chair's informal discussions with Board members and staff.
- We were told that the Board was not aware of whether the former CEO conducted formal performance evaluations of other Senior Officers and their staff. We note that our discussions with Senior Officers found that such performance evaluations occurred on an informal and ad hoc basis. No documentation of any staff performance appraisals was found in the Human Resources files.
- Throughout the summer of 2004, the Executive and Personnel Committee was in the process of reviewing options for implementing a deferred compensation plan such as a Supplementary Executive Retirement Plan (SERP) for Senior Officers.
- We noted that the expenses incurred by the former CEO were not submitted to the Board (or its approved designate such as the Chair or Audit Committee) for approval but rather were approved by the CFO, who reports to the CEO.

Board Effectiveness

- Although many Board members described the Board as 'active', a review of minutes indicates that management recommendations were almost never rejected by the Board. Some Board members informed us that it was difficult for the Board to say "no", especially with respect to follow-on investments. Only once did a member of the Investment Committee have their strong objection to a follow-on investment formally recorded, but even in that instance, the follow-on investment was approved by the Investment Committee and then ratified by the Board.
- The Board did not conduct any formal evaluation of their effectiveness, although we noted that utilizing a formal Board evaluation tool was on the agenda for discussion at a Board retreat. There is no indication that this was ever acted upon. Yet, in our interviews, most Board members felt that the Board had effectively fulfilled its governance role; only a few Board members associated the current difficulties of the Fund with a failure in governance.

Conclusions

- The Board did not provide sufficient control and oversight of the Fund and did not hold Senior Officers sufficiently accountable for the Fund's operations and performance. As a Board's key role is to effectively monitor the performance and results achieved by its Senior Officers in implementing their strategic direction, the Board did not sufficiently fulfil its governance and stewardship responsibilities.

- The quality of the investment and financial information provided to the Board did not facilitate the Board's ability to assess the Fund's operational and management performance. Board members have a duty to demand and expect accurate and complete information on a timely basis from their Senior Officers in order to make informed decisions.
- The Board lacked the necessary knowledge and expertise to fully scrutinize and critique the completeness and quality of the investment and financial information provided to them. While not all Board members need specific venture capital or investment knowledge, having some members that do is essential.
- The Board's adoption of a Sub-Committee structure and their decision to lessen the frequency of full Board meetings, served to relegate the role of Board meetings to a minimal discussion of Committee items. Full Board meetings became little more than a 'rubber-stamp' for Committee decisions. This is an abdication of the Board's ultimate authority. Committees should not replace the decision making role and authority of the overall Board. The intent of creating Committees should be to enhance Board decision-making through the detailed review of information in order to provide the full Board with well-considered recommendations and background information. The onus is still on all Board members to understand what is occurring at the Committees and to have input into, and responsibility for, the final decision made.
- Significant governance improvements are required in order to ensure the Fund's Board more effectively fulfills its role and responsibilities as a mechanism of corporate accountability and to ensure that the Board, its Sub-Committees, and the Investment Advisory Committee, are operating consistent with that described in CIF's prospectus.

4.5 COMPLIANCE WITH THE CROCUS INVESTMENT FUND ACT AND BY-LAWS

Legislative Requirements and Investment Policies

The Fund was established to raise capital primarily through the sale of its Common Shares and to invest the proceeds raised in qualified Manitoba businesses pursuant to the provisions of The Crocus Investment Fund Act and the Fund's Investment Policies. The Fund's prospectuses note that the Fund may also use the capital raised through the sale of shares to pay commission fees, and operating costs that would normally be paid out of the income of the Fund, but any shortfall must be paid from the proceeds of the sale of Common Shares.

In addition, The Crocus Investment Fund Act requires that the Fund maintain a liquid reserve fund equal to the greater of:

- 15% of the fair market value of its investment assets, and
- 50% of the total of its outstanding guarantees.

As a result, not all of the capital generated by the sale of Common Shares may be available for investment purposes.

The primary objective of the Fund is to achieve long term capital growth in the value of its investments. In order to achieve this objective, the Fund strives to be the pre-eminent private sector economic development organization in Manitoba and seeks to:

- Provide competitive financial and non-financial rewards for its shareholders through investments in socially responsible Manitoba businesses that strive to operate in accordance with ethical policies with respect to employment practices, workplace safety, environmental suitability and other matters;
- Maintain continuity of local ownership of Manitoba businesses, bolster job growth, and model and foster social responsibility in Manitoba businesses;
- Provide investment opportunities in the Manitoba economy for all Manitobans; and
- Promote broad-based economic participation opportunities for Manitoba workers with a view to increasing productivity in CIF portfolio companies and as a strategy that can make an important contribution to overall financial compensation for workers at all levels of such a business.

Under The Crocus Investment Fund Act, the business of the Fund is restricted to:

- The operation of an investment fund that will make investments in qualified Manitoba business entities with a view to earning income and promoting and maintaining capital retention and economic stability in Manitoba, employee ownership of qualified Manitoba businesses, and business continuity, job retention and creation, and the ownership of Manitoba businesses by Manitobans; and
- Providing investment capital and other financial assistance and other services to Manitoba businesses to enable them to create, maintain, and protect jobs.

Under The Crocus Investment Fund Act, a “Qualified Manitoba Business” is defined as an entity that:

- Carries on business in Manitoba, has assets of a value less than \$50 million and has a majority of its employees in Manitoba; or
- Substantially all of whose assets would be eligible investments had they been owned by the Fund directly and that has assets of a value less than \$50 million.

The Fund’s prospectuses state that the Fund is required to use its best efforts to ensure that a majority of its investments directly or indirectly promote employee ownership or employee participation in corporate governance and management. Additional investment objectives include:

- Promoting and maintaining capital retention and economic stability in Manitoba; and
- Business continuity, job retention and creation and ownership of Manitoba businesses by Manitobans.

The Crocus Investment Fund Act also limits the size of Fund investments. The Act restricts the Fund from acquiring an Eligible Investment that would result in the total fair market value of the Fund’s investments in any one qualified Manitoba business being more than 10% of the fair market value of its Investment Assets. The size of investments is also addressed in the Fund’s By-laws which state that “for any one business, the minimum amount invested by the Fund will be approximately \$100,000 and the maximum amount invested will be approximately \$5 million.”

In addition, the majority of the Fund’s investments must also be in “eligible” investments. While the Fund is not restricted from investing in ineligible investments, such investments could not be used to satisfy the Fund’s pacing requirements as set out in The Income Tax Act (Manitoba). Under The Crocus Investment Fund Act, the following types of investments are currently deemed to be Ineligible Investments:

- A debt obligation that is secured by an interest in real property held primarily for

gaining or producing rent revenue, development, subdivision or sale, or use in farming;

- A debt obligation secured by an interest in a resource property held primarily for gaining or producing rent or royalties;
- A share in capital stock, or an interest in, or a debt obligation of a financial institution that was not issued by the institution in the ordinary course of its business; and
- An investment in an entity:
 - That carries on a professional practice that is regulated by a governing body of the profession under an Act of the government of Manitoba,
 - That carries on the business of developing or exploring for mineral resources, unless substantially all of the development or exploration is carried on in Manitoba or is part of a business that includes the extraction, processing or distribution of mineral resources,
 - That carries on the business of producing agricultural or horticultural crops,
 - That carries on the business of leasing, rental, development or sale, or any combination thereof, of real property owned by it, or
 - Substantially all of the assets of which are investments of a type that are Ineligible Investments as described above.

The Act also allows the Minister to enter into an agreement with the Fund, where an ineligible investment will be considered an eligible investment of the Fund, even though it does not meet the above noted criteria.

The Fund's Maintenance, Pacing, and Small Business investing requirements as set out in The Income Tax Act (Manitoba) help ensure that the Fund is meeting public policy objectives. The Act establishes three pacing "tests" that must be met by the Fund:

- Maintenance Test - an amount equal to at least 60% of the Fund's Adjusted Shareholder's Equity must be invested in Eligible Investments.
- Pacing Test - the Fund is required to invest 70% of its total Subscription Proceeds in eligible businesses, over a three year period.
- Small Business Investing Test - the Fund is required to invest at least 14% of its total subscription proceeds in "small eligible investments". These are investments of less than \$2 million made to eligible businesses.

The Fund could be liable to pay taxes in the event that it does not satisfy the above noted requirements. An excerpt of The Income Tax Act (Manitoba) regarding these requirements has been included in this report as **Appendix G**.

In addition to the Maintenance, Pacing, and Small Business Investing requirements noted above, The Income Tax Act (Manitoba) also limits the amount of common shares the Fund can sell in any one year to \$30 million. If the Fund exceeds this amount, they are liable to pay a tax equal to 15% of the excess subscription proceeds. This penalty is equal to the Provincial Tax Credit claimable by the purchaser of the shares.

Failure to observe statutory requirements under the various Acts governing the Fund could result in the Fund losing its status as an LSVCC and may result in the Minister ordering that future purchases of Common Shares not be eligible for Manitoba Tax Credits. Although loss of such status or such an order would not directly affect an investment in the Fund, it would impair the ability of the Fund to raise additional capital and could affect the long term viability of the Fund.

In addition to legislative requirements, investment activities are also controlled by the Fund's By-laws and investment policies approved by the Board. The Fund's Investment Policies require that the following be considered when making investments:

- Equity investments are to be made with the primary objective of achieving long term capital appreciation and debt investments with the objective of realizing market interest rates and amortizing principal repayment over a commercially reasonable period;
- Investments are to be made in businesses located throughout Manitoba;
- Investments are to encompass a broad range of industries and may favour investments in industries offering significant potential for employment. The Fund can also make additional (follow-on) investments to an entity it has invested in;
- The Fund will favour investment in businesses that modify proven technology or that apply or adapt proven technology from one industry to another in preference to investments in businesses involved exclusively in technological innovation; and
- The Fund will favour investments in businesses with an established employee ownership structure, promote employee ownership opportunities, and promote employee participation in corporate governance and management.

The prospectuses also identify the criteria that are to guide CIF in making its investment decisions. These include that the business entity being considered should have:

- A business concept identified as having merit;
- An experienced management team;
- Reasonable anticipation of profits based on a history of performance or other characteristics;
- The likelihood of a sustainable competitive advantage which may be associated with superior technology, patented products, established market position, quality service provision resulting from the creation of quality jobs, substantial barriers to entry and/or dominant distribution in its market;
- A commitment to cooperative and innovative labour relations;
- A commitment to ethical employment practices;
- A commitment to workplace safety;
- A commitment to sound environmental practices;
- An established employee ownership structure or a commitment to employee ownership and employee participation in corporate governance and management;
- The ability to acquire an ownership interest in a business that will comprise, either alone or in combination with the ownership interests of the business's employees, an interest that is sufficiently significant to justify the Fund's efforts in making and monitoring the investment;
- A reasonable expectation that the investment could be disposed of or recouped within five to seven years; and
- The likelihood that other venture capital investors would be prepared to participate in the investment.

Investments are to be made in businesses at one of the following stages of development:

- **Early Stage Investments** – provide financing to complete product development or to initiate marketing plans. Usually, the business has not commercially produced its product or service.
- **Expansions** - provide financing to expand sales production, provide services in new markets, or to launch a new product.
- **Internal Acquisitions** – provide financing to assist management or employee groups to acquire the business enterprise in which they are engaged.
- **Turnarounds** – provide financing to businesses which have experienced ongoing losses, but have the potential to succeed if additional investment is received and/or changes in management, staffing or marketing are made.

The Fund's Investment Policy limits investments in "Early Stage" and "Turnarounds" to not more than 25% of the Fund's total Investment Assets.

Investment opportunities must provide an opportunity for a return on the Fund's investment that is commensurate with the perceived risk. In addition, the Fund may invest in specific investments jointly with other equity or venture capital investors in order to achieve greater diversity in its investment portfolio.

The main compliance requirements of The Crocus Fund Investment Act, The Income Tax Act (Manitoba), By-laws, and Investment Policies are disclosed in the Fund's prospectus.

We reviewed investments for a five year period from September 30, 2000 to September 30, 2004 and assessed compliance with the following:

- Appropriate use of capital from the sale of common shares;
- Liquid reserve requirements;
- Investment in Qualified Manitoba Business entities;
- The size of investments in any one entity;
- Eligibility of investments;
- Maintenance, Pacing, and Small Business Investing requirements;
- Limit on Common Share Sales;
- Policy considerations regarding investments; and
- Investments in early stage and turnaround entities.

Our observations and conclusions are summarized below.

4.5.1 Use of Capital from the Sale of Common Shares

Pursuant to The Crocus Investment Fund Act, the Fund is required to invest the capital raised through the sale of shares in qualified Manitoba businesses. The Fund is also required to maintain a liquid reserve of marketable investments in Treasury Bills and other secure investments that can be easily converted to cash. In addition to these two uses of capital, the Fund's prospectus states that the Fund can use share capital to pay commission fees and any shortfall in operating costs that cannot be covered by the Fund's income. (In order to assess the Fund's use of cash, we analyzed cash flow for 2000 to 2004 inclusive.)

OBSERVATIONS

- The Fund has experienced net losses since 2001, with a cumulative loss for 2001 to 2004 of \$46.5 million.

- We analyzed the Fund's financial statements to assess the actual level of the cash shortfall from operations (excluding investment transactions and share capital transactions). We determined over the last five years since 2000, the Fund's operating cash shortfall was \$13.6 million – on average \$2.7 million per year. Because these shortfalls must be covered from the capital raised, less capital from sale of shares is available for investment.
- We reviewed the level of divestiture and share redemptions for the period 2000 to 2004 to determine whether sufficient investments were liquidated to meet redemptions. Proceeds from dispositions and share redemptions are shown in **Figure 20** which indicates, that for the last five years, total share redemptions exceeded the total of funds from disposition of investments by \$5.2 million. Given the operating losses over the last four years (**Figure 6**), it is highly likely that capital from the sale of new shares was used for some portion of the noted share redemptions.

FIGURE 20

	Year (000s)					Total
	2000	2001	2002	2003	2004	
Funds from Disposition	\$11,761	\$ 9,998	\$ 8,771	\$13,914	\$ 7,919	\$52,363
Share Redemptions	2,144	4,942	17,118	20,347	12,990	57,541
Excess (Shortfall)	\$ 9,617	\$ 5,056	\$(8,347)	\$(6,433)	\$(5,071)	\$(5,178)

- We noted that the level of redemptions of shares had risen significantly in the last few years as more shares became eligible for redemption. From discussions with current and former Fund management and from our review of Board minutes, we noted that the Fund was concerned that they would be unable to redeem shares without paying for some of the redemptions from the capital raised through the sale of new shares.
- The prospectus noted that when the Fund is considering an investment decision, there has to be a reasonable expectation that the investment could be disposed of or recouped within five to seven years. This time frame recognizes that shares will be presented for redemption following the mandatory eight year hold period, and that divestiture will be required to ensure that funds are available to pay investors redeeming shares. As noted in **Section 4.2** "Investment Management", the Fund did not have detailed divestiture plans that would ensure the orderly disposition of investments to meet redemption needs. Investment proposals submitted for Board approval usually included vague, non-specific divestiture plans such as "*potential liquidity routes include sale to employees, a co-investor, or a third party*".
- As noted in **Section 4.3.3** regarding the Solidarity transaction, the Fund was experiencing difficulties with maintaining its required liquid reserve. In order to ensure that sufficient cash was available to meet all of the Fund's statutory requirements including investing in eligible businesses for pacing requirements, maintaining liquid reserve limits, and operating requirements such as meeting share redemptions and paying commissions and operating costs, management needed to diligently manage its cash requirements and Fund operations. However, we noted that the Fund did not prepare cash flow analysis and projections until 2002.

- The Solidarity transaction carried a 10% annual dividend. Since November 2002, the Fund has paid \$2 million in dividends to Solidarity. At September 30, 2002 the Fund had a retained deficit and did not have retained earnings from which to pay the dividend. Given the continued operating losses in 2003 and 2004 and the level of divestitures, cash from the sale of new shares would have been required to pay these dividends, reducing the capital available for investment.
- Fund officials were negotiating with government officials to have The Crocus Investment Fund Act and The Income Tax Act (Manitoba) amended to base pacing requirements on the net capital raised (capital from new sales of shares less redemptions). This would allow the Fund to invest a smaller portion of new capital raised in qualified businesses and would leave a greater share of the new capital available for other purposes such as covering operating shortfalls and share redemptions. At the time of our review, government officials had not agreed to these changes.

Conclusions

- The Fund did not adequately manage their cash requirements, including the divestiture of its investment portfolio, to ensure that adequate funds would be available to pay for the redemption of common shares as they came due. The Fund would have been required to use some portion of the capital raised from the sale of new shares to pay for share redemptions. This is not one of the Fund's stated uses of share capital. Because this results in less capital being available for investment, this practice, if it continues, jeopardizes the long term viability of the Fund.
- The Fund has experienced net losses since 2001 with an actual cash shortfall of \$13.6 million. These operating shortfalls were covered from the capital raised through the sale of common shares. While this is a permitted use of capital, it reduces the capital available for investment.
- CIF paid the dividend to Solidarity from the capital raised through the sale of shares. This use of share capital is not a permitted use according to the Fund's prospectus and reduced the capital available for investment. While were this treated as debt, it would have been a permissible expense.

4.5.2 Liquid Reserve Requirements

Under The Crocus Investment Fund Act, the Fund is required to maintain a liquid reserve equal to the greater of:

- 15% of the fair market value of its investment assets, and
- 50% of the total of its outstanding guarantees.

OBSERVATIONS

- We reviewed the type of investments included as marketable securities and noted that the investments were of a type consistent with those listed in The Crocus Investment Fund Act, Regulation 199/2001, Clause 4-Liquid Reserve Investments. The regulation limits investments for the reserve to bonds or treasury bills issued by the Government of Canada or a province, debt obligations of Canadian corporations with a minimum R1-mid rating, and an interest in a mutual fund that invests in only government bonds, or Canadian corporation rated R1-mid or higher. These are low risk investments that can be readily sold and quickly converted to cash if required.

- We calculated the reserve requirement as at September 30, for the years 2000 to 2004 inclusive. We found that the Fund exceeded its minimum reserve requirement in each of these years. However, as noted in **Section 4.3.3** of this report, the reserve amounts for September 30, 2003 and 2004 included \$10 million in marketable securities maintained for redemption of the Series Three Class I special shares issued to Solidarity.
- The Liquid Reserve Investments section of the Regulation was amended on December 21, 2001 to include the following as a permitted investment for purposes of maintaining the reserve:

“A debt obligation of Smart Park Development Corporation for up to \$1,500,000 that is guaranteed by the University of Manitoba, issued to the Fund in 2002, and repayable within 20 years.”

Based on a review of available documentation, this provision was included in the Regulation at the request of Fund management. However, this investment would be inconsistent with what is commonly thought to be a liquid reserve investment and would not qualify as such under the other provisions of Regulation 199/2001. In addition, because Smart Park is in the business of commercial leasing of real estate, it would not qualify as an eligible business under The Act. While the Fund would not be prohibited from making an investment in Smart Park through the normal course of business, it would not count towards the Fund’s pacing requirements under The Income Tax Act (Manitoba).

Documentation reviewed indicated that the government was prepared to designate the investment as “qualified”. However, Fund management informed government officials that they would not be prepared to invest in Smart Park unless the government amended the Regulation to permit the investment to be used towards the Fund’s liquidity requirements.

By including this provision in the Regulation, the government allowed an investment in Smart Park to qualify as part of the Fund’s reserve requirements, even though the investment would not be a liquid asset that could be easily sold.

The purchase of marketable securities can be made by management directly without Board approval. By classifying an investment in Smart Park as a liquid asset, Board approval to make the investment would not be required. If the investment were made in the normal course of business, management would have had to conduct a due diligence review and a social audit. They would have had to summarize their review in an investment memorandum and would have had to vet their recommendation through the Investment Advisory Committee and the Investment Committee of the Board. Board approval would have been required before management could proceed with the investment. By classifying the investment as a liquid asset, these controls over investments could be circumvented.

At the time this amendment to the Regulation was made, the Fund was under criticism by some members of the public for making a previous investment in a business that included rental income, which some thought was an inappropriate investment for the Fund. Because of this, management was concerned that it may also be criticized with making another investment in real estate. Real estate investments are not “qualified investments”. By treating an investment in Smart Park as a liquid asset, the investment would not be shown as part of the Fund’s investment portfolio, avoiding public attention. In the end, the Fund decided not to make the investment.

- The calculation of the liquid reserve requirement is based on investment assets. The Act defines investment assets as “all of the assets of the Fund other than operating assets used by it directly in carrying on its business”. This definition does not readily correspond to items on the Fund’s Balance Sheet. While Fund management and IEDM officials have interpreted investment assets to include two balance sheet accounts - “Investments in Manitoba Businesses” and “Investments in Marketable Securities” the definition is not clear and could be subject to different interpretations.

Conclusions

- The Fund has met the minimum liquid reserve requirements as set out in The Crocus Investment Fund Act. However, without the additional capital obtained from Solidarity and invested by the Fund in marketable securities, the Fund may have fallen below its minimum reserve requirements. If the Fund had failed to meet its minimum reserve requirements for more than 60 days, it would have risked losing its tax credit status.
- The inclusion in the Regulation of a proposed investment in Smart Park as an allowable liquid reserve investment would have allowed Fund management to circumvent liquidity controls, the Fund’s normal due diligence processes and Board approval controls. In addition, this transaction would not have been clearly disclosed to shareholders and the public.
- While the Fund did not proceed with this investment in Smart Park, in amending the Regulation, the government should have ensured shareholder safeguards were maintained and that Fund management could not by-pass compliance provisions of the Act and Fund controls. This amendment weakened the safeguards provided to shareholders.
- The definition of investment assets is not clear and could be subject to various interpretations.

4.5.3 Investment in Qualified Manitoba Business Entities

The Crocus Investment Fund Act defines a “qualified Manitoba business entity” as follows:

“an entity

- (a) that carries on business in Manitoba, has assets of a value less than \$50,000,000 and has a majority of its employees in Manitoba, or*
- (b) substantially all of whose assets would be eligible investments had they been owned by the Fund directly and that has assets of a value less than \$50,000,000.”*

The Act also states in Section 3(2) that:

“The business of the Fund is restricted to

- (a) the operation of an investment fund that will make investments in qualified Manitoba business entities with a view to earning income and promoting and maintaining*
- (i) capital retention and economic stability in Manitoba,*
- (ii) employee ownership of qualified Manitoba businesses, and*
- (iii) business continuity, job retention and creation, and the ownership of Manitoba businesses by Manitobans; and*

(b) providing investment capital and other financial assistance and other services to Manitoba businesses to enable them to create, maintain and protect jobs.”

The OAG reviewed this section and found the understanding of its intent difficult. We believe that it could be subject to two interpretations.

1. That CIF could only invest in qualified businesses and were restricted from investing in any businesses with assets greater than \$50 million, or
2. That CIF could invest in businesses with assets greater than \$50 million, but that these investments would not qualify for pacing calculations.

Our observations deal with these two interpretations.

OBSERVATIONS

Investment in Qualified Manitoba Businesses Only

- Initially we believed that The Act required that the Fund had to meet the preliminary screening requirement of a “qualified Manitoba business” before the Fund could make any investment. The use of the word “restricted” in the above noted section and the use of the word “and” between clause (a) and clause (b), supported by the spirit of The Act to promote investment in small and medium sized businesses led us to this interpretation. If the Fund determined that a potential investment was “qualified”, then it could make the investment. The determination of eligibility was a secondary screen to determine whether the investment could be used for pacing purposes.
- We reviewed investments made by the fund between 2000 and 2004 to determine whether any investments were made in businesses with assets valued at more than \$50 million. We identified six portfolio investments in businesses with assets of more than \$50 million. Based on our initial interpretation of The Act, we believed that the Fund should not have invested in these companies because they did not meet the criteria of a “qualified Manitoba business”. As well, these investments could not be used in determining the Fund’s compliance to pacing requirements under The Income Tax Act (Manitoba).
- Some Fund staff interpreted The Act this way. However, government officials and other Fund staff did not agree, and in their view, the determination of a “qualified” business only applied to the calculation of eligible investments for pacing purposes. They interpreted The Act to mean that the Fund could invest in any business, but could only include “qualified” investments in determining the Fund’s compliance to pacing requirements under The Income Tax Act (Manitoba).

Investment in Qualified Manitoba Businesses for Pacing Purposes Only

- As noted above, we determined that the Fund had invested in six businesses with assets of more than \$50 million. These investments do not meet the definition of a “qualified Manitoba business” and should not be included in the Fund’s calculations of compliance to the pacing requirements under The Income Tax Act (Manitoba).
- The CFO interpreted “assets of a value” as meaning “net assets”. Net assets are calculated by deducting the liabilities of an entity from the assets, and in most cases, “net assets” would be significantly lower than “assets” alone. Of the six investments noted, four had “net assets” of less than \$50 million and were therefore incorrectly considered “qualified investments” by the Fund for pacing purposes.

- In June 2002 the CFO obtained a legal interpretation from the Fund's external counsel for a number of the 2001 amendments to The Crocus Investment Fund Act. The Fund's legal counsel noted that "assets of a value less than \$50 million meant "assets" and not "net assets". However, notwithstanding this clarification, the CFO continued to use "net assets" as the basis for reporting to IEDM on the Fund's compliance with its pacing and maintenance obligations. IEDM did not agree with the Fund's use of "net assets", but did not require that the Fund exclude these from their compliance calculations.
- We assessed the impact of these investments on the Fund's pacing calculations. We determined that the cost of these investments was not sufficient to negatively impact the Fund's compliance to pacing requirements for 2004. However, as noted in **Section 4.7.4**, the impact of not accepting the Fund's interpretation of \$50 million asset test may have a significant impact on the Fund's ability to meet its 2005 pacing hurdle.

Conclusions

- The Crocus Investment Fund Act is confusing with respect to the definition of qualified Manitoba business entity when read in conjunction with Section 3(2). This creates an undue risk of misinterpretation by those who use this Act.
- The Fund incorrectly interpreted the definition of "assets of a value" as used in the criteria for determining a "qualified Manitoba business". As a result, the Fund invested in six businesses with assets of more than \$50 million. These investments do not meet the test of a qualified Manitoba business, and should not be included in the Fund's calculation regarding compliance to the pacing requirements under The Income Tax Act (Manitoba).

4.5.4 The Size of Investments in Any One Entity

Currently, under The Crocus Investment Fund Act, the Fund is restricted from making investments in any one business where the fair market value of the investment exceeds 10% of the fair market value of the Fund's investment assets. Prior to July 6, 2001, The Manitoba Employee Ownership Fund Corporation Act contained a similar requirement, but the 10% limit was based on the cost of the investment and not the fair market value.

We reviewed the Fund's investment portfolio at September 30 for 2000 to 2004 to determine whether the Fund complied with the relevant legislative provision of The Act. In addition, we also reviewed investments on hand as at June 30, 2001, prior to the change in the basis for calculating the 10% limit which came into effect on July 6, 2001 to determine whether the Fund was in compliance immediately prior to the change in the basis for calculating the 10% limit.

OBSERVATIONS

- We found that at September 30, 2000 all investments were below the 10% cost limit. However, we noted that at June 30, 2001, the Fund had invested in Company GG a total of \$20.3 million or 13% of the Fund's total investment assets of \$159.2 million. Based on the 10% limit, the maximum allowable investment amount would have been \$15.9 million. As a result, the Fund's investment in Company GG exceeded the maximum allowable investment amount by \$4.4 million (27%).
- By September 30, 2001, the Fund's investment in Company GG had increased to \$20.9 million which still represented 13% of the Fund's total investment assets at cost. However, based on the revisions to The Act, which came into effect July 6, 2001, the cost

of an investment was no longer the basis for determining compliance. Under the amended Act, the “fair market value” of an investment (and not cost) was the new basis for determining compliance.

The Fund’s September 30, 2001 audited financial statements reflected a significant downward valuation adjustment to the investment in Company GG, and the Fund recorded an unrealized loss on this investment which reduced the book value (fair market value) of the investment to \$5.6 million. This adjusted value represented only 4% of total investment assets (at fair value) at September 30, 2001. Under the revised Act, the Fund’s investment in Company GG was now in compliance.

- We reviewed the notes to the audited financial statements for September 30, 2001 and noted that Note 12 Restrictions and Commitments still contained the wording describing the 10% limit from the previous year’s statements (...the greater of \$750,000 or 10% of investment assets...), and had not been amended to reflect the change in The Income Tax Act. This error was partially corrected in the September 2002 audited statements by dropping the \$750,000, but the Note in the September 2002 and 2003 statements still incorrectly states, *“the Fund cannot invest more than 10% of the investment assets of the Fund”* and not *“the fair market value of an investment cannot exceed 10% of the fair market value of the Fund’s investment assets”*.
- A number of concerns were raised by the public regarding the Fund’s investment in Company GG based on the Fund’s published September 30, 2001 audited financial statements. These statements showed only the cost of investments and not their carrying value. The unrealized loss related to Company GG was netted with other unrealized gains and losses and was included in total as Unrealized Appreciation of Investments on the financial statements. The Fund responded to the public concerns by reporting that the carrying value of the investment had been written down to below the 10% threshold. The investment was completely written off in 2001/02.
- We noted in 2002, 2003, and 2004, the fair market value of the Fund’s investment in Company L exceeded 10% of the total investment assets. However, the Fund’s actual cost of this investment would have met the previous requirements based on cost. This has been a “successful” investment and the Fund has recorded significant unrealized gains that more than doubled the actual cost of the investment. However, because the audited financial statements show only the cost of individual investments and not the individual fair market values for investments, readers of the statements would not be able to determine that the Fund was not in compliance with The Act.
- In addition to the investment size requirements established by legislation, the Fund’s By-laws also limit the size of an investment. The Fund’s By-laws approved by the Board state that:

“For any on business, the minimum amount invested by the Fund will be approximately \$100,000 and the maximum amount invested will be approximately \$5 million”.
- This investment requirement was also disclosed in the prospectus. An investor in the Fund would have considered this policy in assessing the “risk” of investing in the Fund. While the prospectus uses the word “generally” instead of “approximately”, which implies that investments might at times exceed the \$5 million limit, an investor would not expect that this requirement would allow an investment to exceed the upper limit by more than three times, as was the case with Company GG. By not following their By-laws, the Fund placed itself at a higher risk of suffering a significant loss.

- We noted that the \$5 million upper limit for investments was increased to \$10 million in the January 11, 2002 prospectus of the Fund. However, the By-laws were not amended by the Board to reflect this change in policy. We reviewed the Fund's investment portfolio at September 30, 2004 to determine whether the Fund had complied with the By-law regarding a maximum investment size of \$5 million. We found that 10 (22%) of the Fund's 46 investments exceeded the \$5 million maximum investment size established in the Fund's By-laws. These investments ranged from \$5.1 million to \$11.3 million and represented 65% of the total cost value of the portfolio. One investment also exceeded the \$10 million limit as set out in the 2002 prospectus.

Conclusions

- At June 30, 2001, the Fund's investment in Company GG exceeded the 10% maximum allowable investment amount for a single investment as set out in The Manitoba Employee Ownership Fund Corporation Act.
- By investing more than \$20 million in Company GG, the Fund significantly exceeded the maximum investment amount of \$5 million as set out in the By-laws approved by the Board and disclosed in the Fund's prospectus. By not ensuring that Management comply with this maximum investment limit, the Board exposed investors to the risk of significantly higher losses than disclosed in the prospectus.
- The Fund increased the investment limit disclosed in the prospectus from \$5 million to \$10 million without the Board amending the Fund's By-laws. As a result, the By-laws are not consistent with information disclosed to potential investors in the prospectus.
- Because of the amendments made to The Crocus Investment Fund Act prior to the Fund's September 30, 2001 year end, the Fund was able to state that they were in compliance with the legislative requirement to not invest more than 10% of the fair value of their investment assets in any one business. By changing the basis for determining the maximum allowable investment limit from cost to fair market value, the government increased the risk exposure to investors. Fair market value is an estimate of value as determined by Fund management and as such, is subjective. Fair market value does not reflect the actual capital invested and at risk.
- The Fund's audited financial statement notes regarding the 10% limit were not consistent with the wording of the Act and did not correctly describe this limit.
- Because the Fund does not disclose the fair market values of individual investments to shareholders and the public in their financial statements, shareholders and the public cannot determine whether the Fund is in compliance with the statutory requirement regarding the maximum size of investments.
- Changing from cost to fair market value for determining the maximum allowable investment has resulted in an investment exceeding the 10% limit on the basis of fair market value while the cost of the investment is significantly below the 10% limit. This change to The Act could penalize successful investments that have appreciated in value while allowing the Fund to continue to invest in businesses that have been written down. Under the current Act, the Fund could have continued to invest in Company GG, because of the write-down in the value of the investment. This does not serve the best interests of shareholders.

4.5.5 Eligibility of Investments

The Crocus Investment Fund Act (The Act) requires that the Fund invest 70% of the capital it raises through the sale of units in eligible investments. Section 1.1 of The Act defines an eligible investment. Through a Regulation under The Act ineligible businesses are identified. These include:

- real estate investments where the property is held primarily for producing rent revenue, development, subdivision or sale, or for agricultural crops;
- resource properties/businesses unless all of the exploration is carried on in Manitoba or the business includes processing of mineral resources;
- financial institutions; and
- professional businesses.

Any qualified Manitoba business that is not ineligible is an allowable investment for the Fund and can be used in determining compliance to the Fund's pacing requirements under The Income Tax Act (Manitoba).

From time to time, the Fund may make an investment in a business that does not meet eligibility criteria, but fulfills other Fund objectives such as job creation or capital retention. In these instances, the Fund may request that the minister grant approval to consider it as eligible for maintenance and pacing requirements under The Act.

OBSERVATIONS

- In order to determine compliance with eligibility requirements, we reviewed the 16 investments examined as part of our review of investment management processes and procedures in **Section 4.2**. We found that 13 of these investments were clearly eligible businesses. However, three investments had some component related to real estate or rental properties. These included: Companies Q, F and O.
- The Fund's investment in Company Q raised concerns from some members of the public. They viewed this investment as a real estate investment and as such, not an eligible investment. We reviewed the investment proposal prepared by the Fund. In the proposal, management stated that only 10% of the revenue for Company Q would come from rental income, with the majority generated from other sources. Because of this, management believed that the investment was not ineligible under The Act. Company Q recently started operations and sufficient operating information was not available to allow us to assess the reasonableness of management's statements.
- Company F is a real estate venture. However, the Fund obtained approval from the minister to treat this investment as eligible for pacing purposes.
- An investment memorandum prepared by management stated that "*Company O is not an ineligible investment*". We reviewed the financial statements for Company O and noted that all revenue came from rental income. As such, the investment should have been classified as ineligible. We also noted that the Fund had invested \$517,500 in Company O, and as at September 30, 2003, had recorded an unrealized loss equal to the full value of the investment.
- At September 30, 2004, the Fund only had one investment identified as "ineligible" – a \$25,000 investment in Company E.
- We identified eight investments since 1995 that required ministerial approval for the investment to be considered eligible for maintenance, pacing, and small business investing purposes. We asked to examine the authorizing letters from the minister for

these investments. Fund staff were only able to locate three letters in their investment files.

- In our discussions with Investment Department staff and IEDM staff, they were not aware of any instances where ministerial approval regarding an ineligible investment was requested and not approved.

Conclusions

- We are generally satisfied that the Fund had invested in eligible businesses as defined by The Crocus Investment Fund Act or had appropriately obtained exemptions for ineligible investments from the Minister. However, the investment in Company O could be viewed as an ineligible real estate investment since all of its revenue is derived from rental income. We noted that the investment in Company O is not large and would not have a significant impact on the Fund's pacing requirements.

4.5.6 Maintenance, Pacing, and Small Business Investing Requirements

Under The Income Tax Act (Manitoba), the Fund is required to comply with three main tests to help ensure that the Fund invests in businesses that support the public policy objectives of the government. These tests are summarized as follows:

Maintenance Test - an amount equal to at least 60% of the Fund's Adjusted Shareholder's Equity must be invested in Eligible Investments.

Pacing Test - the Fund is required to invest 70% of its total Subscription Proceeds in eligible businesses, over a three year period.

Small Business Investing Test - the Fund is required to invest at least 14% of its total subscription proceeds in "small eligible investments". These are investments of less than \$2,000,000 made to eligible businesses.

OBSERVATIONS

- During our review of IEDM, as noted in **Section 4.7**, we found that the Fund provided information regarding its investment activities to IEDM who then performed the required calculations to determine whether the Fund had complied with the Maintenance, Pacing, and Small Business Investing requirements under The Income Tax Act (Manitoba).
- The Fund also performed its own calculations of the above noted tests on a monthly basis for inclusion in a report titled "Report Card: Key Financial Indicators". This report is attached to the Fund's monthly financial statements and provided to the Board as part of their information package. The report also includes the following:
 - A summary of share equity transactions for all classes of shareholders, total Shareholders Equity/Net Assets, and Share Price – all compared to budget;
 - Management expense ratios for the last five years, reported on the same basis as other mutual funds report; and
 - The Reserve Fund minimum requirement compared to the amount actually invested.

The report also shows all guarantees, including the 50% calculation for determining the minimum reserve requirements.

We scanned these monthly reports and noted that the Fund reported that they were in compliance with all of the noted pacing and reserve requirements. This reported compliance is consistent with IEDM's determination as discussed in **Section 4.7**.

- As an added check of the Small Business Investing test, we reviewed the investment portfolio of the Fund for September 30, 2000 to 2004 and calculated the percentage of investments under \$2 million in comparison to the total value of the investment portfolio. We found that between 19% and 25% of the Fund's total investments were for \$2 million or less. In all cases, the total amount invested was greater than 14% minimum requirement.
- We reviewed Sections 11.1 to 11.5 of Labour-Sponsored Funds Tax Credit of The Income Tax Act (Manitoba). These sections establish the rules under which an LSIF must operate in order to maintain its tax credit status. We noted that the provisions regarding Maintenance, Pacing, and Small Business Investing were amended in 2001 in conjunction with corresponding amendments to The Crocus Investment Fund Act. We found that the amended provisions of The Income Tax Act (Manitoba) were complex, confusing, and difficult to understand. Both Fund staff and IEDM staff expressed similar concerns. A copy of the relevant sections of The Income Tax Act (Manitoba) have been included in this report as **Appendix G**.
- As noted in our review of Qualifying Investments, six investments were made in businesses with assets in excess of \$50 million. As such, these investments should not have been considered as eligible for the purpose of calculating Maintenance, Pacing, and Small Business Investing compliance. We assessed the effect of excluding the amounts invested in these businesses from the compliance calculations. We determined that the Fund invested a total of \$7.7 million in these businesses during the fiscal years 2001 through 2004. The Fund reported that at September 30, 2004, they had exceeded their Maintenance requirement by \$17.9 million and their Pacing requirement by \$34.0 million. Both of these amounts are considerably higher than the potential adjustment of \$7.7 million. The adjustment would not affect the Small Business Investing calculation amount.

Conclusions

- The Fund and IEDM both agreed that the Fund complied with the Maintenance, Pacing, and Small Business Investing requirements under The Income Tax Act (Manitoba) for the fiscal years 2001 through 2003. This is consistent with our review. The information returns for 2004 had not as yet been prepared.
- The provisions of The Income Tax Act (Manitoba) related to Maintenance, Pacing, and Small Business Investing are complex, confusing, and difficult to understand. As a result, these provisions are open to different interpretations. This adds to the difficulty of monitoring for compliance, and contributed to disagreements between staff at the Fund and IEDM.

4.5.7 Limit on Common Share Sales

- The Fund is limited to \$30 million per year in the sale of common shares. If the Fund exceeds this amount, they are liable to pay a tax equal to 15% of the excess. This is an amount equal to the provincial tax credit provided by the government to the purchasers of the shares.

- We reviewed sales for a five year period from 2000 to 2004 inclusive. We noted that in 2000 the Fund had sales of \$33.2 million or \$3.2 million over the maximum limit. As a result, the Fund could have been liable for \$484,000 as a tax penalty on the excess sales. We noted that a similar situation had also occurred in 1999 when the Fund had sales of \$37.7 million.
- On May 7, 1999, the government and the Fund entered into an agreement regarding the excess share sales. Under this agreement, the Fund committed to invest, by September 30, 2000, 75% of the excess sales amount (\$5.7 million) in eligible investments in which the Fund had not previously invested. Each investment could not exceed \$1 million. The agreement also contained the following clause:

"In the event that the regulation to amend Regulation 235/92 is not passed in accordance with the Government's recommendation as described in paragraph 1 hereof, no damages will be payable under this Agreement."

- We noted that the government approved an amendment to the Regulations of The Income Tax Act (Manitoba) that allowed the Fund to exceed the \$30 million sales limit without a tax penalty for the 1999 selling period. This amendment applied to the 1999 selling period only and not to subsequent years.
- On February 21, 2000, the Fund sent a letter to the Minister of Finance advising that the sale of shares for the 2000 selling period would also exceed \$30 million, and confirmed the Fund's request that the \$30 million sales limit be waived for 2000. The letter pointed out that the \$30 million sales cap was disclosed in the Fund's prospectus and that the prospectus stated that the Fund would not exceed this limit if it would result in a tax liability. As a result, the Fund either required a waiver from the government or would have to close off sales before the end of the selling period.

The letter pointed out that the Fund could take in \$8 million to \$12 million in sales in the last two days of the selling period, and that prior to the last two days of sales, the Fund would be well below the maximum sales limit. Because of the significant sales volume in the last two days, closing off sales in advance would not be possible. In addition, cancelling sales after the close of the RRSP season would result in purchasers being left without an RRSP or labour-sponsored tax credit for the previous taxation year.

The letter proposed that the Fund would advise the Minister on or before February 25 as to whether they expected to exceed the sales limit and would require the government's confirmation of waiver at that time.

- The Fund's sales for the 2000 selling period exceeded the \$30 million limit and on May 5, 2000, the Fund and the Government entered into another agreement. Like the previous agreement, the Fund was required to invest, by September 30, 2001, 75% of the excess sales amount (\$2.4 million) in eligible investments in which the Fund had not previously invested. Each investment could not exceed \$1 million. The agreement also contained the statement noted above regarding the government's responsibility to amend Section 4 of Regulation 235/92 to allow the excess sales.
- The government did not amend the Regulations to increase the sales limit for 2000 as was done for the 1999 sales. IEDM officials could not provide any explanation for not making the required amendment.
- On March 5, 2001 the Fund sent a letter to IEDM regarding the Fund's investment compliance for the years 1999 and 2000 and covered the 1999 selling period. The letter

indicated that the Fund invested a total of \$4 million as required by the 1999 agreement. The Fund did not provide any reporting regarding the 2000 agreement.

- We analyzed investments made by the Fund from January 1999 to September 2001 to determine whether the Fund had complied with the investing requirements under the 1999 and 2000 agreements. We found that the Fund had invested a total of \$9.7 million in 23 new businesses and exceeded the minimum investment requirements (\$8.2 million in total) for both the 1999 and 2000 agreements. Each investment was under \$1 million and ranged from \$75,000 to \$999,999.

Conclusions

- The Fund had taken appropriate action to alert the government to potential excess sales and had received waivers allowing the excess sales in 1999 and 2000 without tax penalty providing that the Fund invest 75% of the overage with new portfolio investments in amounts not to exceed \$1 million for each investment.
- The Fund complied with the investment requirements set out in the 1999 and 2000 agreements.

4.5.8 Policy Considerations Regarding Investments

The Fund has developed a number of internal policies designed as guidelines to help guide investment decisions. The Fund endeavors to invest in businesses that exhibit these qualities in order to meet the broader investment objectives of the Fund. The objectives include:

- Promoting employee ownership and participation in corporate governance and management;
- Retaining capital in the province;
- Investing in businesses that modify proven technologies;
- Job retention and job creation; and
- A commitment to ethical employment practices, workplace safety, and sound environmental practices.

In addition to policies regarding investing, the Fund also has a By-law establishing valuation policies. The By-law includes definitions of various components used in valuation such as Investment Assets, Net Asset Value per Common Share, Net Realizable Value, Published Market Value and Qualified Person. It sets out the general principals to be used in valuation. For example, the fair market value of an investment is either its Published Market Value, or its Net Realizable Value. The By-law clearly places responsibility for determining the Net Realizable Value of investments with the Board and charges each Director to:

“...act honestly and in good faith with a view to the best interests of the Fund and its shareholders and shall exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances”.

The By-law requires the preparation of an annual valuation report to be completed by a qualified person. The report should contain:

- An opinion regarding the fair value of the investment;
- A summary of assumptions used in determining value;
- A summary of underlying assumptions; and
- Calculations, and a summary of the scope of the report.

The By-law also requires that debt instruments be valued at their Published Market Value. If this is not available, then the debt should be valued at its unamortized principal amount as at the valuation date. If the Board believes that the amount of the debt exceeds the aggregate of all amounts that the Fund can reasonably expect to receive, then the value should be written down to an amount that the Fund reasonably believes will be recovered.

Finally the By-law gives the Board the authority to have a qualified person review the methodology used by the Fund for valuing investments *“to ensure that the fund has appropriate systems in place to properly value its Investment Assets in the manner set forth in this By-law”*.

OBSERVATIONS

- To determine whether the investment objectives noted above were taken into consideration, we reviewed the investment proposals for the 16 businesses examined as part of our review of investments in **Section 4.2** of the report. We also discussed the above guidelines with Fund management and staff, and reviewed internal documents and reports.
- We noted that many of the investment proposals directly addressed the above objectives. The Fund’s portfolio included investment in three businesses specifically made to facilitate internal acquisitions by staff. In addition, the Fund has also encouraged investees to initiate stock purchase plans to allow employees to become shareholders. The Fund prepares detailed statistics monitoring the status of employee participation.
- When liquidating investments, the Fund endeavors to keep the business in Manitoba and prefers to divest to other Manitoba business and capital providers. In addition, the Fund also provides capital to businesses to encourage them to remain in Manitoba. For example, the Fund’s investment in Company L was made specifically to keep the company in Manitoba. By providing a local source of venture capital, the Fund helps keep businesses in the province that may otherwise have had to go outside the Province to obtain capital.
- By investing in Manitoba businesses, the Fund has played a role in job retention and creation. An internal analysis prepared by the Fund indicates that CIF portfolio company businesses employ over 6,200 people. These jobs may not exist if it were not for capital provided by the Fund.
- To help promote ethical employment practices, workplace safety, and sound environmental practices, the Fund conducts a social audit (SRI) as part of its due diligence process. These audits are conducted by the Vice-President, Social Responsible Investments. The Fund is a leader in the country in conducting these audits. The results of the social audits are considered when making investment decisions and the Fund works with investees to make any required improvements identified by the audit.
- We were told of several instances where the results of the SRI review resulted in the Fund not making investments. In these instances the SRI review revealed situations where significant workplace safety issues existed or where there were serious concerns with ethical employment practices. While SRI proved effective in many instances, the SRI reviewer was not allowed to examine governance practices and was not allowed to conduct background checks on Senior Officers or owners of companies. We were told of two specific instances where either the former CEO or former CIO interfered with the SRI review:

- The review identified a concern with allegations of sexual harassment regarding a senior member of the management team. The former CEO would not let the reviewer investigate further and would not allow any reference to these concerns in the investment memorandum. The Board approved the investment.
- The reviewer had concerns with the principal owner of a business. The reviewer uncovered serious concerns with unethical practices and wanted to conduct in depth background checks. The former CIO would not allow any checks to be performed on the principals and would not even allow discussions with former business partners and associates that could have confirmed or refuted the concerns. No mention was made of these concerns in the investment memorandum, and the Board approved the investment. As a result of the current valuation review, this investment has now been valued at zero. This represents a significant loss on shareholder value that might have been avoided had the former CIO allowed a more thorough SRI review as recommended by the reviewer.
- We conducted detailed reviews of valuations as part of our review of investments in **Section 4.2**. We found that in some cases, the valuation process was adequate and in other cases, the valuation process was inadequate. Generally, the Fund was quick to write up values based on anticipated sales or new capital contributions from third party investors, and was slow to write down investments, even when significant milestones were missed. Staff were limited in the amount of influence they had on a valuation, and much of the information provided to staff came verbally from the former CIO and was not supported by documentation. Staff felt that they did the best job they could, given the information they were provided with to do valuations.
- The By-laws clearly charged the Board with the responsibility for ensuring appropriate valuations. We saw little evidence in Board minutes that would support a vigorous review of valuations by the Board. For the most part, valuations appear to be approved with little challenge.

Conclusions

- In making investment decisions, the Fund considers their policy objectives. These objectives are incorporated into the Fund's due diligence processes. While the assessment of a particular investment opportunity may not address all of these objects, the Fund endeavors to invest in businesses that meet as many of its objectives as possible.
- SRI reviews have had a positive impact on the investment decision making process. However, there have been instances where the review process was curtailed by the former CEO and the former CIO. Had these SRI reviews been completed, the results may have influenced the Board's decision to invest.
- The Board did not fulfill their responsibility for investment valuations as set out in the Fund's By-laws.

4.5.9 Investments in Early Stage and Turnaround Entities

The Fund's policies require that the Fund's investments in early stage businesses and turnarounds not exceed 25% of the Fund's total investment assets.

OBSERVATIONS

- In order to assess compliance to this policy, we reviewed the Fund's investment portfolio with fund management and identified those businesses that were considered "early stage" or "turnaround".
- For the years 2000 to 2004 inclusive, the Funds investment in early stage and turnaround businesses ranged from 21.0% to 24.5%. The average investment level for the five year period was 22.4%.

Conclusion

- The Fund has complied with its policy regarding early stage businesses and turnarounds and has not invested more than 25% of the Fund's total investment assets in these types of businesses.

4.6 CIF AND THE PUBLIC SECTOR

CIF's Board and former CEO believed in CIF having multiple bottom lines and multiple legislative mandates. Over the last few years, CIF experienced liquidity issues and had revenues that were insufficient to cover operating costs. Divesting investments could be considered a key solution to liquidity issues. CIF identified the promotion and development of sub-funds whereby CIF could earn management fees and leverage public sector monies as the key solution to liquidity issues.

This section summarizes the vision, concepts and sub-fund initiatives undertaken by CIF. This section also summarizes how the conceptual framework for local investing was developing through the Manitoba Local Investment Council (LIC). The Council was terminated on April 1, 2005.

Since its inception, CIF has been involved with the public sector and, as at September 30, 2004, 36% of its portfolio at cost or 31% at value (prior to any write-downs subsequent to September 30, 2004) were committed to investments that also contained public funds. The public funds were sourced from the Workers Compensation Board, the Teachers' Retirement Allowances Fund (TRAF), and the Province of Manitoba. As well, the Manitoba Science & Technology Fund (MS&T) contains holdings in which CIF is also directly invested.

4.6.1 The Vision and Business Plan**OBSERVATIONS**

- In an April 21, 2003 Board retreat document titled, "Plan for Corporate Development", the Fund identified a need to diversify its revenue sources and reduce its reliance on a single retail product sold into a highly regulated market. As a response to this need, the Fund committed to building upon its early experience with a subsidiary fund model, represented by the Manitoba Science and Technology Fund (MS & T). This model, in which a wholly-owned subsidiary of CIF serves as the general partner of a limited partnership of institutional and high net worth investors, was highlighted as offering the Fund three key opportunities:
 - *"Alternate opportunities for delivering on the Fund's multiple bottom lines, including economic development, during the period when the Fund's existing business is experiencing constrained net revenue growth;*
 - *A new source of co-investment or an exit strategy for the Fund's existing portfolio companies, while retaining the prospect of local control; and*

- *A new source of net revenue with which the Fund would underwrite its management expenses to enhance shareholder value."*
- CIF noted that this strategy was built upon an understanding of fundamental changes taking place in capital markets in North America, most notably an increase in institutional holdings in private equities. For example, in the U.S., the average annual US pension fund share of total venture capital in the 1990s was 50%. In Australia, the pension fund share of venture capital exceeded 70%. Canada has lagged well behind (pension fund share of venture capital was 5 – 10% in the 1990s). CIF documentation indicated that a similar trend was taking hold in Manitoba, where the development of joint trusteeship of pension fund assets by organized labour offered hope that local investing and socially responsible investing would mark a transition to a new era of active capital management in which CIF could be a key participant.
- CIF's Five-Year Plan, adopted by the Board in April 2003 and incorporated into the 2004 Business Plan, noted the core goals for CIF as including:
 - *"Ensuring the profitability of the Fund through proficient management of the core Fund and by diversifying revenue sources through sub-fund development;*
 - *Continuing to promote Employee Ownership and Participative Management (in portfolio company businesses and more broadly through the newly created Centre for Employee Ownership at the University of Manitoba);*
 - *Continuing to be a leader in Community Development (by investing in business located in downtown Winnipeg and through our ongoing support of Community Ownership Solutions and other related community organizations);*
 - *Continuing to promote education and training related to financial planning in the labour community and to increase the level of participation of labour affiliated investors in the Fund (through our Board and staff representation and work with the newly created Manitoba Centre for Labour Capital); and*
 - *Growth in net asset value, sales, and share price were also projected."*
- In a speech given by the former CEO in July 2004, he said, *"As you know Crocus has a mandate that might best be described as a balanced scorecard. Our primary objectives are capital retention in Manitoba, employee ownership and participation, business continuity and growth, job retention and creation, as well as providing a competitive rate of return to investors."*
- A theme of CIF's 2004 Business Plan was the integration of values, business strategy and budgets. This involved multiple (internalized) bottom lines and multiple (Legislative) mandates. CIF reaffirmed its commitment *"to perform across multiple mandates providing shareholder value consistent with economically-targeted investment (ETI) and socially-responsible investing (SRI)".* The Fund's mandates and accountabilities were identified as follows:
 - *"Rate of Return, Capital Retention, Best of Class Investments;*
 - *Labour Affiliated Sales, Net Sales, Growth in Market Share;*
 - *Participative Management, Management Expense Ratio;*
 - *Employee Ownership, Job Creation and Retention;*
 - *Local Ownership, Ethical Workplaces, Business Continuity;*
 - *Responsibility to Community; and*
 - *Accountable to Shareholders."*

- The 2004 Business Plan for CIF contained limited content dedicated to portfolio management. Instead the thrust was more toward sub-fund management (for the purposes of revenue generation) and involvement in labour related initiatives. Other than mentioning that growth in net asset value is a goal, investment portfolio plans are discussed on only 3 pages of a 61 page document. Planning in general does not address portfolio construction and investment strategy issues.
- Presentation material prepared by the former CEO in the fall of 2004 indicated that one strategy was to “liquidate or harvest” specific portfolio assets on a selective (value) basis. The material also identified that this strategy was difficult to achieve while also achieving the Fund’s multiple bottom-line objectives.

4.6.2 Infrastructure for Sub-Fund Development and Fund Initiatives

OBSERVATIONS

- CIF took a number of steps to position itself to be a catalyst for the development of institutionally funded local capital pools.
- In 2002, the Fund created and filled the position of Vice President, Corporate Development and Operations, to provide focused leadership to the process of creating institutional funds. This position was vacated and that responsibility was then shared by the former CEO and the former CIO.
- Also in 2002, the Fund created and filled the position of Vice President, Labour Affairs and Labour Capital and created the Manitoba Centre for Labour Capital (MCLC). This was intended to position the Fund to be a key player in influencing organized labour to use its growing influence in the trusteeship of public pension plans for mutual benefit through joint understanding and strategies which support local investing and socially responsible investing. The Fund also retained a person, on a consulting basis, to provide support to the MCLC, particularly in the area of capital formation.
- MCLC was constituted with an Advisory Board comprised of the leadership of the Manitoba Federation of Labour (MFL), the Manitoba Government and General Employees Union (MGEU), the Canadian Union of Public Employees (CUPE), the United Food and Commercial Workers Union (UFCW), the Manitoba Building Trades Council, and the Manitoba Teachers Society (MTS).
- MCLC obtained core funding from the MFL, MTS, the Western Canada Economic Diversification Fund and CIF.
- The former CEO served as a member of the Premier’s Economic Advisory Council and as co-chair of the Investment Task Group of the Premier’s Economic Advisory Council (PEAC). The Task Group made a series of recommendations to government to facilitate local investing, including local investment guidelines for public pension plans and Crown Corporations. The guidelines focused on achieving a risk adjusted market rate of return, the creation of an educational centre regarding local investment and the creation of a pooling vehicle for local investment capital. Recommendations of the Task Group prompted the creation of the Local Investment Council (LIC) to champion the concept of local institutional investing. The LIC was comprised of representatives from the Task Group, the MFL, the Winnipeg and Manitoba Chambers of Commerce, the Manitoba Business Council, the Investment Dealers Association and the credit union system.

4.6.3 Sub-Fund Initiatives

OBSERVATIONS

- The Corporate Development Department of CIF set a \$25 million target for sub-fund capitalization by mid-2003, an additional \$25 million by the end of 2003, \$100 million in 2004, \$25 million in 2005, and \$25 million in 2006.
- CIF recognized that gross management fees would vary from sub-fund to sub-fund. The assumption was that aggregate net fees to CIF would be 1% of funds under management. Aggregate net fees are gross fees less costs and expenses (i.e., start up costs; unrecoverable legal and due diligence costs) and additional staff costs (over and above current Investment Department staff and current finance and administration staff) associated with the operation of the sub-fund. It was thought that such staff costs might include a specialized fund manager and/or specialized technical staff specifically hired for, and dedicated to, the management of the sub-fund. Any bonus fees (i.e., fees for performance in excess of a predetermined threshold) would be additional revenue to CIF. However, because bonus fees were planned to be contingent and not be available until sub-fund windup, no bonus fees were reflected in the five year financial plan.
- The Fund participated in and is presently managing the following sub-fund initiatives:
 - **The Manitoba Science and Technology Fund (MS&T)** was capitalized with \$10 million in 1999, including \$2.5 million from CIF. The MS&T Fund has invested approximately \$7.5 - \$8 million in twelve transactions. The balance of the funds was reserved for follow-on investments to existing portfolio companies. As manager of the fund through its Scitech subsidiary, CIF receives 3% of funds invested on an annual basis, plus a premium on windup of 20% of all surplus cash after investment partners have received cash equal to a 10% annual compounded rate of return on their original capital contribution.
 - **The Manitoba Property Fund** was intended to facilitate real estate development in downtown Winnipeg and provide a relatively low-risk investment opportunity for local institutional funds. Initial capitalization of the Fund was targeted at \$25 million with a goal of increasing post-start-up to \$40 - \$50 million. Initial investment plans included monies from the Workers Compensation Board and the Teachers' Retirement Allowances Fund of \$10 million each, a co-investor who provided in-kind property and CIF. CIF earns a management fee to manage the Fund.
- The Fund was also seeking to establish a number of new subsidiary funds:
 - **The I-OVO Trans-Atlantic Growth and Accelerator Fund** - As the primary developer of the fund concept, CIF was looking at an international fund arrangement involving the exchange of licenses and corporate venture opportunities for intellectual properties from large North American based companies wishing to gain low-cost entry into European markets and large European-based multinationals wishing to gain low-cost entry into the North American market.
 - **The Institutional Superfund** was intended to be a \$250 million fund with capital sourced exclusively from Manitoba institutional sources. Initial capitalization was targeted in the \$75 million range sourced from employer contributions to large public sector pension plans. Investment priorities included investments in mid-sized Manitoba businesses requiring an initial investment of \$5 million or more, follow-on investments to companies with existing large LSIF or other local venture capital

positions, purchase of large, mature LSIF or other local venture capital positions, and specific concentration priorities in key sectors (e.g., biotech) identified by stakeholders in businesses at all stages of development. CIF was seeking to serve as the Fund manager.

- CIF was also actively engaged in conducting preliminary research and establishing potential partnership alliances with parties interested in pursuing the creation of institutional funds to be managed by CIF subsidiary companies in several economic sectors including **alternative energy** and **value added agriculture** as well as a venture capital fund for **First Nations' related businesses**.
- In January 2003, CIF developed proposed protocols for the development of sub-funds. These proposed protocols contained the following two points, among others:
 - *"Where a sub-fund is not created or where Crocus is not provided with a carried interest notwithstanding the creation of a sub-fund, the investment in the development company should be written off by CIF and charged against investment portfolio returns."*
 - *"Management of any sub-fund created will be through a management company wholly or partially owned by CIF, which will receive an appropriate management fee. While particular funds may require the hiring (through the management company) of a lead fund manager not presently on the CIF staff, the bulk of the investment due diligence, analysis and monitoring will be undertaken by the CIF investment department."*

These two points highlight that a significant time commitment would have been required by CIF staff on these initiatives. In addition, the costs of any failed sub-fund initiatives would have to be absorbed by CIF.

4.6.4 The SuperFund Concept

OBSERVATIONS

- In January 2000, the former CEO provided a paper to government on the concept of *"economically targeted investments by public pension funds"*. This was in response to the apparent government interest in examining the desirability of a capital retention strategy for public pension funds and Crown corporations, in which a portfolio of assets under management are reinvested in Manitoba. Such investments are generically described as economically targeted investments (ETI).
- On November 19, 2002, the Fund's former Chair and the former CEO met with the Premier of Manitoba to discuss the Superfund Concept. As per CIF Board minutes of December 10, 2002, *"this meeting was building on work done in other contexts, including the PEAC. The presentation to the Premier suggested it would be more effective to create a large pool rather than a series of small pools....The challenge is to circumvent the resistance that existing fund managers are giving to doing any sort of local investing. The goal is to get something started that will provide enough momentum to cause the local managers, in their normal review process, to put some additional money into this type of pool."*
- CIF minutes further noted that a working group would be established that included the Fund's former Chair, former CEO and two government representatives. The minutes indicated that *"the ball was in CIF Senior Officers' court to operationalize this working group of very political people and we're going to push this as hard as we can"*.

- Costs were incurred and CIF staff time was used to study the SuperFund concept. We were unable to quantify the associated costs.
- The Superfund Concept conceptualized:
 - *“A target fund size of \$250 million sourced with \$75 million from the employer portion of the Civil Service Superannuation Fund contributions; \$20 million - \$30 million from small pension funds and Crown corporations including Workers Compensation Board, Manitoba Public Insurance, University Pension Plans, Building Trades, etc.; and \$125 million from the employee portion of the Civil Service Superannuation Fund, Teachers’ Retirement Allowances Fund, and the Civic Employees Pension Funds;*
 - *Investment priorities as initial investments greater than \$5 million; follow-on investments to companies with existing large LSIF or other local venture capital positions (greater than \$10 million); purchase of large, mature LSIF or other local venture capital positions; and specific concentration priorities to pre-determined concentration thresholds in key sectors (i.e., biotech) identified by stakeholders in businesses at all stages of development;*
 - *A limited partnership set up with an investment advisory committee;*
 - *That CIF would have the majority of ownership;*
 - *The Fund management would generate a fee based on percentage of assets under management; and*
 - *That a lead manager with strong credibility within the local investment community was needed. However, staff support would be provided by the CIF Investment Department.”*
- We were informed by provincial officials that although CIF was pursuing a Superfund Concept, there had been no government decision to proceed with this.

4.6.5 The Manitoba Local Investment Council (LIC)

OBSERVATIONS

- In November 2001, the government announced the appointment of 34 members from Manitoba business, labour and other stakeholder groups to a new advisory body on provincial economic issues named the Premier’s Economic Advisory Council (PEAC). PEAC was created in response to The Manitoba Century Summit held in the spring of 2000 where initial discussions were held on skills training, immigration policy, investment, and research and development in Manitoba. Individuals were appointed to PEAC based on a personal invitation from the Premier. A full-time executive coordinator was hired to work with PEAC.
- PEAC makes recommendations to the Premier, who can then determine whether they would be implemented. If items are accepted, they may be incorporated into the Government’s budgets, the throne speech, and economic strategy.
- PEAC created an Investment Task Group that met from December 2001 to November 2002. This group recommended the creation of a local investment council. In the November 2002, Speech From The Throne, the Government indicated that it would work with PEAC to implement a new Capital Retention Strategy for Manitoba that had the following key elements:

- *“Promoting a definition of “local investment” that emphasizes both market rates of return and economic development benefits;*
 - *Broadening understanding of local investment strategies within the investment community; and*
 - *Exploring options to pool smaller investment funds to create a larger local investment portfolio.”*
- In CIF’s identified accomplishments for the 2001/2002 year, one item noted was that the former CEO served as Co-Chair of PEAC’s Investment Task Group and developed recommendations to facilitate local capital strategies, including support for Centre for Labour Capital. A former CIF Board member also participated and there was research and clerical assistance provided from a representative from IEDM and a representative from the Department of Finance. In November 2002, a presentation was made to the Premier indicating the following:
 - *“Local investing by pension funds in Canada and Manitoba is miniscule compared to other jurisdictions.*
 - *The Manitoba labour movement will, in the next several weeks, be announcing the creation of a Center for Labour Capital to educate union trustees on the benefits of local investing within a fiduciary framework that protects the interests of plan beneficiaries and to advocate for appropriate local investment initiatives.*
 - *We believe that local investing, as we have defined it, should be incorporated as a permitted investment in investment guidelines and/or regulations for Crown Corporations and public and private pension funds; and*
 - *We believe that a non-partisan commission, under the auspices of the Premier’s Economic Advisory Council, should be established to champion and generate broad based community support for the concept of local institutional investing. The commission should include leadership from business and labour, as well as from pension funds and Crown Corporations’ investment management committees.”*
 - In October 2003, PEAC created an investment committee called the Local Investment Council (LIC). The LIC was created to champion and create broad-based community support for local investing. We were informed that the LIC Committee was chosen by PEAC.
 - The LIC was comprised of 11 members, 4 of which were also PEAC members, with a fifth member designated as representing PEAC, but not as a PEAC member. Of the 11 members, five were part of CIF including: the former CEO, the current Chair, the former Chair, and two former Board Members.
 - The LIC, after study, advocated the position that increased or more targeted local institutional investing would help the Manitoba economy. The LIC viewed local investing to be *“investments by Manitoban institutional investors into Manitoba: for-profit businesses; infrastructure and real estate development under conditions of appropriate risk-adjusted expected rates of returns.”*
 - The benefits of more local private equity investing in Manitoba as identified by LIC included: retain local control over promising companies (more local companies will grow to become corporate leaders rather than branch plants); attract promising early-stage

companies (small growth companies go to where they can access capital); and if investment capital is available, more small growth companies will choose Manitoba.

- As per LIC documentation, the strategic thinking behind the LIC was that it is within Manitobans' control to direct their pension and insurance funds to invest more in Manitoban businesses. To do so, the funds need appropriate investment vehicles, skilled investment managers, and a focus upon real opportunities.
- In an October 2004 presentation to the Minister of IEDM, LIC put forward the following preliminary recommendations:
 - That *Local Investments* be defined as investments into Manitoba: for-profit businesses (private equity); infrastructure; and real estate development *under conditions of appropriate risk-adjusted expected rates of returns*. *Local Investors* would be defined as the *Big Six Funds* and other Manitoban investment funds;
 - A capital pool be established with a mandate for *Local Investing – Private Equity*. The capital pool be funded with monies committed from the *Big Six Funds* (Civil Service Superannuation Fund; Teachers' Retirement Allowances Fund, the Civic Employees Pension Plan; Manitoba Public Insurance; Workers Compensation Board and the Hospital Employees Pension Plan);
 - The *Big Six Funds* commit 1% of their investment assets to the capital pool (in aggregate the 1% equates to a pool of \$114 million);
 - Subject to confirmation of appropriate deal flow, within five years the *Big Six Funds* commit 5% of their investment assets to the capital pool (in aggregate the 5% equates to a pool of \$570 million); and
 - The Province incorporate clauses in legislation to facilitate Local Investing and to require pension funds to report as to their *Local Investments*.
- The LIC indicated that it was prepared to accept an ongoing role in facilitating and monitoring and may recommend further actions to the Premier.
- A further meeting was held on March 31, 2005 where the LIC provided two documents: their Final Report and Proposal; and The Case for Local Investing in Manitoba. The final recommendation by LIC was that the Province of Manitoba provide seed equity for the creation of an investment fund funded by Manitoba based institutional funds. The purpose of this fund is to provide capital for local investing, which the LIC has defined as Manitoba based investment opportunities including:
 - Risk capital for operating businesses - small cap IPOs and private equity (including sub-debt, mezzanine, buy-out, turnaround and growth capital);
 - Infrastructure; and
 - Real estate development.
- It was further noted that managers of the six funds would be particularly encouraged to participate; however, the fund would welcome investment from smaller public sector institutional funds as well as from private sector funds.
- The Minister of IEDM indicated in a letter to the Chair of LIC dated April 1, 2005 that...*"the Government will need a considerable length of time to consider the recommendation and provide our response....At this point, with the delivery of your report and recommendations to me March 31, 2005, and with our thanks, we consider the work of the Local Investment Council to be concluded"*. LIC was terminated on April 1, 2005.

Conclusions

- We believe that CIF's involvement in PEAC, the Investment Task Group and the LIC was key to CIF's strategy to expand into development and management of funds in Manitoba.
- CIF's corporate development strategy (i.e., expanding into sub-fund development and education programs for pension trustees) may not be consistent with their current legislative framework. An IEDM 2001 internal communication indicated similar concerns.
- The time and effort that CIF, most especially its former CEO, put into the sub-fund and Superfund concepts may have distracted them from paying proper attention to portfolio construction and investment management issues.
- The evolution of CIF's strategies and nature of investments into the management of sub-funds attributable with local institutional investing could have been handled in a separate fund. As an alternative to creating and funding sub-funds out of CIF, sub-funds could have been the result of launching a Crocus II Fund that would have been marketed using a separate prospectus. Crocus II could have sourced subscriptions from Manitobans and financial institutions (as co-investors) interested in supporting the unique investment strategies connected with each sub-fund including institutional investing. Separate funds may have been clearer to incumbent and prospective shareholders in terms of their understanding of the different investment strategies involved. This would have ensured that the strategies and nature of investments of the original CIF would have remained relatively consistent with their prospectus.

4.7 MONITORING BY INDUSTRY, ECONOMIC DEVELOPMENT AND MINES

Industry, Economic Development and Mines (IEDM) is a key organization involved in economic development in Manitoba. The creation of CIF was also intended to spur economic development in the Province of Manitoba.

4.7.1 IEDM Had Many Roles: Monitoring was not Sufficiently Emphasized

OBSERVATIONS

- IEDM has had several roles with respect to involvement with CIF:
 - In one role IEDM has the responsibility for monitoring CIF compliance with their Act.
 - In a second role, IEDM has been in discussions in various forums with CIF on the concept of local institutional investing in Manitoba.
 - In a third role, IEDM has been an investment partner. The Province of Manitoba had a Limited Partnership investment in the Manitoba Science and Technology Fund of approximately \$1,611,069 for the year ended March 31, 2004. In addition, the Province, through MIOP and other government grants, invested in a number of the same companies as CIF.
 - In a fourth role, individuals from IEDM either sat on the Board of CIF as the representative for the Government shares or as an independent advisor on the Investment Advisory Committee.

- In a fifth role, IEDM has been an advocate for the LSIF program, including identifying and promoting legislative amendments to improve the program.
- IEDM advised that much of its efforts have been devoted to developing a relationship with CIF that was more positive and cooperative than it was when they first assumed responsibility for monitoring CIF in 1998. IEDM spoke at length about needing to develop a trusting relationship prior to assuming an effective monitoring role. As a result, IEDM advised that they were reluctant to use more intrusive actions in performing their monitoring role.
- In addition to building a more positive relationship with CIF, IEDM efforts have focused on:
 - Promoting the LSIF program;
 - Managing/negotiating further legislative amendments to improve the LSIF program;
 - Developing a prescribed information return for Section 11.4 of The Income Tax Act (Manitoba); and
 - Monitoring the Fund's compliance with the investment placement (maintenance and pacing) rules.
- These duties were included in the responsibilities of one account manager within IEDM.
- In 1999 Treasury Board directed IEDM to monitor the performance of the Fund and to return annually during the estimates review with a report and recommendations respecting the annual sales limit, including an analysis of the economic benefits, an assessment of the Fund's investment portfolio and its overall performance, investment opportunities as well as cost to the Province. In our view, this should have prompted the development of a more structured and comprehensive monitoring approach.
- In addition, on June 13, 2001, when Bill 28 was introduced for Second Reading in the Legislature, the Minister stated, *"it is important that the government monitor the operations of labour-sponsored funds to ensure that they are adhering to the provisions of the legislation."* (Hansard) We note that the 2001 legislative amendments included significant provisions to support an effective monitoring program.

Conclusions

- Overall, IEDM's roles as monitor, advisor, investment partner, Board representative and program advocate have conflicting priorities. IEDM may have placed themselves in a perceived conflict of interest situation by working with CIF in these varying roles.
- The failure to develop a comprehensive monitoring approach and the reluctance to use more intrusive actions in performing its monitoring role appear to have occurred because IEDM struggled with its conflicting roles. It sees itself first and foremost as an advocate for the LSIF initiative and only secondarily as compliance monitor.

4.7.2 Indications that More Intrusive Actions Were in Order

OBSERVATIONS

- IEDM indicated that they would have only taken more demanding actions if they had been advised of an issue. However, a number of events occurred that in our view, should have prompted IEDM to take more intrusive actions to ensure appropriate management practices were in place at CIF.

- IEDM acknowledged that they could have intervened but chose not to, and questioned what would have been accomplished if they had intervened. IEDM noted that they are not responsible for the performance of CIF.
- The events include the following (each of which is expanded on in more detail below):
 - Repeated requests from CIF for legislative amendments that continued after the 2001 legislative amendments were made;
 - IEDM analyses that predicted a liquidity problem because investment practices were not consistent with the legislated rules; and
 - Long-term plans that gave rise to policy and practical matters.

Repeated Requests for Legislative Amendments

- While significant amendments were made in 1997 and 2001 to The Crocus Investment Fund Act and The Income Tax Act (Manitoba), CIF continued to pursue further amendments throughout 2001 to 2004. Other requested legislative amendments included:
 - Pacing requirements (new share sale proceeds) that are net of redemptions or removed altogether in favour of a more aggressive maintenance test (70% versus 60%). CIF was very up front with IEDM as early as mid-2000 on the fact that they would run into liquidity problems if pacing continued to be based on 70% of gross sales;
 - The elimination of the \$30 million sales cap; and
 - Increasing the allowable size of investees by using a net asset test rather than a gross asset test.
- Of note is that in January 2002, an official from the Department of Finance suggested that CIF's continuing requests for legislative amendments may be a sign of management issues and that an independent review of CIF's operations may be in order. There was no indication that IEDM seriously considered this suggestion until October 2004 when, in an internal document, officials expressed an interest in reviewing CIF's Business Plan. IEDM officials indicated that, in recent years, several requests had been made for a copy of CIF's business plan, but that CIF never complied with the requests.

Analyses by IEDM Predicting A Liquidity Problem

- In January 2001 a senior account manager within IEDM, with a background in accounting but not directly accountable for the CIF file, reviewed information provided by the Fund. The manager observed that unless CIF divested sufficient investments to fund redemptions, they would run into liquidity problems as early as 2002/03.
- This account manager was also asked to review the compliance package received on March 5, 2001 and noted that CIF had calculated its pacing requirements based on sales net of redemptions. Legislation requires that pacing be based on gross sales and not sales net of redemptions.
- In late 2001, CIF indicated that the eight year investment "churn cycle", implied in The Crocus Investment Fund Act by virtue of the 8 year hold period for Class A shares, was inconsistent with CIF's investment management strategy. Internal discussions at IEDM examined whether CIF was not well served by the new legislative regime or whether CIF's investment strategies and practices should better reflect the legislated rules. IEDM

concluded that the public policy benefits derived from the tax credits depended on the enforcement of the existing rules.

IEDM's Concerns over CIF's Long-term Plans

- IEDM officials indicated that concerns regarding the CIF's longer term investment strategy were frequently discussed with the Fund. They found that CIF's answers were vague and that they always preferred legislative amendment as a solution to their operational problems.
- In mid 2001 CIF outlined in a presentation to IEDM officials its vision for the next 10 to 15 years. IEDM officials indicated that these plans gave rise to policy and practical matters that were discounted by the CIF representative by indicating that the plans had already been cleared by those in higher authority. The policy and practical matters included:
 - That the prospectus should reflect the expansion of the business;
 - That government may wish to consider the nature of the original policy purposes for which tax credits were made available;
 - That government may wish to consider the potential impact on the Manitoba economy of a tax supported financing entity being of \$500 million in assets; and
 - That government may wish to consider the impact on current and future shareholders of CIF changing its risk profile.

IEDM did not believe it worthwhile to further pursue their concerns regarding CIF's plans.

Conclusion

- We concur IEDM is not responsible for CIF's performance. However, there were sufficient "red flags" to justify a detailed review in the latter part of 2002. While such a review may not have identified problems with CIF's valuations and investment performance, it is our view that such a review would have highlighted the gaps between CIF's management and investment practices and the legislated rules. The findings of such a review would have provided IEDM with the support to put CIF on notice that it needed to manage its operations in a manner consistent with its legislation.

4.7.3 Monitoring by IEDM is Focused on Investment Placement and Share Sale Limits

Prior to fiscal 1997 responsibility for monitoring CIF was vested with the Economic Development Board.

OBSERVATIONS

From 1997 to 2000 Investment Placement Information Was Obtained By IEDM, But There Was Insufficient Documented Analysis

- For fiscal years 1997 to 2000, CIF provided information to IEDM regarding its compliance with the placement requirements in the former Manitoba Employee Ownership Fund Corporation Act (presently The Crocus Investment Fund Act) and the Memorandum of Agreement, and related amendments. CIF was free to provide the placement information in the format it desired because IEDM had not prescribed a required format for any of its investment placement information requests.
- For fiscal years 1997 and 1998, we noted that the information requested by IEDM, was not forwarded by CIF in a timely manner, but that IEDM took appropriate follow-up

action to obtain the information. We also noted, however, that for fiscal year 1997, IEDM's request for information did not occur until December 1998, more than a year after the end of fiscal year 1997.

- For fiscal years 1999 and 2000, Department files indicate that only the information provided by CIF was analyzed by IEDM. While CIF maintained that they were in compliance with their investment placing obligations for 1999 and 2000, IEDM was of the view that the basis for CIF's calculations was unclear and that insufficient information was provided to determine whether the 60% maintenance test was met. There was no indication in the file on whether CIF was asked to submit additional information.

Compliance with the 1999 and 2000 Excess Sales Agreements Was Inconsistently Monitored

- The regulations to the Income Tax Act (Manitoba) specify an Approved Share Limit of \$30 million per selling period. Sales in excess of this amount are subject to an Excess Limit Tax. Excess sales were incurred by CIF for the 1999 selling period of approximately \$7.7 million and for the 2000 selling period of \$3.2 million. To avoid having CIF incur the Excess Limit Tax, two agreements dated in 1999 and 2000 were put in place between the Province and CIF wherein:
 - The government agreed, for each of the noted selling periods, to amend the regulation by increasing the Approved Share Limit to \$34 million; and
 - The Fund agreed to invest 75% of the excess sale amounts in eligible investments in which the Fund had not previously invested and for amounts not exceeding \$1.0 million. Such investments were to be made within 18 months of the end of each of the noted selling periods (selling periods end on February 28 of each year).
- In March 2001, CIF provided information to IEDM regarding its compliance with the 1999 Agreement. The information indicated that CIF had invested \$4.0 million. Department files contain no indications of analysis or follow-up to ensure accuracy of the information provided and compliance to the terms of the Agreement.
- With respect to the Agreement for the excess sales in 2000, IEDM never requested any information regarding the Fund's compliance nor did CIF provide the information voluntarily. IEDM believed the agreement was not enforceable and focused its efforts on the investment placement requirements introduced in the 2001 amendments to The Income Tax Act (Manitoba).

CIF Was Not Fully Cooperative Regarding Information Returns For 2001, 2002 And 2003

- In 2001, The Crocus Investment Fund Act and The Income Tax Act (Manitoba) were amended so that pacing requirements were now only included within The Income Tax Act (Manitoba). As well, the Memorandum of Agreement with CIF was terminated as its provisions would henceforth be superseded by the 2001 amendments to LSIF legislation and the passage of a new Auditor General Act. As a result, departmental monitoring efforts now focused on Sections 11.1 to 11.4 of The Income Tax Act (Manitoba). IEDM indicated that focusing monitoring efforts on investment placement requirements is consistent with most other Canadian provinces.
- Section 11.4 of The Income Tax Act (Manitoba) requires that the Fund report annually on its investment pacing using a return containing information prescribed by the regulations. Such a regulation, however, was not in place when The Income Tax Act (Manitoba) was amended.

- In 2002, IEDM developed an information return in conjunction with the Department of Finance and Civil Legal Services, and in consultation with CIF and ENSIS. Although the information return had not been prescribed by regulation, both funds were asked in 2003 to use the information returns to report information for fiscal years 2001, 2002 and 2003. As of February 2005, a regulation requiring the use of the prescribed forms had still not been implemented.
- While ENSIS completed their information returns without assistance from the IEDM, CIF did not. For fiscal years 2001, 2002 and 2003 IEDM completed the information returns for CIF based on information provided by CIF between April and September 2003. IEDM officials noted that the investment placement reports provided by CIF were not a good substitute for the information return developed by IEDM because CIF's reports were not in a format that demonstrated full compliance with the Act or which allowed the calculation of any taxes or penalties owing. The information returns completed by IEDM were forwarded to CIF for signing by the CFO.

Conclusions

- IEDM's monitoring efforts prior to 2001 were inconsistent and insufficiently documented. As a result, we are unable to determine whether IEDM was able to reasonably conclude on whether CIF met its placement obligations for 1997 to 2000.
- IEDM did not effectively monitor CIF's compliance with the investment placement terms of the 1999 and 2000 excess share sale agreements.
- While IEDM ensured that they obtained investment placement information for the fiscal years 2001, 2002, and 2003, they acted inappropriately by completing the prescribed information returns for CIF for fiscal years 1999 and 2000 rather than insisting that CIF complete them.

4.7.4 Eligibility of Investments Not Assessed by the Department

The Act defines eligible investments in order to ensure that Fund investments contribute toward the public policy objectives that underpin The Act.

The information returns for Section 11.4 of The Income Tax Act (Manitoba) itemize each eligible investment made by the Fund in a given year.

An eligible investment is a share in the capital stock of a corporation or a debt obligation of an entity that

- Is a "qualified Manitoba business". A qualified Manitoba business under The Crocus Investment Fund Act is an entity *"that carries on business in Manitoba, has assets of a value less than \$50,000,000 and has a majority of its employees in Manitoba"*;
- Is not an ineligible business as defined in the regulation.

OBSERVATIONS

- IEDM did not independently assess the eligibility of the investments included in the prescribed information return. IEDM noted that they followed-up with CIF if the information provided appeared unusual or unclear.
- Of particular note is that CIF indicated on its information returns for 2001, 2002 and 2003 (all of which were prepared by IEDM in 2003 as discussed in **Section 4.7.3** of this report) that the returns were prepared assuming that the \$50 million asset value

criterion of a qualified Manitoba business referred to “net assets” and not “gross assets”. As such, CIF was advising IEDM that certain of their reported “eligible investments” would not meet IEDM’s “gross asset” interpretation.

- Nevertheless, in September 2003, IEDM concluded, based on the information returns, that CIF had met its pacing and maintenance requirements related to fiscal years 2001, 2002 and 2003 and essentially ignored the uncertainty regarding the eligibility (\$50 million asset test) of certain of the noted investments.
- As noted in **Section 4.5.6** of this report, the cost of investments in companies with gross assets greater than \$50 million was not large enough to have impacted IEDM’s conclusions that the Fund had met its pacing obligations up to 2004. However, the impact of not accepting the Fund’s interpretation of the \$50 million asset test may have a significant impact on the Fund’s ability to meet its 2005 pacing hurdle. This is because the cost of the noted investments would be deducted from the total of investments in place, thus increasing any potential deficiency.
- It is important to note that the Minister does not have the authority to exempt a proposed investment from the asset size rule. This means that retroactive approvals under Section 1(11) of The Crocus Investment Fund Act are not possible should it be determined that CIF’s net asset interpretation will not be accepted.

CIF and IEDM Have Long Differed on Their Interpretations of “Asset Value”

- CIF has been discussing the matter of asset value with the province since the mid-1990s.
- Since 2001, CIF has sought legislative amendments that would change the definition of a “qualified Manitoba business”. CIF argued that the size definition should be based on “net assets” rather than “gross assets”. IEDM, on the other hand, maintained that the size definition referred to a business’s “gross assets”.
- In 2002 the Fund discussed their concerns with the Premier and pertinent ministers.
 - On March 11, 2002, the Fund’s former Chair sent a letter to the Premier of Manitoba requesting a meeting to discuss a number of issues, including how to interpret the \$50 million asset value test. An April 8, 2002 meeting was held between the Fund’s former Chair, the former CEO, the Premier and the Minister of Finance.
 - On May 23, 2002, the Fund sent a letter summarizing its understanding of their discussions. Regarding the asset test, it was noted that the Fund believed, “*our discussion of this matter was very clearly an indication that we share a similar set of intentions regarding the purpose and effect of Fund investments. Either maintaining or further confirming our current approach to the “asset value test” (i.e., That investments are eligible if made in entities that have a net asset value of less than \$50 million) will facilitate appropriately scaled investments and add-ons to current investments that are performing well and require further capital to deepen the impact of further growth.*”
 - On a July 29, 2002, a memo was sent jointly from IEDM’s account manager and a Manitoba Department of Finance analyst to the Ministers of IEDM and Finance, and related Deputy Ministers. It noted:

With respect to the asset size issue, [CIF’s] preference is to have “assets” defined by regulation to mean “net assets.” The term “assets” is not defined in legislation, but the Province has always expressed its view that assets means gross assets. Crocus explained that they already have seven companies in their portfolio that would not

meet a gross asset test, i.e., Companies with gross assets over \$50 million but net assets of less than \$50 million.

In our July 18 memo, we expressed the concern that using a net asset test might create an incentive for Crocus to invest in more highly leveraged companies, and we questioned the CFO on this point. She replied that they always aim to invest in companies that are well-managed and have good prospects for success; one aspect of this is choosing companies with a manageable debt load. Moreover, companies with very strong balance sheets would not need to come to Crocus; they would have adequate options in conventional capital markets. She also explained that a relatively high debt load may overstate risk for certain types of companies, such as leasing firms. We accept these explanations and are now comfortable with this option.

We told Crocus that we would recommend to Ministers that “assets” be defined to mean “net assets” by regulation. Crocus requests that the definition be acknowledged retroactively in a Ministerial letter to cover the investments to date that would be offside with a gross asset rule.

- We found no indication that this recommendation was implemented. A year later a letter to IEDM from CIF dated July 28, 2003 stated that the Fund “was surprised to learn the interpretation given by your Department to government was that Crocus was interpreting the \$50 million asset test wrongly... Since this section of the Act is somewhat ambiguous, we have sought and received confirmation both from external counsel and from government that our interpretation was appropriate over the years. Since the inception of the Crocus Fund, the test has been understood to refer to net assets of \$50 million.”
- IEDM indicated that they never agreed with CIF’s interpretation of the definition of asset but also acknowledged that they did not ensure the matter was dealt with.
- As at February 2005, the matter remained unresolved.

Conclusions

- The eligibility of CIF’s investments was not assessed by IEDM. As a result, ineligible investments may be inappropriately counted towards the fulfillment of the Fund’s pacing requirements. This may compromise the public policy intent of The Crocus Investment Fund Act.
- The Minister responsible for IEDM did not ensure that the issue regarding the interpretation of “asset value” for the purposes of determining a ‘qualified Manitoba business’, an issue that has been in dispute throughout our period of review, was resolved in a timely manner.

4.7.5 Department Misinterpreted the Legislated Pacing Timeframe

OBSERVATIONS

- From the information contained in the information returns, IEDM prepared analyses to determine whether the maintenance and pacing tests were being met. In 2003 IEDM concluded that the maintenance and pacing tests pertaining to fiscal years 2001, 2002 and 2003 had been met. See **Section 4.5** of this report for a detailed discussion of investment placement requirements.
- In reviewing IEDM’s investment placement analysis, we noted that IEDM had incorrectly interpreted the pacing timeframe noted in The Income Tax Act (Manitoba). Simply put,

The Income Tax Act (Manitoba) requires that 70% of the funds raised during a selling period be invested in eligible investments within 31 months of the end of the selling period. To illustrate, for the selling period ending February 28, 2001, the 31 month investment placement period would end on September 30, 2003. The IEDM analysis indicated that the investment placement period ended on September 30, 2004.

- This error likely occurred because The Income Tax Act's (Manitoba) description of the timeframe is difficult to interpret. The pacing obligation is described in The Act as follows:

70% of the total equity raised by the corporation in all selling periods ending after 2000 and at least two years before the beginning of the taxation year in which that month ends.

- We recalculated the pacing obligations pertaining to the selling periods ended on February 28, 2001 and 2002 to reflect the 31 month timeframe. For the noted selling periods, 70% of the accumulated sales proceeds needed to be invested in eligible investments by September 30, 2003 and 2004 respectively. We noted that the investment information provided by CIF continued to indicate that they were well ahead of their pacing obligations for these two selling periods.
- In September 2003, IEDM concluded that the Fund had already met its pacing obligations pertaining to the selling period ending on February 28, 2003. The conclusion was incorrect. Our recalculation indicated that \$54.9 million (70% of the accumulated sales proceeds for 2001, 2002 and 2003) needed to be invested in eligible investments by September 31, 2005 (31 months subsequent to February 28, 2003). However, the information available to IEDM as at September 2003, when their conclusion was expressed, indicated that the Fund had invested \$52.3 million and therefore still had to invest approximately \$2.6 million in eligible businesses.
- As noted in **Section 4.7.4** of this report, we are also concerned that IEDM's conclusions were based on an interpretation of the term "eligible investment" that was inconsistent with the intent of the Act.

Conclusion

- IEDM misinterpreted the legislated pacing timeframe when preparing their pacing calculations. As a result, they over-estimated the timelines available to the Fund to meet their pacing obligations.

4.7.6 Information Supporting the Returns Not Audited or Otherwise Reviewed

OBSERVATIONS

- Section 15.1(1)(b) of The Crocus Investment Fund Act requires that the return of information required under Section 11.4 of The Income Tax Act (Manitoba) be submitted to the Minister of IEDM along with a written statement from the Fund's auditor attesting to the accuracy of the information it contains. Such an attestation report has not been submitted by CIF for any of the 2001, 2002 or 2003 returns of information.
- We noted that CIF has not submitted such attestation reports. Our discussion with IEDM indicated that this provision was not pursued because the prescribed forms were not yet

required by regulation and because the Fund was resistant in completing the prescribed forms.

Conclusion

- By failing to ensure that CIF complied with legislative requirements to provide audit assurance on its returns of information, IEDM relied on information that may have been incomplete, inaccurate and irrelevant.

4.7.7 It Should be Clear How the “Spirit of the Act” is Met in Those Instances Where the Minister Deems an Investment Eligible

From the very beginning of CIF, provisions within The Crocus Investment Fund Act and the Memorandum of Agreement allowed the Minister responsible (currently IEDM) to approve investments that would not otherwise be eligible to be counted toward the Fund’s investment placement requirements. It is important to note that some limitations were imposed on this ministerial authority.

OBSERVATIONS

- Ministerial approval was requested for eight investments since 1995. These included: a sub-fund (which was an ineligible investment under The Act prior to 2001); three companies where the majority of employees were not located in Manitoba; a financial institution; and a leasing company. The total cost of investments where eligibility required Ministerial approval was approximately \$31 million.
- We found that Ministerial approvals for otherwise ineligible investments were obtained without the benefit of explicitly documented analyses on how the proposed investments met the “spirit of The Act”. Such documentation is essential for transparent decision-making.

Conclusion

- By not requiring documented analyses on how a proposed investment met the spirit of the Act, IEDM risked that such investments would not be consistent with the policy initiatives contemplated by The Crocus Investment Fund Act.

4.7.8 The Need to Monitor Compliance with the Requirements of The Crocus Investment Fund Act

OBSERVATIONS

- CIF has many obligations under The Crocus Investment Fund Act.
- However, IEDM was not proactive in determining compliance to The Crocus Investment Fund Act. Of particular note are a number of sections listed in Section 15.6 of The Crocus Investment Fund Act whereby non-compliance by the Fund could result in the Minister of IEDM declaring the Class A shares issued after a specific date as ineligible for the tax credit.
- Key sections of The Crocus Investment Fund Act that should be subject to an annual information return, review and analysis include (* denotes those sections whereby non-compliance could jeopardize the Fund’s tax credit status):

- Section 3.2, Objects of the Fund,
 - Section 4(1)*, Amendment requires Minister's approval – Articles of the Fund
 - Section 11(1), Investment Policies and Criteria,
 - Section 11(2)(b), Restrictions - maximum of 10% of the total fair market value of Fund investment assets in one qualifying Manitoba business,
 - Section 11(2)(e), best efforts to ensure majority of investment assets directly or indirectly promote employee ownership or participation in governance and management,
 - Section 12(1)*, Reserve fund requirements,
 - 15.1(1), Annual statements and returns,
 - Section 15(2)*, Asset valuation,
 - Section 15(4), Report of valuation,
 - Section 15.5*, Monthly reporting re: investment shortfalls.
- While The Crocus Investment Fund Act does not include a section specifically granting IEDM authority to monitor or inspect CIF on annual basis, we believe sufficient provisions were added in 2001 to support an effective monitoring program.
 - Section 15.1(2) provides IEDM with the authority to request reports. The section reads, *"The minister may at any time, by written notice to the Fund, require the Fund to file with the minister a return of information on any subject connected with the business, affairs, assets or liabilities of the Fund that, in the minister's opinion, is relevant to the administration or enforcement of this Act..."*
 - Section 15.3 could provide IEDM with full access to CIF's records and staff by requesting that the Minister designate the account manager in Financial Services as an "authorized person". This would allow IEDM to conduct, or have conducted, periodic operational reviews.
 - CIF has made several suggestions to IEDM that it expand its monitoring effort for all of its economic development initiatives/programs by developing reporting mechanisms that focus on intended outcomes, such as creation of jobs, standards and practices respecting environmental, workplace health and safety and social and ethical screening.

Conclusion

- IEDM was not proactive in assessing CIF's compliance with critical sections of The Act and thereby missed an opportunity to provide assurance to Manitobans that CIF complied with its legislation.

4.8 MONITORING BY THE MANITOBA SECURITIES COMMISSION

LSIFs as Mutual Funds

In 1992 the Manitoba Securities Commission (MSC) did not designate CIF as a mutual fund. This was consistent with the MSC's practice of deeming unconventional funds to not be mutual funds. In 1997, ENSIS was also not designated as a mutual fund.

The non-designation of CIF and ENSIS as mutual funds created a degree of uncertainty regarding the application of certain securities legislation to LSIFs, particularly with respect to the application of the Canadian Securities Association (CSA) National Instrument 81-102, adopted via MSC Policy 81-601. This

national instrument applies to a mutual fund that offers, or intends to offer, securities under prospectus or simplified prospectus.

The Notice that accompanied the publication of NI 81-102 indicated that the instrument would regulate all publicly offered investment funds that fall within the definition of “mutual funds” contained in Canadian securities legislation. **Figure 21** details policy statements and rules that were then applicable to LSIFs.

Effective November 30, 2001, the MSC designated LSIFs to be mutual funds. In January 2003 exemptive relief was granted to LSIFs for a number of provisions under NI-81-102. Exemptive relief was granted where the application of NI-81-102 conflicted with the provisions of The Crocus Investment Fund Act and The Income Tax Act (Manitoba). This treatment was consistent with the treatment of LSIFs by other Canadian regulators. Conflicts occurred in the following areas:

- Incorporation and initial capitalization of mutual funds,
- Investment restrictions on mutual funds,
- The borrowing of money by mutual funds,
- The making of an illiquid investment by mutual funds,
- The lending of money by mutual funds,
- The guaranteeing by mutual funds of debts or obligations of other persons or companies,
- The management or control of other issuers by mutual funds,
- The pricing, sale or redemption of securities of mutual funds,
- Valuation requirements for mutual funds and the calculation of the net asset value of securities of mutual funds.

FIGURE 21

MSC Policy Statements and Rules Applicable to LSIFs	
MSC Policy Number	Title
3.04	Mutual Fund Distributors Supporting Staff & “Know Your Purchaser”
3.06	Range of Trading Permitted Registrants Holding Restricted Registrations
81-105	Mutual fund sales practices.
81-601	Designation of Labour-Sponsored Investment Funds as Mutual Funds and Prospectus Disclosure Requirements of such Funds - Result is that the requirements of NI-81-102 apply to LSIFs - Adopts Ontario Securities Commission Form 45 for LSIF prospectus disclosure requirements - MSC approves Exemptive Relief Application under Section 19.1 of NI 81-102, Application dated January 28, 2002, Approval dated January 14, 2003
81-602	Use of After Tax Credit Performance Data by LSIFs
MSC Rule	
2003-12	Adopts NI 81-102 Mutual Funds and companion policy 81-102CP

4.8.1 Review of CIF’s 2004 Prospectuses (January 2004 & October 2004 Amendment) Focused on Changes from Earlier Documents

The prospectus is the core disclosure document provided to investors and it should contain all of the material information they need in order to make an informed investment decision. Per MSC Policy 81-601, an LSIF prospectus shall be prepared in accordance and comply with the disclosure requirements as set out in Ontario Form 45.

The MSC conducts prospectus reviews in order to:

- Ensure that the prospectus is prepared and is in compliance with Form 45 (form and content review); and
- Ensure that it contains full, true and plain disclosure of all material facts relating to the securities being issued.

It should be noted that the MSC:

- Does not do “due diligence” to ensure the accuracy and completeness of the disclosures. That is the responsibility of the underwriter;
- Does not guarantee the quality or completeness of disclosure in a prospectus; and
- Does not perform merit reviews. It is important to remember that all prospectuses contain a disclaimer that states, *“No securities commission or similar authority in Canada has in any way passed upon the merits of the securities described herein and any representation to the contrary is an offence.”*

Role of issuer and underwriter/agent

- *The issuer and the underwriter/agent are required to certify that the disclosure standards prescribed by securities legislation have been met in the prospectus.*
- *It is the responsibility of the persons potentially liable for the disclosure in the prospectus to perform independent verification of the accuracy and completeness of that disclosure (perform due diligence)*
- *The issuer is strictly liable for misrepresentations in the prospectus.*
- *The underwriter/agent have a due diligence defense – conducted reasonable investigation to ascertain no misrepresentations exist.*

When the MSC is satisfied with a prospectus, they issue what is referred to in The Securities Act as a ‘receipt’.

The CSA prospectus review guidelines state that prospectus reviews would typically focus on issues that could form grounds for receipt refusal. The grounds for receipt refusal indicate areas of the prospectus or features of the offering that merit scrutiny. Section 61(1) of The Securities Act (Manitoba) deals with the criteria to be met for receipt refusal. These criteria are limited to fundamental and substantial concerns related to the business of the issuer, the integrity of principals or the adequacy of the disclosure in a prospectus.

Section 61(1) of The Securities Act (Manitoba) states the following:

- *“The director may in his discretion issue a receipt for any prospectus filed under this Part, unless it appears to him that*
 - a) the prospectus or any document required to be filed therewith*
 - i) fails to comply in any substantial respect with any of the requirements of this Part or the regulations, or*
 - ii) contains any statement, promise, estimate or forecast that is misleading, false or deceptive, or*
 - iii) conceals or omits to state any material facts necessary in order to make any statement contained therein not misleading in the light of the circumstances in which it was made; or*

- b) *an unconscionable consideration has been paid or given or is intended to be paid or given for promotional purposes or for the acquisition of property; or*
- c) *the proceeds from the sale of the securities to which the prospectus relates that are to be paid into the treasury of the company, together with other resources of the company, are insufficient to accomplish the purpose of the issue stated in the prospectus; or*
- d) *any escrow or pooling agreement which the director deems necessary or advisable has not been entered into; or*
- e) *such agreement as the director deems necessary or advisable to accomplish the objects indicated in the prospectus for the holding in trust of the proceeds payable to the company for the sale of the securities pending the distribution of the securities has not been entered into;*
- f) *repealed, S.M. 2001, c.26, s. 22."*

OBSERVATIONS

- Receipt letters were issued for all CIF prospectuses issued within our review timeframe:
 - December 22, 1999,
 - January 16, 2001,
 - July 13, 2001,
 - January 11, 2002,
 - January 23, 2003,
 - January 21, 2004, and
 - October 14, 2004 (amendment).
- Checklists or review programs are not used by the MSC to guide their review effort. The Director, Corporate Finance told us that the analysts:
 - Follow the CSA prospectus review guidelines,
 - Refer directly to Form 45 for the required form and content of the LSIF prospectus, and
 - Exercise professional judgment as to the nature of work performed.
- We reviewed the MSC's review file for CIF's January 2004 prospectus and October 2004 amendment. Because the Fund's prospectuses are filed on an ongoing basis (continuous offering), the MSC focused their review on the changes identified by CIF since the last filing. The Director, Corporate Finance indicated that they follow this approach for all continuous official prospectuses, and that this approach is consistent with the approach used by other securities regulators. We noted that the file included indications that the changes had been reviewed and that the review resulted in a comment letter dated December 30, 2003. The comment letter requested various amendments to the prospectus.
- However, although the Director, Corporate Finance confirmed a prospectus review was done and the requirements of the statute were satisfied, there was no other indication in the file as to how the MSC satisfied itself that the prospectus complied with all required disclosure requirements of Form 45. We noted, except for the matters contained in the comment letter and the issuance of the receipt, that there was no such conclusion by the MSC analyst in the file.

- The Director, Corporate Finance noted that as part of MSC's review of prospectuses, they would review whether material new investments appeared to be consistent with the investment objectives of the Fund. In the past he noted that the MSC had asked questions regarding the eligibility of certain investments. In those instances they were advised by CIF that the investments had been approved by the Minister, as is permitted by The Crocus Investment Fund Act.

Conclusions

- By limiting their review of CIF's January 2004 prospectus to the changes identified by CIF from the 2003 prospectus, MSC could not be assured that full and complete disclosure in accordance with Form 45 had occurred. The review approach applied to CIF was consistent with the approach used by MSC for the review of all renewal prospectuses.
- MSC's review file of CIF did not adequately document the nature, results, and conclusions of their prospectus review process.

4.8.2 Required Financial Information was Monitored for Timely Receipt and Compliance with GAAP

OBSERVATIONS

- On an ongoing basis, the MSC's review of the semi-annual financial statements and annual audited financial statements submitted by CIF was limited to ensuring:
 - That the required statements were filed on a timely basis; and
 - By reference to the auditor's report attached to the annual financial statements, that the statements were prepared in accordance with GAAP.
- The Director, Corporate Finance advised us that the MSC has no concerns regarding the timeliness with which CIF submitted their financial statements, with the sole exception of September 2004.
- No analytical review procedures are performed by the MSC until an organization is selected for a continuous disclosure review (see **Section 4.8.4** of this report).

Conclusion

- Required financial information is monitored by MSC for timely receipt and compliance with GAAP.

4.8.3 Compliance Review of Crocus Capital Inc. in December 2000 Was Well Performed

Compliance reviews are conducted pursuant to Part V of The Securities Act. Subsection 35(1) of Part V provides the MSC with the right to examine, at any time, the financial affairs or business operations of registrants. Subsection 35(2) further provides that such an examination may include records of every description of the person or company whose financial affairs or business operations are being examined.

MSC's 2004 Annual Report states, *"the Compliance Officer performs ongoing reviews of the operations of persons and companies registered with the Commission to ensure they are conducting business in a manner that does not pose a risk to the public. This is done through the review of financial reports submitted by*

registrants and by performing compliance examinations. Compliance reviews are an effective way of identifying risks before there is a loss to investors”.

OBSERVATIONS

- In December 2000 a compliance review of Crocus Capital Inc. was conducted.
- Our review of the MSC file indicated that the compliance review was reasonably planned, conducted, supervised and documented.
- A management letter was issued on January 8, 2001. The letter stated that MSC was satisfied with Crocus Capital Inc.’s compliance with The Act except that the suitability of the trades was only being spot-checked. MSC Order 3173, issued on December 12, 2000, required that each trade of shares through Crocus Capital Inc. be reviewed for suitability by a Senior Officer. In its response, Crocus Capital Inc. indicated that, commencing in 2001, trades would be processed on line and reviewed on line.

What is meant by Suitability?

The following is the Crocus Capital Inc. corporate compliance policy on suitability:

The Compliance Officer is responsible for the daily review of subscriptions as it relates to suitability.

Simply defined, suitability is an assessment of the degree of compatibility (similarity) between a client’s stated investment objectives and the Shares.

The Shares are generally for long term investors, as sale, transfer or redemption of the Shares are generally prohibited during the period which is eight years from the date of subscription (the Hold Period). The Shares are speculative, as they are not insured by the Canada Deposit Insurance Corporation or any other insurer. Dividends are not paid regularly, if at all.

Sales representatives must consider the ability of the investor to make the initial transaction and to maintain it. While the investment might initially seem appropriate (due to tax deductions or tax credits) the longer term viability of the investment for the investor should especially be considered.

The Compliance Officer, as part of his trading review process, will advise the sales staff of those accounts found to have incompatible investment objectives or risk tolerance levels versus the Shares. Where the Compliance Officer determines that the Shares are not suitable investment for a particular client, the client’s subscription will be rejected.

- The MSC also required answers to four follow up questions. Crocus Capital Inc. responded by letter dated February 14, 2001. The letter, however, did not satisfactorily address all of the MSC’s enquiries.
- Follow-up was performed by MSC in December 2001 as part of the order renewal process. A Crocus Capital Inc. response dated January 17, 2002 addressed satisfactorily all of MSC’s remaining questions.

Conclusion

- The MSC conducted an appropriately detailed compliance review of Crocus Capital Inc.

4.8.4 The 2003 and 2004 Continuous Disclosure Reviews

In 2003, the MSC announced by way of Notice 2003-19 its intent to conduct continuous disclosure reviews. The Director, Corporate Finance advised us that few other jurisdictions in Canada perform continuous disclosure reviews and there is no legislative requirement that continuous disclosure reviews be performed. The Notice referred to three different types of continuous disclosure reviews, the two more significant types being Full Reviews and Issue-Oriented reviews. In a mutual fund context:

- A **Full Review** would include a comprehensive examination of the investment fund's entire disclosure record, including financial statements for a minimum of two years. In addition to all prescribed regulatory filing, the MSC may review other materials that are aimed at investors such as the fund manager's website, newsletters and marketing brochures.
- An **Issue-Oriented Review** would focus on particular topics which could include valuation, compliance with investment objectives, compliance with conditions of orders, and incentive fee disclosure.

The Director, Corporate Finance indicated that up until two or three years ago, none of the securities commissions in Canada critically examined continuous disclosure documents. Heavy reliance was placed on the financial statement auditors, management and Boards of Directors for compliance with continuous disclosure rules. The Director, Corporate Finance, noted that the CSA realized that while review efforts had historically focused on the prospectus, a document aimed at the primary market (new share offerings), the primary market represented only 3% of security transactions. They concluded that it was inappropriate to focus entirely on primary distributions and that more resources should be allocated to continuous disclosure reviews. This change led to the development of national continuous disclosure standards, namely 51-102 Continuous Disclosure Obligations which came into effect in 2003, and 81-106 Investment Fund Continuous Disclosure which will take effect in June 2005. The latter will impose a more onerous reporting regime on all investment funds, including LSIFs.

OBSERVATIONS

Nature and Extent of Work Performed was Not Well Documented

- On April 28, 2003 the MSC advised CIF of its intent to conduct a continuous disclosure review. Excluding the 2000 compliance review of Crocus Capital Inc, this is the first general or issue driven review conducted at CIF.
- According to the Director, Corporate Finance, the two LSIFs were selected as the first two Continuous Disclosure Reviews conducted by the MSC. They were selected because of their high profile and importance to the local capital markets.
- The CIF review focused on the continuous disclosure documents required by legislation, as well as a review of the Fund's website.
- At the time of the review, the continuous disclosure obligations of CIF were limited to annual financial statements, interim financial statements, and proxies to shareholders. The continuous disclosure documents reviewed by the MSC were:
 - Interim financial statements for March 31, 2001 and 2002;
 - Annual audited financial statements for September 30, 2001 and 2002;
 - Annual proxy materials for the 2002 Annual General Meeting.
- On July 2, 2003 upon completion of their initial review procedures, the MSC issued a comment letter to CIF requesting:

- Clarification on a number of points raised from their review of the interim and annual financial statements;
 - Additional information be included in their financial statements;
 - A minor amendment to the information included on the website;
 - Market values for each of the Fund's investments as at September 30, 2002 and March 31, 2003; and
 - Board committee minutes for the Investment Committee, Labour Affairs Committee, Finance and Audit Committee, and the Valuation Committee for 2001 and 2002.
- CIF responded shortly thereafter providing the clarification requested and indicating that the noted amendments to the financial statements would be considered.
 - We examined the MSC review file and noted that no conclusions were expressed on the quality of the continuous disclosure documents reviewed. We also noted that a review program or checklist was not used by the analyst. As such, it was not clear what criteria the MSC used to evaluate the continuous disclosure documents.
 - The Director, Corporate Finance advised that with respect to the financial statements the analyst was looking for compliance with GAAP, for questionable accounting policies, for the adequacy of the disclosures within the statements and for overall presentation. These areas are consistent with the questions raised by the MSC comment letter dated July 2, 2003.
 - However, we noted that there are no guidelines or other material to assist the analysts regarding their evaluation of the application of GAAP. Topic areas could include: accounting principles where manipulation can occur; the identification of red flags regarding suitability or appropriateness of accounting practices; and accounting policy and presentation options.
 - The Director, Corporate Finance advised that regarding the annual proxy material the analyst was primarily looking for appropriate executive compensation disclosure. No indication was found in the file on what was done in this area.
 - The file included no references to the web-site or any printed screens to indicate the extent to which material on the web-site was reviewed.
 - According to the Director, Corporate Finance the new continuous reporting requirements for mutual funds (NI 81-106) that will come into effect on June 1, 2005 will make the continuous disclosure reviews for LSIFs more meaningful because the reporting requirements include management comments on performance and more stringent requirements for independent valuations. The Director, Corporate Finance, advised that they had originally intended to implement continuous disclosure reviews in conjunction with the release of NI 81-106. However, the release of NI 81-106 is about a year and a half behind schedule.
 - The Director, Corporate Finance indicated that the CSA is working on developing a national continuous disclosure review process that would be linked to NI 81-106. It is expected that this will bring much more rigor and structure to the MSC's process used in Manitoba.

Board Minutes Contained Information that Could Have Prompted Earlier Enquiries by the MSC

- As part of the 2003 continuous disclosure review comment letter dated July 2, 2003, the MSC requested copies of CIF Board committee minutes for 2001 and 2002. CIF challenged MSC's access to this information as being beyond the scope of a continuous disclosure review. As a result, MSC invoked Part V of their Act. CIF forwarded the requested minutes, and included the minutes for 2003, on April 5, 2004.
- According to the Director, Corporate Finance, the MSC requested the minutes because valuations were identified as the highest risk area and they wanted some assurance that valuations were being done as noted in CIF's prospectuses and that the Valuation Committee of CIF was reviewing and approving the valuations.
- There was no documentation in the file as to what specifically the MSC was looking for when reviewing the minutes. The only working paper dealing with the review of the minutes (other than the minutes themselves) states, *"A general review of the submitted minutes, for the Investment, Labour Affairs, Finance and Audit, and Valuation Committees were completed and no significant items were noted for follow-up."*
- Per our review of the CIF Valuation Committee minutes provided to the MSC, the following matters were discussed in the minutes:
 - Amendments to the CIF policy on requiring external valuations once every three years for all of its equity investments. In the minutes CIF management discounts the need for such reviews because of their in-house expertise.
 - There is a pattern of deferring in-house valuations from one quarter to the next.
 - The 2002 change in governance structure to greater use of committees resulted in the full Board approving valuations well after weekly share prices were issued.
 - A September 2002 portfolio write down of \$1 million was not reflected in the share prices until a later date.

Limited Review of Market Value Information

- As part of the 2003 continuous disclosure review comment letter dated July 2, 2003, the MSC requested market values for each individual investment as at September 30, 2002 and March 31, 2003. The Director, Corporate Finance, explained that while LSIFs are allowed to report market values in the aggregate, MSC had advised CIF that as a part of their prospectus review, they wanted to see market values for each of the individual companies. The Director, Corporate Finance, advised that analysts look for anything unusual; including significant overstatements or understatements, based strictly on the knowledge the analyst may have obtained through general sources such as the media. If something appears out of line, they would follow up.
- We noted that the market values for each investment as at March 31, 2003 and September 30, 2002 were provided by the Fund. No indication, however, was found in MSC's file that the information was reviewed or analyzed.
- The file also includes a schedule of the CIF Weekly Share Prices from September 1, 2002 to August 29, 2003. Some analysis is evident because MSC identified the points at which CIF share prices increased or decreased by more than 10 cents. The MSC noted that the differences occurred at quarter or year ends. There was no indication of any other follow-up.

- We noted that the MSC received the CIF Board approved weekly valuation certificates. The Director, Corporate Finance advised that these certificates are not required to be submitted to the MSC. CIF has been filing them voluntarily. MSC simply files the certificates when they are received. They do not monitor the receipt of the certificates, therefore they would not be aware, on an ongoing basis, if the certificates were late or not filed.

Second Continuous Disclosure Review Began in October 2004

- MSC notified CIF on October 26, 2004 of its intent to conduct a continuous disclosure review focusing on the areas of valuation and marketing and requested a number of documents.
- Per the Director, Corporate Finance, the MSC decided to conduct a second Continuous Disclosure Review in response to the significant write-down in the net asset value of the Fund on September 24, 2004 and the concurrent departure of the Fund's former CIO. These were considered material events. The regulatory concern was not that there was a write down, but rather, whether the valuation processes as described in their prospectus had been followed and whether timely disclosure of the events had occurred. MSC wanted to know if the write down had occurred because of a single event or because of issues at more than one portfolio company. The Director indicated that there could be many reasons for the write down that would be appropriate and that would not have required further MSC action.
- CIF responded to the October 26, 2004 MSC requests on November 23, 2004. However, the information provided was incomplete. On December 10, 2004, the MSC requested the missing information and added numerous other information requests which stemmed from their review of the material provided by CIF up until then.
- On December 10, 2004, CIF requested that the selling and redemption of CIF shares temporarily cease.
- The continuous disclosure reviews lead to the MSC opening an investigation and the commencement of enforcement action.

Conclusions

- We commend the MSC for beginning to perform continuous disclosure reviews in 2003. Our observations indicate that there are several ways that these reviews and the documentation thereof could be made more robust. We noted that the MSC's review of CIF's Board minutes in April 2004 did not result in further MSC enquiries at that time. Sufficient information regarding valuation concerns were noted in the minutes and could have prompted the MSC to make more timely enquiries. MSC began a second continuous disclosure review in October 2004 in response to the significant September 2004 valuation write-down reported by CIF.
- A very limited review was performed on market value information and the weekly share prices. Given that company valuations are largely determined by internal CIF processes, and MSC acknowledgment that valuation was a high risk area, additional scrutiny of the valuation processes and their application to a sample of companies was in order, particularly in light of the information contained in the minutes reviewed by the MSC.

4.8.5 Advertising Only Reviewed if Complaints are Received

OBSERVATIONS

- The Director, Corporate Finance, indicated that since inception, there have been a number of issues with respect to the advertising campaigns of both LSIFs. In the opinion of the MSC, CIF has, in the past, run advertising and promotional campaigns which were clearly in violation of Part 15, Sales Communication and Prohibited Representations of NI-81-102. Specifically, the MSC received complaints against CIF which alleged that its advertisements were misleading (whether direct or implied), overly promotional and unbalanced in not presenting the cons as well as the pros of investing in LSIFs.
- In late 2000, the MSC sought compliance by CIF with Part 15 of NI-81-102 and CSA policy on the Use of After Tax Credit Performance Data.
- Most recently, in February 2004 MSC requested that CIF stop using the marketing phrase “make a profit and a difference”. A phrase that CIF was using since November 2002. According to the Director, no formal follow-up of the request was undertaken, but indicated that the MSC met with representatives from both LSIFs in the fall of 2004 with respect to advertising in general.

Conclusion

- The MSC does not routinely monitor advertising by registrants but will review promotional material if a complaint is received or as part of a continuous disclosure review and as part of compliance reviews of registrants.

5.0 Recommendations

5.1 FOR THE DEPUTY ATTORNEY GENERAL AND THE MANITOBA SECURITIES COMMISSION

Regarding Possible Contravention of The Criminal Code, The Securities Act, and The Crocus Investment Fund Act

In conducting our examination, we considered the following provisions of the Criminal Code, The Securities Act and The Crocus Investment Fund Act:

THE CRIMINAL CODE

Fraud/Affecting Public Market

As per Section 380(1) of the Criminal Code:

Every one who, by deceit, falsehood or other fraudulent means, whether or not it is a false pretence within the meaning of this Act, defrauds the public or any person, whether ascertained or not, of any property, money or valuable security or any service:

- (a) is guilty of an indictable offence and liable to a term of imprisonment not exceeding ten years, where the subject-matter of the offence is a testamentary instrument or the value of the subject-matter of the offence is a testamentary instrument or the value of the subject-matter of the offence exceeds five thousand dollars; or*
- (b) is guilty*
 - (i) of an indictable offence and liable to imprisonment for a term not exceeding two years, or*
 - (ii) of an offence punishable on summary conviction,*

where the value of the subject-matter of the offence does not exceed five thousand dollars.

As per Section 380(2) of the Criminal Code:

Every one who, by deceit, falsehood or other fraudulent means, whether or not it is a false pretence within the meaning of this Act, with intent to defraud, affects the public market price of stocks, shares, merchandise or anything that is offered for sale to the public is guilty of an indictable offence and liable to imprisonment for a term not exceeding ten years.

False Prospectus

As per Section 400 of the Criminal Code:

- (1) Every one who makes, circulates or publishes a prospectus, a statement or an account, whether written or oral, that he knows is false in a material particular, with intent*
 - (a) to induce persons, whether ascertained or not, to become shareholders or partners in a company,*
 - (b) to deceive or defraud the members, shareholders or creditors, whether ascertained or not, of a company, or*
 - (c) to induce any person to*
 - (i) entrust or advance anything to a company or*
 - (ii) enter into any security for the benefit of a company,*

is guilty of an indictable offence and liable to imprisonment for a term not exceeding ten years,

- (2) *In this section, “company” means a syndicate, body corporate or company, whether existing or proposed to be created.*

Counselling Offence That Is Not Committed

As per section 464 of the Criminal Code:

Except where otherwise expressly provided by law, the following provisions apply in respect of persons who counsel other persons to commit offences, namely,

- (a) every one who counsels another person to commit an indictable offence is, if the offence is not committed, guilty of an indictable offence and liable to the same punishment to which a person who attempts to commit that offence is liable; and*
- (b) every one who counsels another person to commit an offence punishable on summary conviction is, if the offence is not committed, guilty of an offence punishable on summary conviction.*

THE SECURITIES ACT

“Quasi-Criminal Liability”

The Securities Act provides that a director or officer who “authorized, permitted or acquiesced in” the preparation of a preliminary prospectus or a prospectus that does not contain the prescribed information or that contains any information that, at the time and in light of the circumstances in which it is made, is false or misleading with respect to any material fact, or that omits to state any material fact the omission of which makes the statements contained in it false or misleading, commits an offence and on conviction is liable to a fine of not more than \$1,000,000 or to imprisonment for two years or to both.

Civil Liability – The Meaning of “Material False Statement” and the Expansion of Remedies

The Securities Act imposes a rigorous standard of responsibility and liability upon the Fund and its directors and on the officers of the Fund who sign the prospectus. In summary, it provides that where a prospectus contains a “material false statement”, each purchaser is deemed to have relied on the material false statement and has a remedy against the fund.

“Material false statement” can be defined as meaning:

- (a) an untrue statement of a material fact, or
- (b) an omission to state a material fact that is required to be stated or that is necessary to make a statement not misleading in light of the circumstances in which it was made.

Thus, the term comprises not only errors and incorrect statements, but also omissions and misleading statements. This extended meaning underlines the basic responsibility to provide full, true and plain disclosure of all material facts.

THE CROCUS INVESTMENT FUND ACT

Offences

15.4(1) A person who

- (a) makes a false or misleading statement in any document filed with the minister under or for the purposes of this Act or the regulations; or
- (b) interferes with an inspection, audit or investigation by an authorized person under section 15.3;

is guilty of an offence and is liable on summary conviction

- (c) in the case of an individual, to a fine of not less than \$1,000 and not more than \$20,000 or imprisonment for a term of not more than two years, or both; and
- (d) in the case of a corporation, to a fine of not less than \$5,000 and not more than \$100,000.

Offence by Fund

15.4(2) If the minister notifies the Fund of its failure to comply with a requirement under this Act or sections 11.1 to 11.5 of The Income Tax Act to file or provide, or to produce for inspection, a record, report, return, statement or other information, and the Fund does not comply with that requirement within 30 days after receiving the notice, the Fund is guilty of an offence and is liable on summary conviction to a fine of not less than \$5,000 and not more than \$100,000.

Recommendations

DEPUTY ATTORNEY GENERAL

- That the Deputy Attorney General review this report and make an assessment as to whether certain matters should be referred to the appropriate law enforcement agency for criminal investigation. In particular:

With respect to Section 380(1) and Section 400 of The Criminal Code, we refer the Deputy Attorney General to **Section 4.0** of this report;

With respect to Section 464 of The Criminal Code, we refer the Deputy Attorney General to **Section 4.0** of this report; and

With respect to Section 15.4(1) of The Crocus Investment Fund Act we refer the Deputy Attorney General to **Section 4.0** of this report.

- That the Deputy Attorney General review this report and make an assessment as to whether CIF transactions and involvement with two portfolio companies should be referred to an appropriate law enforcement agency for criminal investigation.

Response from the Deputy Attorney General

The issue for consideration by this department is whether there is a proper basis to refer this matter to a police service for criminal investigation. In the circumstances, I have concluded that it is preferable to have an assessment of this issue undertaken by counsel who is completely independent of the Government of Manitoba and who is unfamiliar with any of the players referred to in your report. For that reason, we have approached the Ministry of the Attorney General for the Province of Ontario, who has agreed to appoint independent counsel to review your report and provide advice on whether the matter ought to be referred to the police.

MANITOBA SECURITIES COMMISSION

- That the Manitoba Securities Commission (MSC) review the report and assess whether there have been any violations under The Securities Act warranting further action by the MSC. In particular, we refer the MSC to **Section 4.0** of this report to assess whether there are any material false or misleading statements in CIF's prospectuses, financial statements and other public communications.

Response from the Manitoba Securities Commission

A Notice of Hearing and Statement of Allegations naming CIF and certain directors was issued by MSC staff on April 4, 2005. These are allegations made by MSC staff and have not been proven at a hearing.

At the time of the issuing of these hearing documents the Director – Enforcement publicly confirmed the MSC's investigation of CIF was ongoing and that further enforcement action may result from the investigation. The Director – Enforcement also stated that as part of the ongoing investigation MSC staff intended on reviewing both this report as well as the independent report on corporate governance sought by CIF.

MSC Staff accept the recommendation to review this report in the context of its continued investigation of CIF.

5.2 FOR THE PROVINCE OF MANITOBA

Recommendations

RESULTING FROM EXAMINATION OF CIF

- That in light of the current challenges facing the Crocus Investment Fund and the observations contained in this report, the Province establish a review process to consider:
 - The impact of this situation on the Province's monitoring role; and
 - Whether there are any beneficial changes to The Crocus Investment Fund Act and The Labour-Sponsored Investment Fund Act that may be required.
- That should a review be conducted, the following be considered:
 - The continued need for an Investment Advisory Committee in LSIFs in light of the fiduciary responsibilities held by Board members serving on the Investment Committee of an LSIF;
 - Amending The Crocus Investment Fund Act to base the calculation of the 10% rule on the cost of investments and not value. Changing both the numerator and denominator to "cost" would prevent the Fund from manipulating the timing or results of valuations to affect the 10% calculation. This would better protect shareholders from the risk of catastrophic loss by restricting the amount of capital the Fund could invest in any one business;
 - Amending the provisions of The Income Tax Act regarding maintenance, pacing, and small business investing with a view to simplifying and clarifying these provisions. To help ensure clarity and to facilitate monitoring for compliance, regulations should be developed that include forms for reporting compliance by LSIFs;
 - Amending The Crocus Investment Fund Act to clearly define "Investment Assets"; and
 - Amending The Crocus Investment Fund Act to clarify the understanding of Section 3(2) of The Act as read in conjunction with the definition of a "qualified Manitoba business entity".
- That the Province address the perception of conflict of interest by appointing individuals other than government employees as its representative on LSIF Boards, unless there is reporting back to the Province from a monitoring perspective.

Response from the Province

Successive governments in Manitoba have supported the goals of labour sponsored investment funds and the role they play in business development and job creation in Manitoba. Indeed, the model of establishing, in cooperation with labour, privately managed pools of risk capital for the benefit of local economic development has been employed by governments across Canada at both the provincial and federal levels.

The findings of the Auditor General's report on the Crocus Investment Fund sadden and trouble this government. We are saddened because over 33,000 Manitobans may realize a

significant reduction in their investments because of the practices pursued by the Fund. We are troubled and disappointed by the findings of this report that the Fund failed to meet its obligations to shareholders.

We will be acting expeditiously to implement the recommendations for government contained in this report. As a first step we will introduce legislation to address the issues of board governance, accountability of senior management and the board, and the completeness of information provided to shareholders and prospective shareholders with regard to labour-sponsored investment funds.

Following the recommendation of the Auditor General, we have engaged an independent outside prosecutor to review the issues outlined to determine the legal action required. We have contacted the Canada Revenue Agency to review the concerns regarding appropriate reporting of taxation and income.

In addition we will establish an implementation team, led by a senior government official and a respected private citizen, to consult widely and oversee implementation of the report's recommendations to government. An essential part of its task will be to clarify the respective roles and responsibilities of:

- the Fund and its Board with respect to managing the Fund in the interest of shareholders;*
- the Manitoba Securities Commission with respect to monitoring the integrity of valuation and other disclosures in the trading of shares; and*
- the Province with respect to monitoring how well the Fund is meeting the public policy objectives enshrined in legislation.*

Hearings have already been scheduled by the Manitoba Securities Commission to investigate many of the findings outlined in this report. Additional issues raised by the Auditor General regarding valuation and other disclosures will also be referred to the Securities Commission for review. The Province will support the Securities Commission in implementing the report's recommendations to improve its capacity in monitoring compliance with the disclosure requirements of The Securities Act.

We acknowledge that more can and should be done by the Province to improve monitoring of how well the Fund is meeting the public policy objectives enshrined in the legislation governing labour funds. While the report finds the Department of Industry, Economic Development and Mines is not responsible for the Fund's performance, we are committed to making the recommended improvements to monitoring of legislated policy objectives.

Finally, this is a significant report representing many hours of work by the Auditor General's Office, the current officers and staff at the Crocus Investment Fund and government officials. Much will need to be done to restore public confidence in this fund and to fulfill its original promise articulated by the Premier of the day, who said in 1992: "We brought it in, Mr. Speaker, because it made good sense...to work cooperatively with labour to form yet another capital pool to help encourage the creation or the enhancement or the consolidation of business in Manitoba and jobs in Manitoba."

5.3 FOR THE CROCUS INVESTMENT FUND

Recommendations

GOVERNANCE (SECTION 4.4)

- That the Board develop a comprehensive action plan to reform and renew their governance, direction and oversight of the Fund. The plan should take into account the results of the recent governance study commissioned by the Board and incorporate the recommendations below.
- That the Board reassess its Committee structure and ensure that Committee mandates and specific responsibilities are clearly defined and appropriately fulfilled.
- That the Board establish a clear set of competencies and guidelines for the future recruitment of Board members, including the potential for increased Class A shareholder representation on the Board by individuals who are independent of the sponsor's organizations. Board members with venture capital knowledge and expertise would be very beneficial to the Fund. It would be beneficial if the Board Chair was not a director or officer of the Sponsor or any institutional stakeholder or of any related organizations. This would also extend to the Chair of the Board also not being an employee of any sponsor, stakeholder, or any related organization.
- That the Board establish term limits to encourage continuous renewal of Board members.
- That the Board develop a formal orientation program for all new members to position them to govern and understand the key strategic and financial risks of venture capital operations.
- That the Board establish regular training and development opportunities for its members in areas that would enhance effective governance.
- That the Board develop documented policies and procedures in key operational areas, and adopt monitoring practices to ensure that management complies with Board policies.
- That the Board actively engage with management in the development of a strategic plan, in consultation with key stakeholders, and hold management accountable for achieving the strategic plan.
- That the Board meet on a regular enough basis to allow it to make decisions in a timely manner. Board authority and responsibility for decision-making should be retained even when certain activities are delegated to committees.
- That the Board, in consultation with the Province, review the continued need for an Investment Advisory Committee in light of the responsibilities held by the Board's Investment Committee.
- That the Board identify the governance information it requires to fulfill its governance responsibilities, and ensure that management provides such information in an understandable format that facilitates the Board's decision-making.
- That the Board conduct an annual formal performance evaluation of its CEO, with input from all Board members. Such annual evaluations are an opportunity for the Board to

assess Senior Officers' performance against plans, adherence to Board policies, and ensure that annual objectives are achieved.

- That the Board approve the expenses of the CEO. This may be done, on the Board's behalf, by the Board Chair or the Audit Committee.
- That the Board conduct periodic Board evaluations to address strengths, and opportunities for improvement in its governance practices.
- That the Board implement a "whistle blower" policy and guidelines to provide employees with access to Board members. Issues of concern that affect the operations of CIF could be raised without fear of retribution.

INVESTMENT MANAGEMENT PROCESSES AND PROCEDURES (SECTION 4.2)

Investment Strategy (Section 4.2.3)

- That the Fund prepare detailed cash budgets for approval by the Board at least annually, and on a monthly or quarterly basis while liquidity issues remain a problem. The technique known as triangulation (developing upside, base and downside cases) should be done and considered before action plans arising out of the cash budget process are determined.
- That a strategic or longer-term cash budget be prepared annually, vetted against the Fund's investment strategy, and approved by the Board.
- That the Fund establish:
 - A policy of attempting to partner with proven, substantial and independent third party co-investors for all new and incumbent portfolio company investments. If a co-investor cannot be found, the reasons should be documented in the Investment Memorandum and brought to the attention of the Investment Committee and the Board as a whole; and
 - A policy regarding the disposition of investments to non-Manitobans. The policy should specifically address the circumstances under which a divestiture will be made to a party residing outside of the Province, taking into consideration the Fund's objective of capital retention in Manitoba.
- That CIF adopt an investment policy setting out the circumstances where a guarantee would be justified as part of an investment commitment. The policy should restrict the use of guarantees in most circumstances and limit the term of the guarantee to short term use. Prior to approval, guarantees should be assessed using the same due diligence processes used for cash investments. All risks should be assessed and clearly disclosed.
- That detailed reports summarizing guarantee exposure be reported to the Board regularly.
- That flexible target selling prices be set from time-to-time on publicly-listed portfolio company investments.
- That the investment be monitored against that target on a regular basis in order to decide whether to sell or hold against that target in light of circumstances at the time.

- That CIF adopt an investment policy whereby the acceptance of in-kind contributions instead of cash from co-investors is rare.
- That CIF's executive management and senior investment staff become actively involved in the Canadian Venture Capital Association (CVCA) and the Association of Labour-Sponsored Investment Funds (ALSIF).

Portfolio Construction (Section 4.2.4)

- That portfolio planning be performed by the Senior Officers. The portfolio plan should then be presented to, and approved by, the Board on a regular basis. This could be monthly, quarterly or annually depending upon the circumstances the Fund is facing at any given point in time.
- That the Fund, as an integral part of portfolio planning, analyze and assess its venture investment portfolio in terms of balance and diversification against the criteria discussed in this section including cash management and investment pacing. Because portfolio construction is ultimately a long term matter, portfolio planning should be part of the Fund's strategic plan.

Staffing Adequacy (Section 4.2.5)

- That since investment management processes and procedures are only as good as the people involved in managing and being managed, initiatives to encourage investment staff to remain with the Fund be undertaken immediately.
- That CIF consider establishing a long term performance-based incentive compensation plan for certain senior investment staff and perhaps others. Such changes may help retain key people and attract others needed to fully equip the Investment Department for the challenges ahead.
- That proper supervision and training of investment staff be made an ongoing priority.

Initial Screening and Selectivity (Section 4.2.6)

- That the primary screening objective of every investment be its rate of return given that the prospectus states that the primary objective of the Fund is to achieve long term capital growth in the value of its investments.
- That although a CIO is ultimately accountable for the decisions of an Investment Department, one individual should not have sole responsibility for developing deal flow and making selections regarding what investment opportunities to pursue.
- That experienced investment staff be encouraged to develop quality deal flow contacts of their own, including possible co-investment partners, and to pursue investment opportunities until ultimately declined or approved.
- That the senior investment staff person responsible for writing up an Investment or Valuation Memorandum sign the document along with any other more junior investment staff that may have worked on the memo. The document should be addressed to the writer's superior and/or the approval committee in question. The writer would be the deal champion and the individual responsible for the ongoing account management and monitoring of the investment.

Due Diligence (Section 4.2.7)

- That the Fund amend its process and procedures to ensure that the due diligence performed on each investment opportunity and each follow-on for a portfolio company is well-organized, with at least two appropriate investment staff doing the work.
- That assistance of industry experts be obtained during due diligence when necessary to complement existing staff expertise.
- That due diligence files and other documentation be retained in case it is needed at a later date (including for litigation purposes).

Investment Approvals (Section 4.2.8)

- That investment approval protocols be redeveloped in light of the challenges facing the Fund. The CIO's and CEO's discretion to fund new and follow-on investments without Board approval should be reduced to \$100,000.
- That there be separate protocols developed for dealing with problematic portfolio companies and potential conflict-of-interest situations.
- That CIF adopt an investment policy requiring that the deal transacted always be materially consistent with the deal approved, and that material changes from the approved deal be communicated to the CEO and to the Board for their comments and required action prior to funding.

Initial and Follow-on Financings (Section 4.2.9)

- That at initial funding, and at every follow-on financing, a recommendation to support and obtain approval for an investment be for an amount that fully funds against an exit horizon, milestone, or stage of development as set forth in a portfolio company's initial, annual or otherwise relevant business plan. If a co-investor is involved, such arrangements would be the same for that co-investor.
- That a more customized, more rigorous approach to follow-on approvals, particularly for problematic portfolio companies, is needed.
- That under certain circumstances, for portfolio company investments which are performing badly, a more customized approach involving more than just CIF investment staff and executive management involvement be developed. Increased governance in terms of extra reporting and approvals would be valuable. As well, consideration should be given to supplementing CIF resources with outside professionals to deal with particularly difficult portfolio companies.

Documentation and the Use of Puts (Section 4.2.10)

- That the Fund adopt an investment policy of obtaining stronger legal provisions in its agreements to enter into a venture investment. The Fund should insist on striking a fair but firm bargain that includes the use of puts, wherever feasible, when it advances funds. The use of a put may be useful in forcing an exit when an exit is desired.
- That regular training sessions be conducted to help investment staff understand all facets of the legal documentation that govern CIF's investments.

Account Management and Monitoring (Section 4.2.11)

- That CIF ensure that investment professionals involved in significant areas of the investment process have a reasonable level of industry sector investment expertise.
- That on a limited basis, for certain investment opportunities where the expertise does not exist in the Investment Department, an independent industry expert be hired to assist with due diligence and other work. Alternatively, an experienced co-investor known to have specific industry sector experience can also help assess the merits of an investment opportunity.
- That the Board thoroughly follow-up on problem portfolio companies. Sufficient documentation should be prepared by the Investment Department to help the Board understand the problems identified and the remedial action taken and to be taken.
- That the Board ensure that account management and monitoring processes are reviewed semi-annually, with reports being provided to the Board, through the Finance and Audit Committee, for approval.
- That account management and monitoring plans and other important considerations be documented in each Investment memorandum, and updated as to progress and status in Valuation Reports.
- That the Fund consider expanding the substance of the Watchlist reports that are now prepared for portfolio companies that are not performing in accordance with expectations. Such expanded reports, prepared on a quarterly basis, would provide an update and comment on many of the account management and monitoring considerations, including problems identified and remedial action taken and to be taken. An interim view as to the appropriateness of the carrying value of the portfolio company would be included, as well.
- That terms and conditions set in place at the time of funding be enforced by the investment staff member responsible for managing the particular portfolio company. Failures to comply with contracted terms and conditions must be taken seriously and considered to be a sign that the investment may be either headed for or is in trouble. Reporting deficiencies should be routinely reported in Watchlist reports.

Valuation (Section 4.2.12)

- That when valuation decisions are made all of the necessary information be available and put forward to the decision-makers. It is necessary that CIF ensure proven investment and valuation experience is applied with common sense. Emphasis should be placed on valuation rigour and ensuring necessary information is received on a timely basis from portfolio companies.
- That Watchlist reports include a comment on the carrying value of each portfolio company on the list. That is, whether or not the carrying value is trending up or down given current operating results, and at what date or due to what event or lack of an event a full Valuation Report should be prepared to formally adjust the carrying value.
- That the Board Valuation Committee be composed of:
 - A minimum of two people that are familiar with valuation; and
 - A member from the investment committee (this arrangement should be reciprocal).
- That the Board Valuation Committee have access to all members of the investment staff.

- That Investment Department staff make regular presentations and reports to the Board and/or its Committees since they are the ones with the detailed knowledge regarding what is going on at each portfolio company.
- That a schedule for valuation work be prepared for individual portfolio companies. It should be carefully prepared and communicated to all parties concerned including the person(s) who will perform the valuation work, management of the portfolio company, and the Valuation Committee of the Board.
- That deferrals of valuation be rare. Each deferral should be investigated carefully by the Board to ensure that the underlying reasons for the deferral are not an indication that the portfolio company is troubled and in need of an immediate change in carrying value.
- That experienced Investment Department staff prepare all Valuation Reports and defend them in front of the Board Investment Committee. These investment professionals should know the portfolio companies the best. They should have the relevant competency to prepare the reports (which is really not much different in substance that the valuation/pricing work required to make an initial investment in a company).
- That the position of a Valuation Manager be phased out over a reasonably short period of time in favour of more Investment Analysts that can support experienced investment staff and learn from the experienced investment staff.

Internal Reporting within the Fund (Section 4.2.13)

- That the CEO of the Fund ensure that the Finance Department serves the needs of the Investment Department, Senior Officers and the Board.
- That CIF develop a system which can inform Investment Department staff, Senior Officers and the Board what the rate of return on the investment portfolio is at any given point in time. Useful information would include, for individual investments, investments in a defined sector. As well, for the entire portfolio would include: the portfolio company name; brief product or service description; location; date of initial investment; the cost of the investment and its carrying value at various dates; realized gains and losses; unrealized gains and losses; total gains and losses; and internal rate of return.
- That closing and exit memos be considered as a part of the Investment Department's regular reporting regimen and that such memos be circulated among investment staff and be provided to the Board for the edification of both, routinely.
- Each time an initial investment or a significant follow-on financing is made in a portfolio company, a one or two page "closing memo" could be written virtually immediately indicating, among other things, that the terms and conditions of the deal approved was the one closed, comments regarding co-investors, any outstanding items requiring follow-up and the expected timing of resolution, and any other information that the writer deems appropriate and/or informative.
- Similarly, an "exit memo" could be prepared when an investment is exited indicating the nature of the transaction, the buyer, outstanding items for follow-up, the return on investment both in dollars and internal rate of return, co-investor comments, and any lessons learned during the management of the investment that might benefit future generations of CIF investment staff.

Exiting (Section 4.2.14)

- That exits - and as a result realized return on investment - be a top priority of the Fund. When a venture investment is being made and at the time of all significant follow-on financings, the exit plan and possible exit candidates should be identified if and as they may exist.
- That the Fund always be on the lookout for opportunities to exit its investments. Rewarding exit opportunities should be taken advantage of when they appear even if the buyer is located outside of Manitoba. Commitments to remain in Manitoba could be pursued.
- That the Fund co-invest more with out-of-province funds. This will lead to more exit opportunities.
- That return statistics for venture capital and private equity across Canada be regularly provided to the Board.

CROCUS OPERATIONS (SECTION 4.3)

Financial Results (Section 4.3.1)

- That CIF take steps to assess, and put in place actions to address the Fund's on-going operating loss situation. This should be incorporated into a financial plan linked with a strategic plan to address the future of CIF.

Share Pricing (Section 4.3.2)

- That CIF obtain an independent qualified opinion outlining an appropriate method for the calculation and approval processes of the weekly share price.
- That CIF document the procedures for calculating Net Asset Value (NAV) and Net Asset Value per Share (NAVPS).
- That CIF document detailed income recognition policies, including recognizing dividend income on ex-dividend date and management fees and director fee income on an accrual basis.
- That CIF consider acquiring a portfolio management software product, to ensure the accurate and efficient recording of transactions for its investment portfolio and to generate reports to assist in managing the portfolio.

Liquidity, Cash Flow, and the Solidarity Transaction (Section 4.3.3)

- That the Fund amend its prospectus to fully disclose the covenants of the Agreement between the Fund and Solidarity so that readers of the prospectus can make an informed decision regarding the impact of this transaction on the Fund and assess the related risks.
- That the Fund amend its audited financial statement presentation to ensure that the statements are presented in accordance with GAAP. Specifically, the transaction with Solidarity should be reflected as a liability, and not equity, in keeping with the fundamental characteristics of the transaction and CICA disclosure requirements.

- That the Fund communicate with shareholders and the public in a balanced, clear, factual, and open manner.

Employee Travel and Other Expenses (Section 4.3.4)

- That the Board review and assess the appropriateness of expenses incurred by the former CIO over the last four years. Should the Board question the appropriateness of certain of these past expenses, that they seek legal advice.
- That the Board put in place processes to ensure that future expenses are more closely monitored and that remedial action is taken on a timely basis. This should include the Board receiving periodic reports on executive travel and hospitality expenses.

Recovery of Costs from Portfolio Companies (Section 4.3.5)

- That a policy be established that representatives of the Fund do not routinely submit expenses to portfolio companies for reimbursement, except for reasonable travel and accommodation costs in connection with Board meetings. Since CIF invests only in Manitoba, these costs should not be significant.
- That in all cases, the need for expenses are to be disclosed in each Investment Memorandum, and be pre-approved by the CEO. Should special situations arise, these also should be pre-approved by the CEO prior to submission for reimbursement.

Management Expense Ratio (MER) (Section 4.3.6)

- That CIF, for the years ended September 30, 2003 and September 30, 2004, ensure that the Solidarity transaction is appropriately treated in accordance with GAAP, and that CIF properly calculate its MER for its next prospectus.
- That the Finance and Audit Committee annually approve the MER calculation prior to inclusion in public documents.

Cash Receipts and Payment Processes (Section 4.3.7)

- That CIF document the procedures for processing receipts of funds regarding investment assets and related income, including the cut-off procedures to ensure that receipts are recorded in the proper financial period.
- That CIF document detailed income recognition policies, including recognizing dividend income on ex-dividend date and management fees and director fee income on an accrual basis.
- That CIF review and implement recommendations highlighted in management letters from their external auditors. The Board and its Finance and Audit Committee should ensure the implementation of the recommendations.
- That the Finance Department develop a robust cash flow model and consistently use cash flow budgets to compare actual receipts with expected receipts so as to be able to identify and investigate variances.
- That the Finance Department prepare aged accounts receivable schedules to monitor the collection efforts and likelihood of collecting receivables.
- That the reconciliation for a bank account be prepared by personnel not responsible for preparing and recording the cheques and deposits for that account.

- That the supervisory review of bank reconciliations be evidenced.
- That cheques received in mail are forwarded directly to the Finance Department for deposit to the bank account.
- That CIF document the procedures for processing payments regarding investment assets and related income, including the cut-off procedures to ensure that payments are recorded in the proper financial period.
- That the Finance Department use robust cash flow budgets to compare actual payments with expected payments so as to be able to identify and investigate variances.

Executive Compensation (Section 4.3.8)

- That the Board review the continuing need and appropriateness of the perquisite policy. If it is to be retained, the levels should also be reviewed, and appropriate monitoring should occur by the Board to ensure the policy is adhered to by all Senior Officers.
- That the CFO establish a system of control over perquisites. This should include periodic reporting to the Board on the use of perquisites and ensuring that taxable amounts are properly declared.
- That disclosure of Senior Officer compensation in the prospectus should include the Employee Share Ownership Plan (ESOP).

Director Fees from Portfolio Companies (Section 4.3.9)

- That the Board review the issue of the Fund receiving director fees for non-public company board involvement and consider the appropriateness of this on a go-forward basis.
- That the Finance Department implement a process to ensure controls are in place over the receipt of director fees, where it is determined the receipt of such fees by CIF is appropriate.

Income from Portfolio Companies (Section 4.3.10)

- That the Finance Department design and implement a system to keep track of all venture investment instruments and their various features including: debt principal amounts and maturity dates; interest rates and payment due dates; preferred share maturity dates; dividend payment dates; and the key amounts and dates regarding all other fee and income items as they arise. Such a system should build in reminders for individuals both in the Finance and Investment Departments as to due dates and follow-up until the income item is ultimately resolved.
- That investment income be recorded when due, and if determined not to be collectible, fully-reserved at that time. Valuation work performed on individual investments should be linked with interest and other income recorded and not deemed to be collectible.
- That the Investment Department articulate and support the risk and reward ratio behind all investment structures when an investment is initially made, at the time of each significant follow-on investment, and each time a Valuation Report is prepared.

Conflict of Interest and Interwoven Roles of Individuals (Section 4.3.11)

- That the Fund adopt a comprehensive conflict of interest policy for employees, Senior Officers, and the Board.
- That the Fund's Board develop a clear, documented policy on conflict of interest and a declaration form be signed annually by all Board members, to ensure a consistent approach to issues and perceptions of conflict. Given the inter-relationships on this Board due to its current structure and composition, this would enable the Board to demonstrate an active role in ensuring that the perception or potential perception of conflict of interest does not exist.
- That relationships and connectivity within CIF's investment portfolio be closely monitored and that the Board Investment Committee be kept apprised of such relationships on a quarterly basis and each time an investment memorandum and Valuation Report is prepared where the individuals and/or companies are involved. In every case, there should be an explanation regarding whether or not the relationship(s) represent a conflict-of-interest situation, and if so, what mitigating factors or compensating monitoring controls are in place to ensure that the best interests of the Fund and its shareholders are being satisfied.
- That the Fund ensure that where an employee is serving on a portfolio company board, that the employee recognize that they have a responsibility to report back to CIF to assist in the monitoring and assessment of CIF's investment in that company.

Donations (Section 4.3.12)

- That the Board develop and enforce a policy on charitable and political donations. Given that CIF raises its capital from individual Manitobans, the appropriateness of providing donations from these proceeds should be reviewed and if it decides to make such donations, at a minimum, these should be disclosed to investors.

Other CIF Initiatives (Section 4.3.13)

- That the Board revisit whether particular initiatives such as Community Ownership Solutions Inc., the Manitoba Centre for Labour Capital Inc. or the Center for Employee Ownership Inc., etc., is an appropriate use of Fund monies. If it decides to continue with such initiatives, it should fully disclose the activities and costs in its financial statements and prospectuses. In this case, the Board should also ensure that these activities do not distract management from maximizing returns on shareholder funds.
- That the Board adopt a formal policy with respect to the practice of approaching portfolio companies for sponsoring CIF initiatives.

External Reporting (Section 4.3.14)

- That CIF develop an MD&A that is sufficiently consistent with its prospectuses and meets its stated commitment to greater accountability and transparency.
- That CIF prepare an annual MD&A that more fully complies with the CICA Standards and Guidance on MD&A.

COMPLIANCE WITH THE CROCUS INVESTMENT FUND ACT AND BY-LAWS (SECTION 4.5)

Use of Capital from Sale of Common Shares (Section 4.5.1)

- That the Fund comply with its stated use of proceeds from the sale of common shares as set out in its prospectuses.

Investment in Qualified Manitoba Business Entities (Section 4.5.3)

- That the Fund ensure that Investment memoranda should include sufficient detail regarding the value of assets and other information regarding potential portfolio companies to allow the Board to assess for themselves whether the investment meets the criteria of a Qualified Investment.
- That the Fund use “assets”, not “net assets”, as the basis for determining whether the investment meets the criteria of a qualified Manitoba business entity.

The Size of Investments in Any One Entity (Section 4.5.4)

- That until The Crocus Investment Fund Act is modified, the Fund make a statement in its annual financial statements and prospectus as to whether it has complied with the present requirements for the size of investments in any one entity.

Eligibility of Investments (Section 4.5.5)

- That the Fund improve its documentation protocols to require that the all documentation related to requesting approval from the minister for ineligible investments be retained as part of the main investment files. Further, that the Fund contact IEDM and request copies of ministerial approval letters where the Fund received approval for an ineligible investment, but cannot locate the approval letter in their investment files.
- That a copy of the approval letter from the minister should be attached to the investment memorandum prior to submission to the Board for their approval. In this way, the Board can be better assured that a proposed investment will be considered eligible for maintenance and pacing requirements under The Crocus Investment Fund Act.

Policy Considerations Regarding Investments (Section 4.5.8)

- That the Board broaden the mandate of its Social Responsibility Investment (SRI) review process to allow for governance reviews and background checks of portfolio company principals and senior management and that the Board set out a process to ensure independent investment review by the SRI Vice-President.
- That a separate SRI report be prepared on each potential investment and be submitted to the Board along with the investment memorandum to provide the Board with more information when making investment decisions.
- That the Board conduct a more thorough challenge of valuations and ensure that there is strong, substantial, verifiable information to support any write up of investments.

CIF AND THE PUBLIC SECTOR (SECTION 4.6)

- That CIF, on a go forward basis, focus its attention on the issues involved in the management of its remaining investment portfolio.

5.4 FOR INDUSTRY, ECONOMIC DEVELOPMENT & MINES

Recommendations

DEPARTMENT MONITORING OF CIF (SECTION 4.7)

- That senior government administration ensure public sector employees involved in monitoring an organization, not be placed or place themselves in the position of working on provincial policy initiatives in concert with the organizations they monitor. Consideration could be given to having one department responsible for monitoring and another for other activities.
- That IEDM assess the advantages and disadvantages of assigning to one individual as well as to one department, the potentially conflicting roles of championing the LSIF program and monitoring for compliance.
- That IEDM subsequently ensure that a comprehensive monitoring function is appropriately designed and resourced. This includes developing appropriate LSIF monitoring policies and guidelines.
- That Deputy Ministers not be placed on Boards of organizations under their monitoring authority.
- That IEDM define the appropriate courses of action to take when information obtained indicates that compliance with the spirit and letter of applicable legislation may be in jeopardy.
- That IEDM not complete the information returns on CIF's behalf.
- That the Department of Finance amend The Income Tax Act (Manitoba) regulations to include the prescribed forms for the reporting requirements of Section 11.4.
- That on a going forward basis, as part of a comprehensive monitoring program, IEDM require documentation to support the eligibility of each of the Fund's investments.
- That IEDM and Department of Finance representatives make a final determination as to the meaning of the word "asset" as it is used in the definition of "qualified Manitoba business" and if deemed necessary by legal counsel, amend The Crocus Investment Fund Act to include the definition of asset.
- That IEDM's pacing analysis reflect the 31 month pacing requirement.
- That IEDM require an analysis of how a proposed investment is consistent with the "spirit of The Act", whenever the Fund requests ministerial approval regarding an investment's eligibility. The analysis should explicitly consider each of the stated objects of the Fund per Section 3.2 of The Crocus Investment Fund Act.
- That as part of a comprehensive monitoring program, IEDM confirm CIF's compliance with critical provisions of The Crocus Investment Fund Act.
- That IEDM require CIF to obtain a written statement from their external auditors attesting to the completeness, accuracy and compliance of the information provided under Section 11.4 of The Income Tax Act (Manitoba).

Response from the Department

Industry, Economic Development & Mines officials have reviewed and accept the recommendations of the Office of the Auditor General (OAG).

The Department is responsible for monitoring Crocus Investment Fund's (Crocus) compliance with The Crocus Investment Fund Act (Crocus) and with the Labour-Sponsored Funds Tax Credit section of The Income Tax Act.

The policy objective of the Crocus Act is to stimulate the supply and demand for risk capital for small and medium sized Manitoba enterprises. This objective is among the Department's top priorities. Accordingly, it has been a Departmental priority to monitor for Crocus' compliance with the Crocus Act.

The Crocus Act's overarching policy intent is for Crocus to be managed privately. It is clear in the Crocus Act that Crocus' board of directors is responsible for Crocus' governance, management and performance. While the Department acknowledges the Minister's authority to compel Crocus to provide information, it should be noted that the authority is limited to information relevant to the administration or enforcement of the Crocus Act and parts of The Income Tax Act.

The Department uses a variety of tools to monitor Crocus' compliance with legislative requirements.

Annual Information Returns, certified by the Chief Financial Officer of Crocus, were enabled by the 2001 legislative amendments. While the OAG is critical of the assistance provided to Crocus in the preparation of these returns, the ultimate responsibility for the accuracy of information remained with the Fund and was certified by the CFO.

The annual prospectus is used as a tool to monitor management practices against the Crocus Act. The prospectuses provide detailed descriptions of Crocus' policies and practices and are signed by Crocus officers and directors. The prospectuses are filed with the Manitoba Securities Commission and are required to provide full, true and plain disclosure of all material facts relevant to the shares being sold by Crocus. In addition, the annual audited financial statements are reviewed and discussions are held with Crocus officers. From time to time, the Department requires Crocus to provide compliance details on other issues such as reserve fund provisions.

The OAG suggests that certain events should have prompted the Department to take action above and beyond its routine monitoring. The Department acknowledges that Crocus frequently requested legislative changes. The act of requesting legislative amendments is not necessarily indicative of broader problems. The other Labour-Sponsored Investment Fund (LSIF) also made representations to the Department regarding legislative, regulatory and policy changes. The economic environment in which the funds operate is constantly changing and the legislative and regulatory framework requires adjustment from time to time. Legislative changes have been made in the past and will continue to be made in the future.

The Department acknowledges that in 2002 and subsequent years it discussed with Crocus the challenges of Crocus meeting its share redemptions in 2005 and beyond. Crocus

indicated that it had a range of options including a more aggressive disposition of investments and changes to the investment pacing rules in The Income Tax Act. Crocus indicated preference for changing the investment pacing rules but expressed confidence that it could deal with the challenges.

The Department acknowledges that Crocus was not forthcoming with the details of its long-term business strategy. It is not uncommon for a business that operates in a competitive environment to restrict the dissemination of confidential information to third parties, including government.

The Department notes that none of the events cited are germane to the issues of Crocus Investment Fund's valuation practices or investment performance.

The Department acknowledges timeline errors in its summaries of Crocus' statutory investment pacing targets. The errors were in the summary report. The detailed calculations were correct and the assessments that Crocus met its statutory investment pacing targets in respect of its 2001 and 2002 tax years were accurate. In September 2005, the Department will assess as to whether Crocus met its investment pacing targets in respect of its 2003 tax year.

Upon a request from Crocus, the Minister may deem a proposed investment to be an Eligible Investment, even if the investment does not meet the strict statutory definition for Eligible Investment. This provision is used to enable Crocus to make investments that meet the spirit of the Crocus Act, if not the strict definition of Eligible Investment. The use of this provision does not constitute an endorsement of the investment merits of any particular investment. The OAG recommends the Department develop fulsome criteria and documentation for assessing such requests from Crocus. The Department accepts this recommendation.

The Department acknowledges the miscalculation to the pacing requirements in 2003. It should be noted, however, CIF still had until September 30, 2005 to invest the \$2.6 million shortfall. The Department has corrected this calculation so the pacing obligation timelines as at September 30, 2005 will be accurately assessed.

The Department has in place a process to monitor Crocus' compliance. The Office of the Auditor General has recommended improvements to the process and the Department sees value in adopting the recommendations. The Department commits to the following plan of action:

- Within existing resources, the Department will develop organizational options for separating the policy and investment functions from the monitoring and compliance functions.*
- Practice within the Department since 2001, has been to ensure that the Deputy Minister, or any other staff member who advises the Minister on policy or compliance issues related to Labour-Sponsored Investment Funds do not sit on a LSIF board. That practice will continue.*
- The Department will request Manitoba Finance to prescribe, by regulation, a form of Annual Information Return.*

- *The Department will recommend the Annual Information Return include a description of the statutory basis for claiming that an investment is an Eligible Investment.*
- *Once the return is prescribed in regulation, the Department will work with Crocus toward an auditor attestation of Crocus' annual return.*
- *The Department will develop fulsome criteria and documentation for assessing requests from Crocus for deeming proposed investments to be Eligible Investments.*
- *The Department will put in place a process for diligently reviewing the eligibility of Crocus' Eligible Investments.*

5.5 FOR THE MANITOBA SECURITIES COMMISSION

Recommendations

MSC MONITORING OF CIF (SECTION 4.8)

- That MSC use a risk-based approach to develop a standard and consistent method to determine the breadth and depth of a prospectus review. A risk-based approach would ensure that greater MSC scrutiny would be applied to the review of a prospectus of a market participant that poses a greater potential risk to the marketplace.
- That the MSC enhance its prospectus review documentation standards to include the risk assessment, the review procedures performed and the results thereof.
- That the MSC develop documented guidance regarding the nature and extent of work expected, and the documentation required, when conducting continuous disclosure reviews.

Response from Manitoba Securities Commission

The Manitoba Securities Commission has a dual mandate of investor protection and the facilitation of capital markets in Manitoba. The administration of The Securities Act and this dual mandate requires the MSC to carry out a series of functions. MSC works closely with securities regulators throughout Canada through the Canadian Securities Administrators (CSA). The work of the CSA includes the development of Mutual Reliance Systems where the work of the MSC is recognized and utilized by other securities regulators in Canada.

MSC welcomes the report of the Auditor General as an opportunity to receive an independent review of its operations in several areas relative to CIF. Information relating to CIF contained in the report will also be of assistance to investigative staff of the Commission.

Prospectus reviews

Prospectus reviews are conducted by MSC to assess whether a prospectus contains full, true and plain disclosure. In 2003-2004 MSC reviewed 812 prospectuses, including the CIF prospectus. A properly prepared prospectus provides an investor with the information required to make an informed investment decision. A prospectus review is not a judgment about the quality of the securities offered in the prospectus, or of the ability of a business to successfully carry out its business plan.

The prospectus review process involves an element of professional judgment and discretion. MSC staff who review a prospectus routinely exercise professional judgment when deciding if the wording of the prospectus is adequate, as well as the degree and scope of each prospectus review. The need to exercise professional judgment and discretion in the review of a prospectus is not challenged in the report.

MSC accepts the recommendation in the report to better document details of the professional judgment and discretion applied in the review of a prospectus. While adoption

of this recommendation will not change the risks inherent in purchasing a security offered in a prospectus, it will provide a more detailed record of the steps taken by staff during a prospectus review, as well as a written record why those steps were taken.

MSC also accepts the recommendation to develop a more formalized risk based approach to determine the nature and breadth of prospectus reviews. Although MSC staff exercises professional judgment in the assessment of risk, a more standardized and documented system would enhance the prospectus review process.

Monitoring of Receipt of Financial Information

The report makes no recommendations in this area and concludes financial disclosure is monitored for timely receipt and compliance with GAAP.

Compliance Review of Crocus Capital Inc. in December 2000

The report reaches a positive conclusion with respect to how the detailed compliance review of Crocus Capital Inc. was completed by MSC staff. MSC believes this conclusion supports the position of the MSC that there is a benefit to a process that is properly planned, conducted, supervised and documented.

While there are no recommendations following the positive conclusion in this part of the report, MSC staff continue review and modify the method for conducting compliance reviews of registrants to ensure these reviews continue to be effective.

Continuous Disclosure Reviews

MSC is one of a limited number of Canadian securities regulators that began conducting Continuous Disclosure reviews in 2003. It is a new process which is being upgraded and improved through experience. As with a prospectus review, a continuous disclosure review requires MSC staff to exercise an element of discretion and professional judgment.

The recommendation to develop documented guidance to better detail how these reviews will be conducted is consistent with the plans of the MSC (and other securities regulators throughout Canada) to monitor and improve the continuous disclosure review process. A well developed process will set standards for each review and will ensure proper reporting of the steps taken during a review.

MSC will incorporate this recommendation into its ongoing development of the continuous disclosure review program.

6.0 General Observations

The following are some general thoughts and observations that readers may want to consider when thinking about the future of the LSIF sector:

- 1) The Board of Directors is ultimately responsible for ensuring that the LSIF is being operated in accordance with strong internal controls, in compliance with legislation and with the shareholders interests of primary concern.
- 2) Members of a fund's Board of Directors should be carefully chosen. Significant experience in venture capital and private equity investment, corporate finance, accounting and turnaround management are valuable credentials to consider. The Board chair should be chosen for his or her corporate governance experience.
- 3) The Board of Directors should collectively have the skill sets and knowledge necessary to assess whether information provided to them is appropriate and complete.
- 4) Board representation should more closely reflect the equity and risk positions in the entity.
- 5) It is essential that Senior Officers have extensive knowledge and practical experience in venture capital operations and investing. It is essential that their performance be formally assessed and that this assessment either be performed by the Board of Directors, in the case of the CEO, or at a minimum, formally discussed by the Board of Directors.
- 6) Portfolio management teams are instrumental to the success of most venture capital and private equity investments. Due diligence conducted on management teams should be in-depth and performed over a period of time that allows for a full assessment of all facets of the character and capabilities of key management team individuals. Changes to portfolio management teams should be made when appropriate and viewed as a part of the normal development of a successful investment.
- 7) Loss of staff continuity is rarely a good thing for a venture capital investment's return on investment. Staff turnover contributes to the loss of knowledge which impacts understanding and monitoring of portfolio companies. The level and form of compensation is important in attracting and retaining the most qualified staff.
- 8) It would be prudent for return on investment for common shareholders to be the "primary" screening objective when entering into an investment in an portfolio company. The interests of the shareholder should be front and center at all times. Other "multiple bottom-lines" could to be considered after the primary screening objective has been met and in certain cases could be viewed as being achieved or enabled as a by-product of good investment decision-making.
- 9) It is essential that an investment strategy be formally established, and the risks and financial implications of that strategy be understood by the Board of Directors and management.
- 10) The potential for conflicts of interest, or the perception of conflicts of interest in the operation of LSIFs need to be continually reassessed and challenged by the Board of Directors.
- 11) Where a management company structure does not exist, the impact of the utilization of fund monies for non-revenue generating initiative, donations, and discretionary spending

at the expense of return to shareholders should be considered where the trade-off has a direct impact on share price.

- 12) LSIFs should operate within the legislation in place, or until the desired changes are approved by legislators.
- 13) It would be prudent for LSIFs to limit their risk exposure from providing guarantees and related undertakings for portfolio companies to no more than a minimal percentage of the LSIFs total portfolio assets at cost.
- 14) Operating without a management company, CIF did not have a conventional venture capital model. By operating without a management company, decision-making as to the appropriateness of using monies to cover operating losses arises and may not be transparent. A management company places constraints of spending, but also provides the shareholder with a clear communication of the separation of “fund monies” and “management company monies”.
- 15) Legislated pacing requirements should have some flexibility build-in so that no fund is required to consider making a marginal investment in order to satisfy pacing requirements at any given point in time. If quality investments are not available, an LSIF could be allowed to not make an investment upon application to the appropriate provincial governing or regulatory body.
- 16) Provincial monitoring and partnering roles should be segregated in order to ensure that legislation is not changed to facilitate certain initiatives at the risk that existing shareholders interests may be negatively affected.
- 17) Notwithstanding pacing and eligibility requirements, it may be beneficial for LSIFs to have the opportunity to make co-investments in any location for several reasons including: to enhance return on investment for their shareholders; and to take advantage of the value adding capabilities that co-investment can provide not the least of which are state-of-the-art investing trends, techniques, processes and procedures. Such investments could be limited to a certain percentage of a companies total portfolio assets at cost at any given time.
- 18) All LSIFs should perform a valuation on each portfolio company at least once a year. Securities Commissions could consider requiring LSIFs co-invested in the same company to use the same valuation model and methodology so that identical investments are carried at identical values.
- 19) Most of the Canadian Securities Administrator’s recent corporate governance guidelines, audit committee rules, continuous disclosure requirements, and Chief Executive Officer and Chief Financial Officer certification requirements would be appropriate for LSIFs.
- 20) Prospectus and certain other public disclosure documents could include an LSIFs investment strategy indicating how much capital is needed to execute their strategy in order to maximize return on investment to shareholders.
- 21) Prospectus and certain other public disclosure documents, could include a section on cash or liquidity management which elaborates on the LSIF manager’s plan to ensure that the fund will be able to meet all of its cash obligations, including redemptions and follow-on investment requirements, as they become due or otherwise arise.

- 22) Regional LSIFs could consider leaving the carrying values of portfolio companies at the lower of cost or fair value. Increases in NAVPS would occur only when portfolio companies are exited for cash (in whole or in part), or when the investment in the portfolio company is liquid.
- 23) The majority of LSIFs in Canada have adopted the conventional venture capital and private equity structure and legal framework. This involves the creation of a management company staffed with proven, experienced venture and/or private equity individuals that contracts to manage the assets of the fund.

GLOSSARY OF TERMS AND ACRONYMS

Appendix A

Add-on investment	See follow-on financing/investment .
Aged accounts receivable schedule	Listing of accounts receivable grouped according to the length of time the receivable has been owed, such as under 30 days, 30 to 60 days, and over 60 days.
Capitalization table	"Also called a "Cap Table", this is a table showing the total amount of the various securities issued by a firm. This typically includes the amount of investment obtained from each source and the securities distributed — e.g. common and preferred shares, options, warrants, etc. — and respective capitalization ratios." [VCEexperts.com]
Cash exit	Cash received from the exit (also called a divestment or realization) of an investment in a private equity company.
Common equity interest/ common equity investments	Investment in the common shares of a company. Common shares offer no performance guarantees. [Based on VCEexperts.com]
Convertible subordinated loan	"Debt with inferior liquidation privileges to senior debt in case of a bankruptcy; sub debt will carry higher interest rates than senior debt, to which it is subordinated, to compensate for the added risk, and will typically have attached warrants or equity conversion features." Conversion means the debt is "exchangeable for another type of security (usually common stock) at a pre-stated price." [VCEexperts.com]
Deal flow	"The measure of the number of potential investments that a fund reviews in any given period." [VCEexperts.com]
Discounted cash flow (DCF)	A valuation method used to estimate the attractiveness of an investment opportunity. DCF analysis uses future cash flow projections and discounts them to arrive at a present value, which is used to evaluate the potential for investment. Present value is the amount that a future sum of money is worth today given a specified rate of return. The rate of return is used as the discount rate in determining the present value of future cash flows. [Based on www.investopedia.com]
Exit	The divestment of an investment in a private company. The divestment could be by sale to another investor, or repurchase by either the private equity company or its management, or through sale on a formal stock exchange in the case where the company has started trading its shares on the stock exchange. [Based on VCEexperts.com]
Exit climate	"The conditions that influence the viability and attractiveness of various exit strategies." [VCEexperts.com]

Appendix A | GLOSSARY OF TERMS AND ACRONYMS

(cont'd.)

Exit horizon	The expected date for the exit from an investment.
Exit options	See exit strategy .
Exit strategy	"A fund's intended method for liquidating its holdings while achieving the maximum possible return. These strategies depend on the exit climates including market conditions and industry trends." See exit for discussion of methods. [VCEexperts.com]
Follow-on financing/ investment	"A supplementary round of financing in an existing portfolio company that builds on the original financing, generally in line with business growth and development. Venture-backed firms are often engaged in multiple follow-on deals. Typically, a venture-backed company receives cumulative rounds of financing to facilitate its progression from one stage of development to the next." [Industry Canada: Small and Medium-sized Enterprise Financing in Canada - Glossary of Terms]
Incentive fee (disclosure)	A fee paid to an investment fund's adviser that generally consists of a basic fee plus a bonus (or less a penalty) if the fund's performance exceeds (or fails to match) that of a specified benchmark. The adviser is a person or company providing investment advice, research and, often, administrative and similar services. The fund manager could be the adviser or could contract for advisory services. [CICA: Financial Reporting by Investment Funds; CICA: Assessing Risks and Controls of Investment Funds]
In-kind contribution	A non-cash input which can be given a cash value.
Institutional investors	"Includes pension funds and insurance companies such as Quebec's Caisses des dépôts et placements, Ontario Municipal Employees Retirement System, and the Ontario Teachers Pension Plan." [Industry Canada: Small and Medium-sized Enterprise Financing in Canada - Glossary of Terms] "A non-bank person or organization that trades securities in large enough share quantities or dollar amounts that they qualify for preferential treatment and lower commissions. Institutional investors face less protective regulations because it is assumed that they are more knowledgeable and better able to protect themselves." [www.investopedia.com]
Monetize	To convert into money.
Performance-based incentive compensation	Compensation based in part on the performance of the Fund.
Post-money valuation	"The valuation of a company immediately after the most recent round of financing. For example, a venture capitalist may invest \$3.5 million in a company valued at \$2 million "pre-money" (before

GLOSSARY OF TERMS AND ACRONYMS

Appendix A
(cont'd.)

	the investment was made). As a result, the startup will have a post-money valuation of \$5.5 million." [VCEexperts.com]
Pre-money valuation	"The valuation of a company prior to a round of investment. This amount is determined by using various calculation models, such as discounted P/E ratios multiplied by periodic earnings or a multiple times a future cash flow discounted to a present cash value and a comparative analysis to comparable public and private companies." [VCEexperts.com]
Preferential cumulative cash dividend	Dividends payable in cash, with respect to preferred shares, that accrue until paid. Such dividends can accumulate at a fixed rate or simply be payable as and when determined by a company's board of directors in such amount as determined by the board. [VCEexperts.com]
Redemption/retraction covenants	Redemption is the right or obligation of a company to purchase its own shares from shareholders. [VCEexperts.com] Retraction is the right of the shareholder to require the company to repurchase its shares from the shareholder.
Retail investors	"Individuals who buy and sell securities for their personal account, and not for another company or organization." [www.investopedia.com]
Roll-up	In the context of venture capital, when a venture capitalist, such as venture capital fund, forces small companies to merge in order to reduce costs. [Based on www.investopedia.com]
Tranche	A piece, portion or slice of a deal or structured financing. This portion is one of several related securities that are offered at the same time but have different risks, rewards and/or maturities. "Tranche" is the French word for "slice". [www.investopedia.com]
Triage	Triage is a system used by investment managers to help them ration their limited resources and capital available for investing. This often includes identifying and classifying portfolio investments into three groups: • the core investments that should be actively supported and kept; • the investments that may receive limited additional support, with divestiture made when suitable opportunity exists; and • those investments that should no longer receive any support and should be liquidated as soon as possible.

Appendix A

(cont'd.)

GLOSSARY OF TERMS AND ACRONYMS

CD	Continuous Disclosure
CEO	Chief Executive Officer
CICA	Canadian Institute of Chartered Accountants
CIF	Crocus Investment Fund
CIO	Chief Investment Officer
COO	Chief Operating Officer
COS	Community Ownership Solutions Inc.
CSA	Canadian Securities Administrators
ESOP	Employee Share Ownership Plan
FTQ	Quebec Federation of Labour
GAAP	Generally Accepted Accounting Principles
GM	General Manager
IEDM	Industry, Economic Development and Mines
LIC	Local Investment Council
LSIF	Labour-Sponsored Investment Fund
LSVCC	Labour-Sponsored Venture Capital Corporation
MCLC	Manitoba Centre for Labour Capital Inc.
MER	Management Expense Ratio
MFDA	Mutual Fund Dealers Association
MFL	Manitoba Federation of Labour
MGEU	Manitoba Government Employers' Union
MIOP	Manitoba Industrial Opportunities Program
MSC	Manitoba Securities Commission
MS&T	Manitoba Science & Technology Fund
MTS	Manitoba Teachers Society
NAV	Net Asset Value
NAVPS	Net Asset Value Per Share

GLOSSARY OF TERMS AND ACRONYMS

OAG	Office of the Auditor General
OSC	Ontario Securities Commission
PEAC	Premier’s Economic Advisory Committee
RRSP	Registered Retirement Savings Plan
SEC	Securities and Exchange Commission
SRO	Self-Regulatory Organizations
SERP	Supplementary Executive Retirement Plan
TRAF	Teachers’ Retirement Allowances Fund
VP	Vice-President
WCB	Workers Compensation Board

Appendix A
(cont’d.)

Appendix B

THE CROCUS INVESTMENT FUND ACT

APPENDIX B
THE CROCUS INVESTMENT FUND ACT
C.C.S.M. c. C308
The Crocus Investment Fund Act

Table of Contents	Regulations
-------------------	-------------

(Assented to July 26, 1991)

WHEREAS the Government of Manitoba and the Manitoba Federation of Labour recognize the need to support economic development and renewal and consider it to be in the public interest to promote long-term capital formation and a broad understanding of local ownership;

AND WHEREAS it is in the public interest to establish the Crocus Investment Fund ("the Fund") for the purpose of making investments with a view to earning income and promoting and maintaining

- (a) capital retention and economic stability in Manitoba,
- (b) employee ownership in Manitoba businesses, and
- (c) business continuity, job retention and creation and ownership of Manitoba businesses by Manitobans;

AND WHEREAS it is intended that the Fund will, among other things, make investments in Manitoba businesses that operate in accordance with ethical policies with respect to employment practices, workplace safety, environmental suitability and other matters;

AND WHEREAS the Fund is intended to provide investment capital and other financial assistance and other services to Manitoba businesses to enable them to create, maintain and protect jobs;

AND WHEREAS it is intended every Manitoban who is an individual be entitled to invest in the Fund and be eligible for tax credits;

AND WHEREAS it is intended that the Fund will provide an opportunity for long-term investment that can be used to supplement employee savings through conventional retirement plans or pension plans;

AND WHEREAS, through the investment activities of the Fund, investor and employee awareness and knowledge relating to economic and management matters will increase enabling investors and employees to increase their influence on provincial economic development;

NOW THEREFORE HER MAJESTY, by and with the advice and consent of the Legislative Assembly of Manitoba, enacts as follows:

THE CROCUS INVESTMENT FUND ACT

Appendix B
(cont'd.)

PART 1

INTERPRETATION AND APPLICATION

Definitions

1(1) In this Act,

"**Board**" means the Board of Directors of the Fund; (« conseil »)

"**Class "A" Common Share**" means a share of the capital stock of the Fund that is issuable only to an individual (other than a trust) or a trust governed by a registered retirement savings plan, and that entitles the holder

(a) to receive notice of and, subject to *The Corporations Act*, to attend and vote at all meetings of the shareholders of the Fund,

(b) to receive dividends at the discretion of the Board, and

(c) to receive, on the dissolution of the Fund, rateably with all the other holders of Class "A" Common Shares, all the assets of the Fund that remain after payment of all amounts payable to the holders of other classes of shares of the Fund; (« action ordinaire de catégorie « A » »)

"**Class "G" Special Share**" means a share of the capital stock of the Fund that

(a) may be issued only to, and held only by, the Minister of Finance on behalf of Her Majesty in right of Manitoba,

(b) entitles the holder to elect one director to the Board, and

(c) does not entitle the holder to any dividends; (« action spéciale de catégorie « G » »)

"**Class "L" Special Share**" means a share of the capital stock of the Fund that is issuable only to, and may be held only by, the Manitoba Federation of Labour, and that entitles the holder

(a) to receive notice of and, subject to *The Corporations Act*, to attend and vote at all meetings of the shareholders of the Fund, and

(b) to receive, on the dissolution of the Fund, an amount equal to the amount of the consideration received by the Fund on the issue of the Class "L" Special Shares divided by the number of Class "L" Special Shares issued,

but does not entitle the holder to any dividends; (« action spéciale de catégorie « L » »)

"**eligible investment**" of the Fund means

(a) a share in the capital stock of a corporation that was a qualified Manitoba business entity when the Fund acquired the share,

(b) a partnership interest in a partnership that was a qualified Manitoba business entity when the Fund acquired the interest,

Appendix B

(cont'd.)

THE CROCUS INVESTMENT FUND ACT

(c) a debt obligation of an entity that was a qualified Manitoba business entity when the Fund acquired the obligation, if the debt obligation meets the following requirements:

(i) by its terms, or by the terms of any agreement related to it, it does not restrict the entity from incurring other debts,

(ii) by its terms, or by the terms of any agreement related to it, it is subordinated to all other debt obligations of the entity except that, where the entity is a corporation, the debt obligation need not be subordinate to a debt obligation

(A) issued by the entity that is prescribed as a small business security for the purposes of paragraph (a) of the definition "small business property" in subsection 206(1) of the *Income Tax Act* (Canada), or

(B) owing to a shareholder of the entity or to a person related to any of its shareholders,

(iii) it is secured solely by a floating charge on the assets of the entity,

(d) a debt obligation of an entity that was a qualified Manitoba business entity when the debt obligation was issued to the Fund, and that requires that the funds advanced to the entity by the Fund be advanced by the entity to another entity all or substantially all of whose assets are investments of a type referred to in clause (a), (b) or (c),

(e) a guarantee provided by the Fund in respect of a debt obligation that, if the Fund had acquired the debt obligation at the time the guarantee was given, would have been a debt obligation described in clause (c), (d) or (f) at that time,

(f) a debt obligation issued by a qualified Manitoba business entity, if all or substantially all of the entity's assets at the time the debt obligation was acquired by the Fund were investments described in this clause or any of clauses (a) to (d),

(g) an option or right granted by a qualified Manitoba business entity, in conjunction with the acquisition by the Fund of an investment that is described in any of clauses (a) to (f), to acquire a share of the capital stock of a corporation or an interest in a partnership that would have been described in clause (a) or (b) if the share or interest had been acquired at the time of the option or right was granted,

(h) an investment or part of an investment that, under a written agreement between the Fund and the minister, qualifies as an eligible investment,

(i) an investment of a flow-through investment vehicle, as defined in the regulations, to the extent that the investment qualifies under the regulations as an eligible investment of the Fund, and

(j) any other investment that, under the regulations, is an eligible investment,

but does not include an investment declared under section 11.1 to be an ineligible investment or an investment that, when it was acquired by the Fund, was an ineligible investment under the regulations; (« placement admissible »)

THE CROCUS INVESTMENT FUND ACT

Appendix B
(cont'd.)

"entity" means

- (a) a corporation that is a taxable Canadian corporation,
- (b) a partnership of corporations, each of which is a taxable Canadian corporation, or
- (c) a trust that is resident in Canada; (« entité »)

"Fund" means the Crocus Investment Fund incorporated by subsection 3(1); (« Fonds »)

"investment assets", when used with respect to the Fund, means all of the assets of the Fund other than operating assets used by it directly in carrying on its business; (« actif de placement »)

"investment shortfall" of the Fund in respect of a month means, at a particular time,

- (a) if the month ended in a taxation year of the Fund that ended before the particular time, the Fund's monthly deficiency, as defined in subsection 11.1(1) of *The Income Tax Act*, for the month, and
- (b) if the month ended in the Fund's current taxation year, the amount, if any, that would be its monthly deficiency for the month if the taxation year had ended at the end of last month that ended before the particular time; (« écart de placement »)

"minister" means the member of the Executive Council charged by the Lieutenant Governor in Council with the administration of this Act; (« ministre »)

"original acquisition date" in relation to a share means the date of the share's original acquisition as determined under section 11.1 of *The Income Tax Act*; (« date d'acquisition initiale »)

"qualified Manitoba business entity" means an entity

- (a) that carries on business in Manitoba, has assets of a value less than \$50,000,000. and has a majority of its employees in Manitoba, or
- (b) substantially all of whose assets would be eligible investments had they been owned by the Fund directly and that has assets of a value less than \$50,000,000.; (« entité manitobaine admissible »)

"registered retirement income fund", "registered retirement savings plan" and "taxable Canadian corporation" have the same meaning as in the *Income Tax Act* (Canada); (« fonds enregistré de revenu de retraite », « régime enregistré d'épargne-retraite » et « société canadienne imposable »)

"valuation date" means a date or dates determined by by-law of the Board. (« jour d'évaluation »)

Interpretation of "related"

1(2) For the purposes of this Act, a person or entity is related to another person or entity if they are related for the purposes of sections 11.1 to 11.5 of *The Income Tax Act*.

Appendix B

(cont'd.)

THE CROCUS INVESTMENT FUND ACT

Interpretation of "secured"

1(3) For the purposes of subclause (c)(iii) of the definition of "eligible investment", a debt obligation is not secured by reason only that a guarantee is given in respect of that obligation.

Determination of value of assets

1(4) For the purpose of determining the value of the assets of an entity in the definition of "qualified Manitoba business entity", the assets of a corporation, partnership or trust are deemed to include the assets of any other corporation, partnership or trust that is an affiliate of the corporation, partnership or trust.

Interpretation of "affiliate"

1(5) For the purposes of subsection (4), a corporation, partnership or trust is deemed to be an affiliate of another corporation, partnership or trust if one of them is controlled by the other or if each of them is controlled by the same person, corporation, partnership or trust.

Control of corporation

1(6) A person, corporation, partnership or trust is deemed to control a corporation, if

- (a) it owns shares in the corporation carrying more than 50% of the votes for the election of directors of the corporation; or
- (b) it owns shares of the capital stock of the corporation having a fair market value of more than 50% of the fair market value of all of the issued shares of the capital stock of the corporation.

Control of partnership

1(7) A person, corporation, partnership or trust is deemed to control a partnership if

- (a) it owns interests in the capital or income of the partnership carrying more than 50% of the votes associated with all interests in the capital or income of the partnership; or
- (b) it owns interests in the capital or income of the partnership having a fair market value of more than 50% of the fair market value of all of the interests in the capital or income of the partnership.

Control of trust

1(8) A person, corporation, partnership or trust is deemed to control a trust if

- (a) where the terms of the trust provide that the beneficiaries of the trust are entitled to vote on any matter concerning the business or affairs of the trust, it owns interests in the capital or income of the trust carrying more than 50% of the votes associated with all interests in the capital or income of the trust; or
- (b) it owns interests in the capital or income of the trust having a fair market value of more than 50% of the fair market value of all of the interests in the capital or income of the trust.

Beneficial ownership

1(9) For the purpose of determining whether a corporation, partnership or trust is controlled by a person, corporation, partnership or trust, a person, corporation, partnership or trust shall be deemed to own

THE CROCUS INVESTMENT FUND ACT

Appendix B
(cont'd.)

beneficially shares, partnership interests or interests in the capital or income of a trust that are owned beneficially by any corporation, partnership or trust that is an affiliate of the person, corporation, partnership or trust.

Agreement to make additional investments

1(10) When for the purposes of sections 11.1 to 11.5 of *The Income Tax Act* the Fund's cost of a particular investment includes an amount under clause 11.1(1.1)(d) of that Act because the Fund is required to make an additional investment, the additional investment, when it is acquired, shall qualify as an eligible investment of the Fund if it would have been an eligible investment had it been acquired by the Fund when it acquired the particular investment.

Minister may enter into agreement

1(11) Subject to subsection (12), the minister may enter into an agreement with the Fund under which, on any terms or conditions the minister considers appropriate, an investment of the Fund or of a flow-through investment vehicle qualifies as an eligible investment of the Fund.

Limitation

1(12) An investment cannot qualify as an eligible investment of the Fund under an agreement made under subsection (11) unless, at the time that the Fund acquired

(a) the investment; or

(b) by acquiring or holding an interest in a flow-through investment vehicle, an indirect interest in the investment held or acquired by the flow-through investment vehicle;

the entity that issued the investment would have been a qualified Manitoba business entity if clause (a) of the definition "qualified Manitoba business entity" in subsection (1) were read as follows:

"(a) all or substantially all of the fair market value of the property of which is attributable to

(i) property used in a specified active business, as defined in subsection 204.8(1) of the *Income Tax Act* (Canada), carried on by the entity or by an entity related to it,

(ii) investments in other qualified Manitoba business entities, or

(iii) any combination of properties described in subclauses (i) and (ii),

and that has assets with a total value of not more than \$50,000,000., or".

S.M. 1997, c. 40, s. 2; S.M. 1998, c. 28, s. 2; S.M. 2001, c. 24, s. 6.

Application of Corporations Act

2(1) Except as provided in this Act, *The Corporations Act* applies to the Fund with such modifications as the circumstances require.

Appendix B

(cont'd.)

THE CROCUS INVESTMENT FUND ACT

Inapplicable provisions

2(2) Sections 5 to 9, subsections 10(1) to (3) and (6), sections 12 and 13, subsections 27(3), 45(9), 101(1), 126(2) and (3), 167(7), 181(2) and 182(1), and sections 191 and 194 of *The Corporations Act* do not apply to the Fund.

Partially applicable provisions

2(3) Subsections 32(2), 33(3) and 34(2), section 38, clauses 113(2)(a) and (f), and subsections 184(26) and 234(6) of *The Corporations Act* do not apply with respect to Class "G" Special Shares.

Conflict of Acts

2(4) If this Act conflicts with *The Corporations Act*, this Act prevails.

S.M. 1997, c. 40, s. 3; S.M. 2001, c. 24, s. 7.

PART 2

INCORPORATION AND ORGANIZATION

Establishment

3(1) There is hereby established a corporation, to be known as the Crocus Investment Fund, consisting of the first directors and those persons who, from time to time, are shareholders of the corporation.

Objects of the Fund

3(2) The business of the Fund is restricted to

(a) the operation of an investment fund that will make investments in qualified Manitoba business entities with a view to earning income and promoting and maintaining

(i) capital retention and economic stability in Manitoba,

(ii) employee ownership of qualified Manitoba businesses, and

(iii) business continuity, job retention and creation, and the ownership of Manitoba businesses by Manitobans; and

(b) providing investment capital and other financial assistance and other services to Manitoba businesses to enable them to create, maintain and protect jobs.

3(3) and (4) Repealed, S.M. 2001, c. 24, s. 8.

S.M. 2001, c. 24, s. 8.

Articles of the Fund

4(1) The articles of the Fund that are filed under *The Corporations Act* must

(a) set out the authorized capital of the Fund, which shall consist of

THE CROCUS INVESTMENT FUND ACT

Appendix B
(cont'd.)

- (i) Class "A" Common Shares,
 - (ii) Class "G" Special Shares that may be issued for a maximum consideration of \$2,000,000.,
 - (iii) Class "L" Special Shares,
 - (iv) any additional classes of shares that were issued before this subclause came into force, and
 - (v) any additional classes of shares created by filing articles of amendment under *The Corporations Act*,
- (b) set out the rights, privileges, restrictions and conditions attaching to each class of shares which, in the case of the Class "A" Common Shares, must be consistent with sections 4.1 and 4.2; and
- (c) provide that the business and affairs of the Fund shall be managed by a board of directors a majority of whom are elected by the holder of the Class "L" Special Shares.

Amendment requires minister's approval

4(1.1) The articles of the Fund shall not be amended without the minister's approval except to create a new class or classes of shares or to amend the rights, privileges, restrictions or conditions attaching to a class of shares other than the Class "A" Common Shares.

4(2) Repealed, S.M. 2001, c. 24, s. 9.

Rights of Class "G" Special Shares

4(3) Where an agreement entered into between the Fund and the Government of Manitoba requires amendments to the rights attaching to the Class "G" Special Shares, the directors shall, by filing articles of amendment under *The Corporations Act*, make those amendments.

4(4) Repealed, S.M. 2001, c. 24, s. 9.

Reduction of stated capital

4(5) The Fund shall not reduce the stated capital in respect of its Class "A" Common Shares otherwise than on a redemption, acquisition or cancellation of shares of that class by the Fund or under prescribed circumstances.

S.M. 1993, c. 13, s. 2; S.M. 1997, c. 40, s. 4; S.M. 2001, c. 24, s. 9.

Definitions

4.1(1) In this section and section 4.2,

"common-law partner" has the same meaning as in the *Income Tax Act* (Canada); (« conjoint de fait »)

"qualifying trust", in relation to an individual, means a trust governed by a registered retirement savings plan or a registered retirement income fund where the annuitant under the plan or fund is the individual or his or her spouse or common-law partner. (« fiducie admissible »)

Appendix B

(cont'd.)

THE CROCUS INVESTMENT FUND ACT

Repurchase of share acquired after May 1997

4.1(2) A holder of a Class "A" Common Share is not entitled to require the Fund to repurchase the share before the eighth anniversary of its original acquisition date if that date is after May 1997.

Repurchase of share acquired before June 1997

4.1(3) Except as otherwise provided in the articles of the Fund, a holder of a Class "A" Common Share is not entitled to require the Fund to repurchase the share before the seventh anniversary of its original acquisition date if that date is before June 1997.

Exceptions to 8-year hold period

4.1(4) Subsection (2) does not apply to a request for the repurchase of a Class "A" Common Share if the Board is satisfied that

- (a) the holder acquired the share as a consequence of the death of the individual to whom or to whose qualifying trust the share was issued;
- (b) the holder, or an individual from whom the holder acquired the share or whose qualifying trust is the holder of the share, has experienced an involuntary loss or interruption of employment that was not compensated through employment insurance benefits or workers' compensation benefits; or
- (c) the holder requested the repurchase within 60 days after the share was issued to the holder.

S.M. 2001, c. 24, s. 10.

Restrictions on transfers

4.2 A Class "A" Common Share may not be transferred except as follows:

- (a) by an individual to
 - (i) his or her brother, sister, parent, child, spouse or common-law partner, or former spouse or common-law partner, or
 - (ii) the trustee of a qualifying trust for the individual;
- (b) by the trustee of a qualifying trust for an individual to
 - (i) the individual or his or her brother, sister, parent, child, spouse or common-law partner, or former spouse or common-law partner, or
 - (ii) the trustee of another qualifying trust for the individual;
- (c) as a consequence of the death of an individual, to the individual's estate or to his or her heirs;
- (d) to the Fund on a repurchase of the share;
- (e) when the transfer is necessitated by an involuntary loss or interruption of employment of the holder or of an individual whose qualifying trust is the holder of the share, and the loss or interruption of employment is not compensated through employment insurance or workers' compensation benefits; or

THE CROCUS INVESTMENT FUND ACT

Appendix B
(cont'd.)

(f) when the transfer is at least

(i) seven years after the share's original acquisition date, if that date is before June 1997, or

(ii) eight years after the share's original acquisition date, if that date is after May 1997.

S.M. 2001, c. 24, s. 10.

5 Repealed.

S.M. 1993, c. 13, s. 3; S.M. 1997, c. 40, s. 5; 3">S.M. 1998, c. 28, s. 3; S.M. 2001, c. 24, s. 11.

6 Repealed.

S.M. 2001, c. 24, s. 11.

7 Repealed.

S.M. 1997, c. 40, s. 6; S.M. 2001, c. 24, s. 11.

8 Repealed.

S.M. 2001, c. 24, s. 11.

Quorum

9 At least one director who is not elected by the holder of Class "L" Special Shares shall be present at any meeting of directors of the Fund.

S.M. 2001, c. 24, s. 12.

Investment advisory committee

9.1(1) The Fund shall establish an investment advisory committee to advise the Board regarding the financial merits of proposed acquisitions of eligible investments.

Composition of committee

9.1(2) The investment advisory committee shall consist of a minimum of five persons,

(a) one of whom shall be appointed by the Board from among its members to chair the committee;

(b) a majority of whom shall be selected and appointed by the Fund from a list of nominees approved by the Board for their experience or expertise in a particular business sector or in the management of investments; and

(c) a majority of whom shall not be employees, directors or officers of the Fund.

Conflict of interest

9.1(3) A member of the investment advisory committee who has a material interest in a proposed investment by the Fund that is under consideration by the committee

Appendix B

(cont'd.)

THE CROCUS INVESTMENT FUND ACT

(a) shall disclose the nature and extent of his or her interest in writing to the committee

(i) at or before the meeting of the committee at which the proposed investment is first considered,

(ii) if the member did not then have an interest in the proposed investment, at the first meeting after he or she becomes interested in it, or

(iii) if the member had an interest in the proposed investment before becoming a member, at the first meeting after he or she becomes a member at which the proposed investment is considered; and

(b) thereafter shall not participate in the committee's deliberations or advice to the Board regarding the proposed investment.

Committee to advise Board

9.1(4) The Fund shall provide the particulars of each proposed acquisition of an eligible investment to the investment advisory committee, and the committee shall advise the Board regarding the financial merits of the proposed acquisition.

Board to consider committee's advice

9.1(5) Before approving the acquisition of an eligible investment, the Board shall consider the investment advisory committee's advice regarding the investment.

S.M. 1997, c. 40, s. 7.

10 Repealed.

S.M. 2001, c. 24, s. 13.

PART 3

OPERATION AND ADMINISTRATION

Investment policies and criteria

11(1) Subject to subsection (2), the Fund shall by by-law establish from time to time investment policies and criteria with respect to

(a) the promotion of employee ownership and employee participation in corporate governance and management;

(b) the creation, retention or protection of employment in Manitoba;

(c) employment practices, workplace safety, environmental suitability and other matters; and

(d) the composition of the investment portfolio of the Fund in terms of industry sectors, income, growth and risk.

THE CROCUS INVESTMENT FUND ACT

Appendix B
(cont'd.)**Restrictions**11(2) The Fund shall

- (a) repealed, S.M. 2001, c. 24, s. 14;
- (b) not acquire an eligible investment that would result in the total fair market value of its investments in a qualified Manitoba business entity being more than 10% of the fair market value of the Fund's investment assets;
- (c) not prohibit investment in non-unionized or unionized qualified Manitoba business entities and other businesses;
- (d) not be used as an instrument for organizing employees into unions; and
- (e) use its best efforts to ensure that a majority of its investment assets directly or indirectly promote employee ownership or employee participation in corporate governance and management.

11(3) Repealed, S.M. 2001, c. 24, s. 14.S.M. 1992, c. 58, s. 7; S.M. 2001, c. 24, s. 14.**Notice of intent to declare investment ineligible**11.1(1) Where,

- (a) at any time after the acquisition of an eligible investment by the Fund, the investment would, if it were acquired at that time, not be an eligible investment of the Fund because of one or more transactions or events in a series of transactions or events that included the Fund's acquisition of the investment; and
- (b) in the minister's opinion, the Fund's acquisition of the investment as an eligible investment is contrary to the object and spirit of this Act or sections 11.1 to 11.5 of *The Income Tax Act*;

the minister may, by written notice to the Fund within two years after the day on which the series of transactions or events came to the attention of the minister, propose that the investment be declared to be an ineligible investment.

Objection

11.1(2) The Fund may, within 30 days after receiving a notice under subsection (1), object to the proposed declaration by filing a written notice of objection with the minister setting out the relevant facts and its reasons for the objection.

Action of minister

11.1(3) Where the minister has made a proposal under subsection (1) in respect of an investment, the minister may, after considering any objection made under subsection (2),

- (a) abandon the proposal; or
- (b) declare the investment to be an ineligible investment;

Appendix B

(cont'd.)

THE CROCUS INVESTMENT FUND ACT

and shall give the Fund written notice of the decision.

Effect of declaration

11.1(4) For the purpose of sections 11.1 to 11.5 of *The Income Tax Act*, an investment that is declared under this section to be an ineligible investment is deemed never to have been an eligible investment.

Minister's declaration final

11.1(5) A declaration under subsection (3) by the minister is final and is not subject to appeal.

S.M. 1997, c. 40, s. 8; S.M. 2001, c. 24, s. 15.

Reserves

12(1) The Fund shall maintain a reserve fund equal to the total of

(a) all amounts each of which is an amount included in the cost of an eligible investment of the Fund for the purposes of sections 11.1 to 11.5 of *The Income Tax Act* because of clause 11.1(1.1)(d) of that Act; and

(b) the greater of

(i) 15% of the fair market value of its investment assets, and

(ii) 50% of the total of its outstanding guarantees.

Investment of reserve fund

12(2) The Fund shall invest the assets of its reserve fund in

(a) money on deposit with a bank to which the *Bank Act* (Canada) applies, a credit union or caisse populaire to which *The Credit Unions and Caisses Populaires Act* applies or a trust company that is incorporated under the laws of Canada or of a province of Canada and carries on the business of a trust company in Manitoba;

(b) guaranteed investment certificates issued by a bank, credit union, caisse populaire or trust company referred to in clause (a);

(c) debt obligations of

(i) the Province of Manitoba,

(ii) municipal governments within Manitoba, or

(iii) Manitoba crown corporations,

(iv) repealed, S.M. 2001, c. 24, s. 16;

(d) prescribed investments; or

(e) any combination of investments referred to in clause (a), (b), (c) or (d).

THE CROCUS INVESTMENT FUND ACT

Appendix B
(cont'd.)**Interpretation of "guarantee" or "security"**

12(3) For the purpose of subsection (1), the amount of the guarantees and securities given by the Fund does not include the amount of any guarantee or security in respect of which the liability of the Fund is limited to the portion of its investment assets comprising its investment in the person for whose benefit the guarantee or security is given.

S.M. 1997, c. 40, s. 9; S.M. 2001, c. 24, s. 16.

13 Repealed.

S.M. 1997, c. 40, s. 10; S.M. 2001, c. 24, s. 17.

Payroll deduction for share purchase

14(1) Subject to subsection (2), an employer who has been requested to do so in writing by

- (a) 20% of the Manitoba employees, if the employer has less than 250 Manitoba employees; or
- (b) 50 Manitoba employees, if the employer has 250 or more Manitoba employees;

shall, for the purpose of facilitating an employee's purchase of Class "A" Common Shares of the Fund, deduct from the salary or wages of any employee who requests that a deduction be made the amount for the number of pay periods specified in writing by that employee.

Notice to terminate deduction

14(2) If an employee gives notice to an employer in writing that the deduction of amounts from his or her salary or wages referred to in subsection (1) is to cease, the employer shall commence with the pay period following the giving of the notice cease to make the deduction.

Remittance of deductions

14(3) The employer shall, not later than the 15th day of the month following the month in which the deduction was made, remit the amounts to the Fund together with a statement specifying the amount deducted in respect of each employee, the employee's name, address, date of birth and social insurance number.

Deemed subscription

14(4) The amount remitted to the Fund by an employer on behalf of an employee is deemed to be a subscription by the employee for as many Class "A" Common Shares, including fractional shares, as may be purchased with that amount.

Amounts deemed to be salary

14(5) Until an amount deducted by the employer with respect to an employee under subsection (1) is remitted to the Fund, the amount is, for the purposes of the rights of the employee, deemed to be salary or wages owed by the employer to the employee and, if the employer fails to remit to the Fund any amount so deducted, the employee shall be entitled to enforce the payment to the employee and for that purpose is entitled to all of the rights of employees in respect of the payment of wages or salaries under any Act of the Legislature.

Appendix B

(cont'd.)

THE CROCUS INVESTMENT FUND ACT

Valuation

15(1) The fair value of the Class "A" Common Shares of the Fund shall be determined by the Board as at each valuation date.

Asset valuation

15(2) For the purpose of determining the fair value of the Class "A" Common Shares of the Fund as at any valuation date, the value of the investments assets of the Fund on that valuation date shall be determined by the Board in accordance with the following rules:

- (a) investment assets held by the Fund for which there is a published market value shall be valued at their published market value as at the valuation date;
- (b) if, despite the existence of a published market value for particular investment assets of the Fund,
 - (i) in the opinion of the Board such investment assets could not readily be disposed of through such market at the valuation date, the Board may adjust the value of those assets to reflect the amount which would likely be realized from their sale, or
 - (ii) it was the intention of the Board at the time such assets were acquired to hold them as a fixed income security until maturity, the Board may value those assets at cost, adjusted to reflect the amortized portion of the discount or premium, as the case may be;
- (c) for each valuation date preceding the first anniversary of the date on which it was acquired by the Fund, an investment asset held by the Fund for which there is no published market value shall be valued at its cost unless the Fund is required by subsection (6) to revalue the assets prior to the expiration of that one year period;
- (d) for each valuation date following the first anniversary of the date on which it was acquired by the Fund, each investment asset held by the Fund for which there is no published market value shall be valued at its net realizable value as at that date;
- (e) assets of the Fund other than investment assets shall be valued at cost less any depreciation applicable to them as determined by the Board in consultation with the auditors of the Fund.

Definition of "net realizable value"

15(3) In this section, "**net realizable value**", means the amount which would be received by the Fund from the sale of the investment asset on an orderly basis over a reasonable period of time in an arm's-length sale between the Fund and an informed, knowledgeable and willing purchaser, acting without restraint.

Report of valuation

15(4) For the purpose of determining the net realizable value of an investment asset, the Board shall cause a person qualified to make an evaluation of the investment asset to prepare a report annually, as at each anniversary date of the acquisition of the investment asset, giving his or her opinion as to the fair value of the investment asset.

THE CROCUS INVESTMENT FUND ACT

Appendix B
(cont'd.)**Duty of Board in determining value**

15(5) In determining the net realizable value of an investment asset the Board shall have regard to the report under subsection (4), to any other bona fide arm's-length transactions respecting the investment asset which in the opinion of the Board provide a valid indication of the net realizable value of the investment asset and to such other factors as the by-laws of the Fund may provide.

Revaluation

15(6) If on any valuation date the Board determines that there has been a change which may have a material effect on the value of any investment asset of the Fund, the Board shall cause a revaluation of the investment asset or investment assets affected by the change as at that valuation date.

Duty of the Board in determining value

15(7) Subject to subsection (8), for the purpose of assisting it in determining the value of the Class "A" Common Shares at a valuation date, the Board shall cause a person qualified to make an evaluation of the Fund to prepare a report stating his or her opinion as to the manner in which the value of the Class "A" Common Shares should be calculated by the accountants to the Fund at such valuation date on the assumption that the values of the investment assets of the Fund at that valuation date are the values determined in accordance with the rules set out in this section.

Exception

15(8) If on any valuation date the Board determines that since the preceding valuation date there has been no change in the assets or liabilities of the Fund which could have a material effect upon the manner of calculating the value of the Class "A" Common Shares of the Fund, the Board may dispense with the report as to the manner in which the value of the Class "A" Common Shares should be calculated, and, when it does so, the calculation determining the value of the Class "A" Common Shares shall be done by the accountants to the Fund in accordance with the last report prepared by the person qualified to make an evaluation of the Fund.

S.M. 1994, c. 27, s. 2; S.M. 1997, c. 40, s. 11; S.M. 2001, c. 24, s. 18.

PART 4

REPORTING AND COMPLIANCE

Annual statements and returns

15.1(1) The Fund must file with the minister for each fiscal year, on or before the day on or before which it is required to file its return of income under Part I of the *Income Tax Act* (Canada),

(a) a copy of its audited financial statements, together with the auditor's report on those statements; and

(b) a copy of the return of information it is required to file for the year under section 11.4 of *The Income Tax Act*, along with a written statement from the Fund's auditor attesting to the accuracy of the information it contains.

Appendix B

(cont'd.)

THE CROCUS INVESTMENT FUND ACT

Request for additional information

15.1(2) The minister may at any time, by written notice to Fund, require the Fund to file with the minister a return of information on any subject connected with the business, affairs, assets or liabilities of the Fund that, in the minister's opinion, is relevant to the administration or enforcement of this Act or of sections 11.1 to 11.5 of *The Income Tax Act*, including information that would assist the minister in determining whether or not to make a declaration under section 11.1.

Return of additional information

15.1(3) When the Fund receives a notice under subsection (2), it must provide the required return of information required by the notice within the time specified in the notice.

Extension of time

15.1(4) The minister may extend the time for filing any statement, report or return of information under this section.

S.M. 2001, c. 24, s. 19.

Records to be maintained

15.2(1) The Fund must maintain records in the form and containing the information that the minister considers necessary to determine whether the Fund is in compliance with this Act, the regulations, the articles of the Fund and sections 11.1 to 11.5 of *The Income Tax Act*.

Location and time for retention of records

15.2(2) The Fund must

- (a) keep its records at its head office in Manitoba or at any other location in Manitoba approved by the minister; and
- (b) retain them for the period of time its records are required to be retained for the purposes of the administration and enforcement of *The Income Tax Act*.

S.M. 2001, c. 24, s. 19.

"Authorized person" defined

15.3(1) In this section, "authorized person" means a person authorized by the minister for the purposes of this section.

Demand for production of records

15.3(2) If the minister considers it necessary for the administration or enforcement of this Act or sections 11.1 to 11.5 of *The Income Tax Act*, he or she may, by a demand served personally or by registered letter, require the Fund to produce for inspection, audit or examination by an authorized person any of the records referred to in section 15.2.

THE CROCUS INVESTMENT FUND ACT

Appendix B
(cont'd.)**Audits and inspections**

15.3(3) An authorized person may, at any reasonable time and for any purpose related to the administration or enforcement of this Act or sections 11.1 to 11.5 of *The Income Tax Act*, inspect, audit or examine

- (a) records produced pursuant to a demand made under subsection (2); and
- (b) records referred to in section 15.2, including documents that relate, or in the opinion of the authorized person may relate, to those records;

and the authorized person may make or cause to be made one or more copies of those records or documents.

Authorized entry

15.3(4) An authorized person may, in order to carry out an inspection, audit or examination permitted by this section,

- (a) enter into any premises or place where the Fund carries on business or where records relating to its business are kept; and
- (b) require a person having responsibility for management of the Fund's business or custody of its records, or any other person in the premises or place, to give the authorized person all reasonable assistance and to answer all proper questions relating to the administration and enforcement of this Act and sections 11.1 to 11.5 of *The Income Tax Act* and, for that purpose, require the person to attend at the premises or place with the authorized person.

S.M. 2001, c. 24, s. 19.

Offences

15.4(1) A person who

- (a) makes a false or misleading statement in any document filed with the minister under or for the purposes of this Act or the regulations; or
- (b) interferes with an inspection, audit or investigation by an authorized person under section 15.3;

is guilty of an offence and is liable on summary conviction

- (c) in the case of an individual, to a fine of not less than \$1,000. and not more than \$20,000. or imprisonment for a term of not more than two years, or both; and
- (d) in the case of a corporation, to a fine of not less than \$5,000. and not more than \$100,000.

Offence by Fund

15.4(2) If the minister notifies the Fund of its failure to comply with a requirement under this Act or sections 11.1 to 11.5 of *The Income Tax Act* to file or provide, or to produce for inspection, a record, report, return, statement or other information, and the Fund does not comply with that requirement within 30 days after receiving the notice, the Fund is guilty of an offence and is liable on summary conviction to a fine of not less than \$5,000. and not more than \$100,000.

Appendix B

(cont'd.)

THE CROCUS INVESTMENT FUND ACT

Liability of director, officer or agent

15.4(3) If a corporation commits an offence under this Act, a director, officer or agent of the corporation who authorized, permitted or acquiesced in the commission of the offence is also guilty of an offence and is liable on summary conviction to a fine of not more than \$20,000., whether or not the corporation has been prosecuted or convicted.

Defence re false or misleading statement

15.4(4) A person is not guilty of an offence under clause (1)(a) or under subsection (3) in respect of a statement that is false or misleading if the person

(a) did not know, and in the exercise of reasonable diligence could not have known, that the statement was false or misleading; and

(b) upon becoming aware that the statement was false or misleading, took steps to notify the minister that the statement was false or misleading.

Defence re interference with audit or inspection

15.4(5) A person is not guilty of an offence under clause (1)(b) in respect of a refusal to provide, disclose or permit access to information or records if the person demonstrates to the satisfaction of the court that

(a) he or she communicated to the minister or a person authorized to act for the minister that the information or records were protected by a solicitor-client privilege; and

(b) he or she believed on reasonable grounds that the information or records were protected by a solicitor-client privilege that had not been waived by the person entitled to waive it.

Limitation on prosecution

15.4(6) No prosecution for an offence under this Act may be instituted more than two years after the day on which evidence sufficient to justify a prosecution for the offence came to the knowledge of the minister, and a certificate of the minister as to the day on which the evidence came to his or her knowledge is, in the absence of evidence to the contrary, proof of that date.

S.M. 2001, c. 24, s. 19.

Monthly reporting re investment shortfalls

15.5(1) If at any time the Fund has had an investment shortfall of more than \$1,000,000. for any 18 months in a 36-month period, it must provide to the minister, by the end of each month and in a form approved by the minister, a report setting out

(a) all information required to determine whether the Fund had an investment shortfall for the immediately preceding month; and

(b) the value, as at the end of the immediately preceding month, of the Fund's investment assets and of its reserves under section 12.

THE CROCUS INVESTMENT FUND ACT

Appendix B
(cont'd.)**Duration of monthly reporting**

15.5(2) The monthly reporting requirement under subsection (1) applies to the first month after the last of the 18 months referred to in that subsection and to every month after that until the monthly reports demonstrate that the Fund has had no investment shortfall for a period of 12 consecutive months and is meeting the liquid reserve requirement in section 12.

S.M. 2001, c. 24, s. 19.

Minister may declare shares ineligible for tax credit

15.6(1) In the following circumstances, the minister may, by written order, declare the Class "A" Common Shares that are issued after a date specified in the order to be ineligible for the labour-sponsored funds tax credit under section 11.1 of *The Income Tax Act*:

- (a) the minister has notified the Fund of its failure to comply with a requirement under this Act or sections 11.1 to 11.5 of *The Income Tax Act* to file or provide, or to produce for inspection, a record, report, return, statement or other information, and the Fund does not comply with that requirement within 30 days after receiving the notice;
- (b) the minister has notified the Fund of its failure to value its shares in accordance with section 15, and the Fund does not make the valuation as required within 30 days after receiving the notice;
- (c) the Fund has had an investment shortfall of at least \$1,000,000. for any two months within a period during which it is required to provide monthly reports to the minister under section 15.5;
- (d) the Fund fails for a period of more than 60 days to maintain the reserve required by section 12;
- (e) the Fund fails to pay a tax or penalty payable under section 11.1, 11.2 or 11.3 of *The Income Tax Act* within 60 days after it is assessed; or
- (f) the articles of the Fund are amended contrary to subsection 4(1.1).

Notice of order

15.6(2) The minister must give the Fund written notice of an order made under subsection (1) at least seven days before the date specified in the order.

Cancellation or suspension of order

15.6(3) If, after an order is issued under subsection (1), the Fund is no longer in default under that subsection, the minister

- (a) must cancel the order if no order has been made under that subsection within the immediately preceding 96 months; and
- (b) in any other case, may cancel the order, or may suspend it subject to any conditions the minister considers appropriate.

When no longer in default

15.6(4) For the purpose of subsection (3), the Fund is no longer in default under subsection (1) when all of the following conditions are met:

Appendix B

(cont'd.)

THE CROCUS INVESTMENT FUND ACT

- (a) if it was given notice under clause (1)(a) or (b) of a failure to comply with a requirement, it has complied with that requirement;
- (b) if applicable, the Fund has filed with the minister the latest monthly report required to be filed under section 15.5 and, according to that report, did not have an investment shortfall for the month for which that report was filed;
- (c) the Fund is meeting the requirements of section 12 respecting reserves;
- (d) the Fund has paid all taxes and penalties payable under sections 11.1, 11.2 and 11.3 of *The Income Tax Act*;
- (e) if the articles of the Fund were amended contrary to subsection 4(1.1), the minister has approved the amendments or the articles are further amended with the approval of the minister.

S.M. 2001, c. 24, s. 19.

16 to 22 Repealed.

S.M. 1997, c. 40, s. 12.

PART 5

REGULATIONS

Regulations

23 The Lieutenant Governor in Council may make regulations

- (a) for the purpose of subsection 4(5), prescribing the circumstances in which the stated capital of the Fund may be reduced;
- (b) for the purpose of clause 12(2)(d), prescribing investments in which the Fund may invest its reserve fund;
- (c) for the purpose of the definition "eligible investment" in subsection 1(1),
 - (i) prescribing classes of investments as ineligible investments and enabling the minister, on application by the Fund, to exempt specific investments from those classes, and
 - (ii) prescribing investments or classes of investments as eligible investments;
- (c.1) defining "flow-through investment vehicle", prescribing the circumstances under which, and the extent to which, an investment of a flow-through investment vehicle qualifies as an eligible investment of the Fund, and establishing the Fund's cost of such an investment for the purposes of sections 11.1 to 11.4 of *The Income Tax Act*;
- (d) respecting any other matter that the Lieutenant Governor in Council considers necessary for carrying out the purposes of this Act.

S.M. 1997, c. 40, s. 13; S.M. 2001, c. 24, s. 20.

THE CROCUS INVESTMENT FUND ACT

Appendix B
(cont'd.)

PART 6

CONSEQUENTIAL AMENDMENTS AND COMING INTO FORCE

24 NOTE: This section contained consequential amendments to *The Income Tax Act* which are now included in that Act.

C.C.S.M. reference

25 This Act shall no longer be referred to as chapter E95 of the *Continuing Consolidation of the Statutes of Manitoba* but may be referred to as chapter C308 of the *Continuing Consolidation of the Statutes of Manitoba*.

S.M. 2001, c. 24, s. 21.

Coming into force

26 This Act comes into force on a day fixed by proclamation.

NOTE: S.M. 1991-92, c. 48 was proclaimed in force March 21, 1992.

SCHEDULE

Repealed.

S.M. 1993, c. 13, s. 4 and 5; S.M. 1994, c. 27, s. 3 and 4; S.M. 1997, c. 40, s. 14 to 17; S.M. 2000, c. 51, s. 2; S.M. 2001, c. 24, s. 22.

Appendix C

EMPLOYEE EXPENSE AND TRAVEL POLICY



Crocus Investment Fund
Bringing Your Investments Home

Expense and Travel Policy

For the Employees of

Crocus Investment Fund

EMPLOYEE EXPENSE AND TRAVEL POLICY

Appendix C
(cont'd.)Corporate Expense and Travel Policy**TABLE OF CONTENTS****1. Expense Reimbursement**

Our Policy

- Documentation Requirements
- Acceptable Receipts
- Unacceptable Receipts
- Incorrect or Incomplete Expense Reports
- Approval Levels

2. Mileage Allowance

Our Policy

3. Corporate Charge Cards

- Required Use of Corporate Charge Card
- Personal Use of Corporate Charge Credit Card
- Reporting Lost/Stolen Cards
- Cardholder Employee Termination
- Business Use of Personal Charge/Credit Card
- Cash Advances
- Cash Advance Limits
- Cash Advance Fees

4. Out of Town Travel Reimbursement Policy

Our Policy

- Expense Reimbursement Process
- Airline Tickets
- Class of Service
- Saturday Stay Overs
- Frequent Flyer points
- Unused Tickets
- Reimbursable items and Process
- Safety Tips

Appendix C

(cont'd.)

EMPLOYEE EXPENSE AND TRAVEL POLICY

Corporate Expense and Travel Policy

Crocus & You Expense Reimbursement

THE CROCUS INVESTMENT FUND APPROACH

- To provide you with the policies and guidelines you need to submit expense reports in a manner that is efficient and effective for all parties involved.

OUR POLICY

- Expense reports should be completed and submitted on a monthly basis or as soon as possible after the expense has been incurred, to ensure work in progress and office expenses are up to date.
- Expenses submitted after 3 months from the later of the expense date or billing date are considered "stale-dated" and will not be reimbursed.
- For reimbursement of business expenses, staff must use their corporate credit card whenever it is accepted, for all charges.
- Expense reports must be supported with original receipts and proper approvals in pen. Expenses not supported by original receipts will not be accepted by Accounting for processing and will be returned to the submitter. Exceptions to the original receipts requirement are mileage claims and electronic (e-ticket or ticketless air travel) airline tickets which will be paid directly to travel Unlimited.
- Staff are expected to maintain accurate expense records and use discretion in incurring costs.
- Where business development expenses are claimed (particularly in case of meals), the individual participants covered by the expense claim should be identified.
- Expenses will be reimbursed through the accounts payable clerk when an approved expense report is received in Accounting. Payment will be made by cheque within 5 working days to the employee.

DOCUMENTATION AND REVENUE CANADA REQUIREMENTS

An original receipt must be submitted with the expense report for any individual meal or entertainment expense. In addition, for business meal and entertainment expenses: the following documentation is required by Revenue Canada, and must be recorded on the expense report in order to be reimbursed for expenditures:

- Names of individuals present and company name
- Name and location of where the meal or event took place
- Exact amount and date of the expense
- Specific business topic discussed
- In the case of entertainment events, the specific time the business discussion took place (i.e., before, during or after the event)

NOTE: Writing the names etc on the back of receipts at time of event helps prepare reports.

EMPLOYEE EXPENSE AND TRAVEL POLICY

Appendix C
(cont'd.)Corporate Expense and Travel Policy

Employees must submit the following documentation along with their expense report form:

- Hotel – hotel folio plus charge card receipt or other proof of payment
- Car Rental – rental car agreement plus charge/credit card receipt or other proof of payment
- Meals/Entertainment – charge receipt or cash register receipt (no restaurant tear tabs)
- Receipts for all miscellaneous expenses

When a receipt is unavailable, a full explanation of the expense and the reason for the missing receipt is required.

Actual bills/receipts must be submitted whenever possible; photocopies will be acceptable only with a detailed explanation as to why the originals are not available.

Receipts must include the name of the vendor, location, date and dollar amount.

ACCEPTABLE RECEIPTS

The following receipts are acceptable:

- Original receipt completed by the vendor
- Customers copy of charge card slip
- Charge card billing statement
- Original phone bill

UNACCEPTABLE RECEIPTS

The following receipts are NOT acceptable:

- Restaurant tear tabs
- Photocopies, unless accompanied by a full explanation

INCORRECT OR INCOMPLETE EXPENSE REPORTS

Expense reports that are incorrect or incomplete:

- Will be returned to the approver for corrective action
- May result in delay or non-reimbursement of specific items

Disregard for company policy or altering of receipts can result in disciplinary action or termination.

APPROVAL LEVELS

The level of authority required for approving travel, general expense and entertainment related expenses is as follows:

- Direct supervisor whether Manager, Director, VP or CEO
- When expenses are related to another departments activities that Manager, Director, VP or CEO departments may approve.

No employee is authorized to approve their own, a peer's, or a superior's travel expense report. An authorized employee of Crocus Investment Fund will sign off on the CEO's report.

Appendix C

(cont'd.)

EMPLOYEE EXPENSE AND TRAVEL POLICY

Corporate Expense and Travel Policy

Each employee expense report will be reviewed by Accounts Payable for:

- Approval signatures
- Business purpose
- Correct totals
- Supporting documentation and receipts
- Policy compliance

EMPLOYEE EXPENSE AND TRAVEL POLICY

Appendix C
(cont'd.)

Corporate Expense and Travel Policy**Crocus & You**
Mileage Allowance**THE CROCUS INVESTMENT FUND APPROACH**

- To provide a reasonable reimbursement for the cost you incur when using your own vehicle for business purposes.

OUR POLICY

- Mileage allowance is paid for travel to client locations.
- Effective September 1, 2000 the mileage rate is \$.34/km when using your own car for Crocus business. If you go directly to the business location from home, you can charge the distance to the client's location, less the normal distance to work.
- Trips to the airport should be based on distance from home or office (as appropriate) to the airport.
- The mileage allowance is intended to cover various costs, including gasoline. Accordingly, a separate claim for gas expenses should not be made where a mileage allowance is claimed.
- Mileage to social events is not eligible to be claimed.
- This policy will be reviewed on an annual basis and adjusted accordingly, if required.
- Mileage is not paid from home to office.
- T2200 will be available on request.

Appendix C

(cont'd.)

EMPLOYEE EXPENSE AND TRAVEL POLICY

Corporate Expense and Travel Policy

Crocus and You Corporate Charge Cards

OUR POLICY

- For reimbursement of business expenses staff must use their corporate credit card whenever it is acceptable for all charges.
- Visa expense reports should follow the same guidelines as expense reports.
- All Visa's must be reconciled monthly.
- All Visa's submitted after three months may result in card cancellation or other corrective action.

REQUIRED USE OF CORPORATE CHARGE CARD

Employees must use corporate charge card to pay for all:

- Business meals and entertainment
- Air travel
- Lodging
- Car rental
- Rail travel
- Miscellaneous expense and travel expenses

The company will absorb annual fees for all corporate cards.

PERSONAL USE OF CORPORATE CHARGE CREDIT CARD

Corporate charge cards may NOT be used for personal expenses. Where Crocus and the employee are sharing the cost of an item, pay employee portion immediately with a personal cheque.

REPORTING LOST/STOLEN CARDS

A lost or stolen charge card must be reported as soon as the employee discovers it is missing. Data on stolen charge or credit cards indicates that unauthorized use of stolen cards is greatest in the first few hours after the theft.

To report a lost or stolen card, please call 1-800-ROYAL-1-2, outside North America (514) 874-8588

CARDHOLDER EMPLOYEE TERMINATION

Upon termination of employment, all corporate cardholders must:

- Cut the corporate card in half and send to Accounts Payable.

BUSINESS USE OF PERSONAL CHARGE/CREDIT CARD

Personal charge or credit cards may be used for business travel only:

- By employees who do not meet the insurance criteria for a corporate charge card.
 - At establishments that do not accept the corporate charge card (a written explanation must be recorded on the expense report form)
 - Where other cards offer insurance not covered by our corporate charge card.
- Travelers will NOT be reimbursed for annual fees on personal charge or credit cards.

EMPLOYEE EXPENSE AND TRAVEL POLICY

Appendix C
(cont'd.)Corporate Expense and Travel Policy

CASH ADVANCES

Employees are discouraged from using cash advances to pay for business travel expenses. Cash advances should only be incurred:

- Under emergency situations.

CASH ADVANCE LIMITS

The amount of cash requested should be the minimum necessary to cover anticipated out-of-pocket expenses not chargeable to the employee's corporate card. The maximum amount advanced using your VISA card at an ATM will be:

- \$100.00 per day for domestic travel
- \$200.00 per day for other International travel and US.
- All cash advances require receipts to confirm amount spent. Excess must be returned with receipts promptly or advance will be added to employee loan owing.

CASH ADVANCE FEES

Fees for cash advances from charge cards/ATMs will be reimbursed within reasonable limits.

Appendix C

(cont'd.)

EMPLOYEE EXPENSE AND TRAVEL POLICY

Corporate Expense and Travel Policy

Crocus & You Out-Of-Town Travel Reimbursement

The Crocus Approach

- To provide a framework for staff to balance the need to manage the Fund's costs with the goals of making business travel comfortable and conducive to doing business.
- To support the Fund's mission where ever possible.

Our Policy

- The details included in this policy describe the process for incurring reimbursable expenses while travelling out-of-town.
- Staff members must ensure their senior staff member (authorized to approve such business travel) is aware of the proposed travel prior to any given trip. Staff should exercise their good business judgement to determine whether an expense is necessary and in support of the interests of the business.

EXPENSE REIMBURSEMENT PROCESS

In order to deliver the most efficient method of managing the costs of business travel, the Fund provides Corporate VISA cards. All business expenses must be charged to your VISA card.

Travel tickets are booked directly with Travel Unlimited.

AIRLINE TICKETS

Travel tickets are booked directly with Travel Unlimited. We use only unionized airlines (Air Canada and Canadian).

You are required to book the most economical fare at the time of booking. Generally, the earlier a ticket is booked, the greater the chance of getting a discounted ticket. For your information, flexibility is often noted as a key requirement for business travel. Full fare tickets can be changed as required with no penalty. Discounted tickets can also be changed, for a fee, usually \$100. Also, if a trip booked with a discounted, non-refundable ticket, has to be changed, the traveler can apply the value of that ticket to his or her next trip on that carrier, again, for a fee.

CLASS OF SERVICE

Effective immediately, all new airline bookings with our contracted agency will be made according to the following policy:

All North American travel	Economy
All International travel	Business Class

Staff who traveled more than 15 round trips during the preceding 12-month period may fly in Business Class. Eligibility will be determined from reports provided by our contracted agency and the eligible staff will be notified. Eligibility will be reviewed every 6 months using agency reports on the previous 12 months.

EMPLOYEE EXPENSE AND TRAVEL POLICY

Appendix C
(cont'd.)Corporate Expense and Travel Policy

If a director/manager is travelling with an employee not authorized to travel in the higher class of service and they sit together, upgrades may be used if available. If you are travelling with a client, the same class should be used. Otherwise, all must purchase tickets in the lower class of service.

SATURDAY STAY OVERS

If your business trip doesn't already include a Saturday stay over, and you personally wish to extend your trip to include a "Saturday stay over" the Fund will support this. You may decide to add your personal time to the beginning or end of business travel such that this extension results in a saving to the overall business travel cost. As example, airfares are often significantly reduced if the trip includes staying a Saturday night in the destination assignment, you may claim the cost of the additional hotel night(s) as long as these additional costs do not exceed the savings gained on the "Saturday stay over" airfare. Our contracted travel agency, upon request, will provide you with the cost differentials to assist you and your partner with this option.

FREQUENT FLYER POINTS

Any frequent flyer miles or points may be retained for use at your discretion. You may not increase the cost of your business travel to earn extra miles or points.

UNUSED TICKETS

Airline tickets and unused flight coupons are like cash and are negotiable documents. Never destroy or deface unused airline tickets. Even non-refundable tickets have value – if cancelled prior to departure, the face value of the ticket can be applied to future travel for the passenger named on the ticket, up to one year after booking and on the same carrier.

All unused tickets must be returned to the issuing agency, which will manage their re-issue on behalf of the passenger.

REIMBURSEABLE ITEMS & REIMBURSEMENT PROCESS

The Fund will reimburse the actual cost of lodging, including the room charge and any associated taxes. Personal discretionary charges, such as minibar and movies are not reimbursable.

BUSINESS CALLS, FAXES, ETC

All calls will be reimbursed, based on original receipts. In order to minimize these costs, please use your calling card.

PHONE CALLS HOME

The Fund will reimburse for the costs associated with reasonable length telephone calls home to help you stay in touch with family or friends.

LAUNDRY AND DRY CLEANING

The Fund will reimburse reasonable laundering and dry cleaning expenses based on original receipts.

Appendix C

(cont'd.)

EMPLOYEE EXPENSE AND TRAVEL POLICY

Corporate Expense and Travel Policy

PREFERRED CLIENT PROGRAMS

Many hotel chains offer preferred guest programs. You are encouraged to join these programs, as membership may entitle you to upgrades when available, requests for personal preferences, local papers, free coffee in-room, and free local calls. You are also encouraged to use unionized hotels whenever possible.

ALTERNATE LODGING

If you stay with family or friends on a business trip, you may claim up to \$50 per trip, based on actual receipts, to cover the cost of a gift or meal by way of Thanks.

CHILD CARE

The Fund will reimburse for overnight childcare where the other parent is not available.

HEALTH CLUB FACILITIES

The Fund will reimburse employees for expenses incurred for the use of health club facilities while traveling.

GENERAL TRAVEL SAFETY TIPS

The Following suggestions will provide a more safe and pleasurable trip for travelers:

AIR TRAVEL

- Plan to arrive at the airport at least one hour before domestic flights and two hours before international flights. To avoid having to stand in line, ask the travel counselor to include boarding passes with your ticket whenever possible.
- So not leave luggage unattended or with someone you do not know.
- Never agree to carry anything on board or in your luggage. For added security, use tags that conceal your name and address.
- Remove all old destination tags to avoid misdirection by baggage handlers.
- Carry all medication, important business papers, some toiletries and a change of clothing in carry-on luggage in case the checked luggage is misplaced.

UPON ARRIVAL AT YOUR DESTINATION

- Beware of people claiming to be cab drivers in unmarked cars. Use licensed taxi or limousine services only.
- If renting a car, get maps in advance or from the rental car counter and clearly write out the directions from the airport to the hotel. Stop to ask for directions only in well-lit public areas. Keep the phone number of your destination with you.
- If unfamiliar with the local language, carry a card or matchbook with the hotel's name and address. This can be shown to a cab driver or police officer should you become lost.
- Do not leave a sign on the hotel room door for maid service as it announces an empty room for would-be thieves.
- Be sure to carry your credit/charge card company's telephone number in case the card is lost or stolen. Always report losses immediately.

EMPLOYEE EXPENSE AND TRAVEL POLICY

Appendix C
(cont'd.)Corporate Expense and Travel Policy

HOTEL FIRE SAFETY TIPS

While major hotels are equipped with smoke alarms, sprinkler systems and emergency evacuation instructions, fire safety awareness will increase a traveler's chance of survival in the unlikely event of a hotel fire.

WHEN STAYING AT A HOTEL...

- Check fire exits. Find the two nearest exits to your room and count the doorways so you can feel your way in the dark and smoke.
- Place your key on the nightstand and your shoes by the bed so they are accessible.

IN CASE OF FIRE OR SMOKE...

- Put on your shoes, grab your room key and head for the door. If there's any smoke in your room, get on your hands and knees and crawl. The fresh air you need to survive is near the floor.
- Feel the door and the knob. If they are cool open the door and check the hall. If they are hot, do not open the door. Stay in your room and fight the fire.
- If the hallway is clear, close the door behind you and walk to the nearest exit. Never take an elevator in case of fire! Keep your room key with you in case the hallway becomes blocked and you need to return to your room.
- If the hall has smoke in it, close the door and crawl to the nearest exit. Stay against the wall so that you can count the doorways.
- When walking down the stairwell, hold the handrail to keep your balance.

IF YOU MUST STAY IN YOUR ROOM TO FIGHT THE FIRE

- Open your window to vent smoke. If your window doesn't open, do not break it unless absolutely necessary. You may have to close it later if smoke is outside. Never jump from the third floor or above, chances are you won't survive the fall.
- Call the desk to tell them you're in your room. Hang a sheet out the window to signal firemen.
- Fill the tub with water and turn on the bathroom vent fan.
- Wet some sheets or towels and stuff cracks of your door to keep out smoke. Use your ice bucket to bail water on the door. If the walls are hot, bail water on them. Keep everything wet.
- If there is a fire outside, get everything combustible out of the way from the window.
- A wet towel tied around your nose and mouth is an effective filter if you fold it in a triangle and put the bottom corner in your mouth.
- Don't panic! Keep fighting the fire until rescue arrives.

Appendix D

DRAFT CONFLICT OF INTEREST POLICY



CROCUS INVESTMENT FUND

("Crocus")

WORKPLACE CONFLICT OF INTEREST AND CONFIDENTIALITY POLICY

INTRODUCTION

Crocus is proud of its tradition of integrity and the high standard of conduct of its employees. Underlying Crocus' reputation as a quality organization and a trusted partner is the culture that the business and affairs of Crocus and its business partners and potential partners are maintained in confidence by Crocus, its directors, officers and employees and that Crocus' employees operate in a manner that avoids conflicts of interest.

PURPOSE

Employees of Crocus have certain legal obligations to act appropriately with confidential information relating to Crocus, its investee companies and its potential investee companies. Accordingly, it is essential that all employees of Crocus are aware of these obligations. The purpose of this policy is to establish clear guidelines for the duties and obligations of Crocus employees in the context of avoiding actual or potential conflicts of interest. It is essential that all employees of Crocus avoid any situation or interest that might interfere with his/her judgment or responsibilities to Crocus. Additionally, this policy sets out the expected standard for maintaining confidentiality of matters arising as a result of working for or on behalf of Crocus and the ethical conduct expected of Crocus employees in performing their obligations as employees of Crocus. Adherence to this policy will limit any potential exposure that employees of Crocus may have for violating securities laws or other confidentiality requirements.

APPLICABILITY

This policy applies to all employees of Crocus.

POLICIES

1. **Good Faith** All employees shall serve Crocus faithfully and to the best of their abilities, and shall, during the term of their employment, act diligently, honestly, in good faith, and devote sufficient time and attention to Crocus as is required to fulfill the terms and conditions of their employment obligation.
2. **Maintenance of Confidentiality** The employee, while employed by Crocus and after such employment ends, will not disclose or release to or discuss with any

DRAFT CONFLICT OF INTEREST POLICY

Appendix D
(cont'd.)

person any Confidential Information unless so authorized by Crocus.

3. **"Confidential Information"** means information pertaining to the business and affairs of Crocus generally or to any of its directors, officers, employees, shareholders, suppliers, investee companies, potential investee companies or its affiliates, subsidiaries, related funds or other persons or entities that have dealings with Crocus, but does not include information that generally is available to the public without breaching this policy or that has been authorized to be released by Crocus, the person or entity.
4. **Insider Trading** The employee must comply with the provisions of *The Securities Act* (Manitoba), relating to "Insider Trading". The employee is prohibited by law from trading on inside information and from disseminating inside information. Insider information means material information regarding Crocus or its investee companies, or potential investee companies, which is available to the employee by virtue of his/her employment with Crocus.
5. **"Inside information"** means material information regarding Crocus or its investee companies, or potential investee companies, which is available to the employee by virtue of his/her employment with Crocus.
6. **Investments by Employees** No employee of Crocus, nor the spouse, or child of an employee of Crocus, shall make an investment in or with or loan money to or accept a loan from any investee company of Crocus or potential investee company of Crocus (other than nominal amounts (less than \$500 (Cdn)) of shares in public companies purchased on the open market and units or shares of prospectus qualified mutual funds). Any exception to this must be cleared by the President of Crocus after full disclosure, and such exceptions to this policy will be granted only if there are compelling circumstances for making such an investment.
7. **Conflicts to be Avoided** The employee has read Crocus' "Bylaw Establishing Investment Policies" dated January 5, 1993 and the conflict of interest provisions contained therein. Accordingly, the employee acknowledges that he/she must not place himself/herself in a position where there may be a conflict of interest between the employee and Crocus or any investee or potential investee company. In the event an employee is involved in an actual or potential conflict of interest situation, the employee must notify his/her immediate supervisor who will make a written record of the details of said notification and submit the written record to the designated person of Crocus.

The designated person of Crocus will immediately advise the President of Crocus of the reported actual or potential conflict of interest situation and facilitate a clear and directive response to the employee through his/her immediate supervisor.

8. **Conflict of interest includes** circumstances where Confidential Information is used or may be used by an employee for the employee's self-interest or where the

Appendix D

(cont'd.)

DRAFT CONFLICT OF INTEREST POLICY

employee has the potential to benefit or will benefit from action taken by Crocus or any investee or potential investee company (outside of the ordinary employer-employee relationship or the employee's relationship with Crocus as a Class A Common Shareholder).

9. **No Outside Payments** Except with the prior written permission of Crocus, an employee will not accept any compensation, consideration, commission, gratuity or other material payment or benefits of any kind (monetary or otherwise) from any person, including from investee companies, other than Crocus in respect of the performance or intended performance of the employee's duties or the exercise or intended exercise of the powers and discretions associated with employment by Crocus. Any compensation, consideration, commission, gratuity, stock options, dividends or other material payments of any kind received by an employee from an investee company of Crocus will be received by the employee in trust on behalf of Crocus and the employee will promptly remit such payment to Crocus or deal with it as Crocus may direct.
10. **Non-Conflict of Interest Change of Status** In the event an employee has a business relationship with a non-investee company that becomes a potential investee company, the employee may not accept any form of gratuity, stock options, dividends or other payments or benefit of any kind from that company. In such a case the employee must also declare the business relationship and all gratuity, stock options, dividends or other payments of any kind that have been received by him/her during the business relationship with that non-investee company.

In the event the potential investee company status fails to proceed to a Crocus investment, the employee may resume his/her normal business relationship with the non-investee company as it were prior to the potential of a Crocus investment so long as the employee continues to meet his/her employment obligations to Crocus in a responsible manner.

CONSEQUENCES OF BREACH OF POLICY

Crocus considers this policy to be vital to its existence and mandate. An employee who is found to have breached this policy may be subjected to discipline, up to and including dismissal, and Crocus may also pursue other remedies as may be available through due process of the law.

PENSION AND PERQUISITE POLICY

Appendix E

Pension and Perquisite Policy**Pension Plan – All Employees**

Those staff earning an annual salary over the Revenue Canada cap for individual pension contributions will receive an adjustment to their compensation based on the application of the percentage of the CLC plan's mandated employer contribution match (currently 7.5%) to the difference between their salary level and the Revenue Canada pension cap.

Executive Management Perquisite Program – Officers Only

This program applies to Officers of the Fund. The program is a flexible perquisite instrument that will operate as a "capped envelope" of perquisite offerings for which the Company will compensate executive management Officers. Each Officer will have an annual entitlement to a \$22,000.00 fixed cap envelope from which they will be able to choose from a list of available items. The envelope exists solely for the known items and reimbursement of costs incurred by the Officers (there are no cash disbursement associated with the concept).

The items within the envelope for which people can be reimbursed is fixed as follows:

Transportation

- Car allowance (lease and operating expenses)
- Vehicles leased or purchased under this benefit must be union made in North America.

Memberships

- Professional associations (note 1)
- Business luncheon club (Note 2)
- Recreation club (note 3)

Personal & family services

- Daycare & eldercare
- Personal services (Note 4)

Health & family protection (Note 5)

- Life insurance (term)
- Health & wellness services

Appendix E

(cont'd.)

PENSION AND PERQUISITE POLICY

Notes:

1. Items to be contained within the envelope include those organizations and/or associations that have a combined business networking rationale and a social component. Items that will not be contained in the envelope include professional associations or institutes in which membership is required in order for an individual to maintain a professional standing to the benefit of the Fund. The cost of these kinds of associations and memberships would be fully covered by the Company and not impinge of the \$22,000.00 envelope.
2. Officers may choose to hold memberships in clubs that typically are used for social networking with business associates (e.g. Winnipeg Winter Club). These costs will be covered within the envelope.
3. Officers may choose to hold memberships in recreation clubs such as golf clubs, fitness centres, etc.
4. Personal services from which officers may choose include:
 - a. Legal counselling
 - b. Financial planning and estate planning
 - c. Tax preparation
 - d. Retirement counselling – pre/post
5. Any services purchased in this area would be above those already provided for in established corporate coverage.

Beyond these details, any expenditure that has not been pre-budgeted will be presumed to be an “in envelope” cost unless a pre-expenditure approval for an expenditure to be treated as outside the envelope has been granted.

PENSION AND PERQUISITE POLICY

Appendix E (cont'd.)

Perquisite Policy – Non-Officer Vice Presidents

Application

This perquisite policy applies to Non-Officer Vice President (NOVPs) positions generally to include Vice Presidents (VPs) and Senior Vice Presidents (SVPs) (or any other title similar in job scope as VP or SVP).

Eligibility

All NOVPs are eligible to receive this perquisite package one year following their promotion to the NOVP position. Should an employee receive a mid-year promotion to a NOVP position, the supervising manager shall have the discretion to recommend eligibility for the perquisite package commencing the beginning of the following fiscal year, subject to budgetary approval and approval of their manager. Exceptions include:

1. When determined necessary in hiring a new employee into a NOVP position, and it is determined that providing the perquisite package to the prospective employee upon commencement of employment is required to secure the hire. This exception is subject to both budgetary approval and manager approval.
2. If an employee already has a plan equivalent to a perquisite package, the employee will not be eligible to apply for perquisite benefits under this program.

Management Perquisite Program – Non-Officer Vice President's

This program applies to Non-Officer Vice President's (NOVPs) of the Fund. The program is a flexible perquisite instrument that will operate as a "capped envelope" of perquisite offerings for which the Company will compensate NOVPs. Each NOVP will have an annual entitlement to a \$12,000 fixed cap envelope from which they will be able to choose from a list of available items. The envelope exists solely for the known items and reimbursement of costs incurred by the NOVPs (there are no cash disbursements associate with the concept).

The items within the envelope for which people can be reimbursed is fixed as follows:

- Transportation
 - Car allowance (lease and operating expenses)
 - Vehicles leased or purchased under this benefit must be union made in North America
- Memberships
 - Professional associations (Note 1)
 - Business luncheon club (Note 2)
 - Recreation club (Note 3)

Appendix E

(cont'd.)

PENSION AND PERQUISITE POLICY

- Personal and family services
 - Daycare and eldercare
 - Personal services (Note 4)
- Health and family protection (Note 5)
 - Life insurance (term)
 - Health and wellness services

NOTES:

1. Items to be contained within the envelope include those organizations and/or associations that have a combined business networking rationale and a social component. Items that will not be contained in the envelope include professional associations or institutes in which membership is required in order to an individual to maintain a professional standing to the benefit of the Fund. The cost of these kinds of associations and memberships would be fully covered by the Company and non impinge on the \$12,000 envelope.
2. Officers may choose to hold memberships in clubs that typically are used for social networking with business associates (e.g. Winnipeg Winter Club). These costs will be covered within the envelope.
3. Officers may choose to hold memberships in recreation clubs such as golf clubs, fitness centers, etc.
4. Personal services from which Officers may choose include:
 - a. Legal counseling
 - b. Financial planning and estate planning
 - c. Tax preparation
 - d. Retirement counseling – pre/post
5. Any services purchased in this area would be above those already provided for in established corporate coverage.

Beyond these details, any expenditure that has not been pre-budgeted will be presumed to be an “in envelope” cost unless a pre-expenditure approval for an expenditure to be treated as outside the envelope has been granted.

ANNOUNCEMENT OF \$10 MILLION SOLIDARITY TRANSACTION

Appendix F



December 3, 2002 - For Immediate Release

Crocus attracts \$10 million institutional investment

(WINNIPEG) Crocus Investment Fund announced today it has concluded a \$10 million institutional investment from Fonds de solidarité FTQ, a Quebec based Labour Sponsored Investment Fund.

"This is tremendous news for businesses in Manitoba and a strong signal to other local and national institutional investors that Manitoba has a strong economy and is a great place to invest," said Shernian Kreiner, President and CEO of Crocus. "This is also a strong endorsement of the Crocus management team and the Crocus Fund's investment portfolio."

Ponds de solidarité VFQ is the oldest and largest fund of its kind in Canada with approximately \$4.4 billion in assets under administration. Solidarité and Crocus are both founding members of the Labour-Sponsored Investment Funds Alliance which includes five funds from across Canada that share a common mission of creating value for shareholders and making a real social and economic difference in their local communities.

The Solidarité investment is part of a continuing relationship between the two organizations that has benefited both the Manitoba and Quebec economies. Their combined advocacy work at the federal level through the LSIF Alliance has protected and improved federal tax support for LSIF investors. Solidarité is also an institutional investor with Crocus in the Manitoba Science & Technology Fund (MS&T). Further, Crocus recently announced a partnership with BioCapital, a Montreal-based international biotechnology venture capital fund, created by Solidarité, in which Crocus would seek to inject up to \$30 million dollars sourced from local institutional investors as part of a \$200 million US offering.

"The investment by Solidarité supplements funds from our retail investors and gives us extra flexibility to take advantage of growth opportunities in the current portfolio," said James Umlah, the Chief Investment Officer at Crocus. "It will also allows us to respond more aggressively to new opportunities that may be available at very attractive prices in this economy."

With today's announcement Crocus reinforces its position as Manitoba's largest and most successful labour-sponsored venture capital corporation with \$184 million in assets under administration including \$174 million in its flagship Crocus Investment Fund and \$10 million in the Manitoba Science & Technology Fund managed through its wholly-owned subsidiary SciTech Management. Investments by Crocus in approximately 60 Manitoba businesses have helped create, save or maintain 11,400 jobs and have made a major impact on the economy of Manitoba.

-30-

For more information, contact:

Bob Jones

Vice-President of Marketing and Communications

Crocus Investment Fund

(204) 925-7771

(204) 797-8839 (cellular)

bjones@crocusfund.com

Appendix G

SECTIONS OF THE INCOME TAX ACT RELATED TO THE PACING REQUIREMENTS OF A LABOUR-SPONSORED FUND

Definitions

“monthly deficiency”, in relation to a labour-sponsored venture capital corporation in respect of a month, means the greatest of

- (a) the amount, if any, by which 60% of the lesser of
 - (i) the adjusted shareholders’ equity in respect of the Class A shares of the corporation’s capital stock at the end of the taxation year in which that month ends, and
 - (ii) the adjusted shareholders’ equity in respect of the Class A shares of the corporation’s capital stock at the beginning of the immediately preceding taxation year,
 exceeds the greater of
 - (iii) the lowest amount that is the total cost to the corporation of its eligible investments at any time in the month, and
 - (iv) 50% of the total of
 - (A) the total cost to the corporation of its eligible investments at the beginning of the taxation year in which that month ends, and
 - (B) the total cost to the corporation of its eligible investments at the end of that taxation year,
- (b) the amount, if any, by which
 - (i) 70% of the total equity raised by the corporation in all selling periods ending after 2000 and at least two years before the beginning of the taxation year in which that month ends,
 exceeds
 - (ii) the corporation’s new investments total at the beginning of that month, and
- (c) the amount, if any, by which
 - (i) 14% of the total equity raised by the corporation in all selling periods ending after 2000 and at least two years before the beginning of the taxation year in which that month ends,
 exceeds
 - (ii) the corporation’s small investments total at the beginning of that month;

“new investments total” of a labour-sponsored venture capital corporation at a particular time means the total of all amounts each of which is

- (a) the corporation’s cost at the particular time of an investment that was acquired by it after February 2001 and that, at the particular time, is an eligible investment of the corporation, or

SECTIONS OF THE INCOME TAX ACT RELATED TO THE PACING REQUIREMENTS OF A LABOUR-SPONSORED FUND

Appendix G (cont'd.)

- (b) the greatest amount that would, if subsection (1.1) were read without reference to clause (d), have been the corporation's cost of an investment that was but is no longer an eligible investment of the corporation;

Interpretation

Section 11.1(1.1) For the purposes of this section and sections 11.2 to 11.5,

- (d) if on the day that a labour-sponsored venture capital corporation acquires a particular eligible investment in an entity the corporation is legally bound by a written agreement to acquire, within two years after that day, an additional share, partnership interest or debt obligation that
 - (i) the entity is required to issue to the corporation, and
 - (ii) if it were issued on that day, would be an eligible investment of the corporation,

then at all times within that two-year period that the corporation continues to be bound by the agreement to acquire the additional share, partnership interest or debt obligation, the corporation's cost of the particular eligible investment is deemed to include the amount that the corporation is bound to pay for the additional share, interest or obligation.

Note – (a) to (c) relate to sections of the Act not related to pacing requirements and have been excluded from this excerpt.

Conditional obligation

Section 11.1(1.2) For the purpose of clause (1.1)(d), a corporation whose obligation to acquire an additional investment in an entity is subject only to one or more conditions that

- (a) are set out in the agreement; and
- (b) at the time of entering into the agreement, can reasonably be expected to be satisfied within the time limit or limits set out in the agreement for the satisfaction of those conditions;

shall be considered to be legally bound to acquire the additional investment.

Additional year to meet 70% and 14% requirements

Section 11.1(1.3) In determining a corporation's monthly deficiency at any time in a taxation year, the references in subclauses (b)(i) and (c)(i) of the definition "monthly deficiency" to "two years" shall be read as references to "three years" if

Appendix G

(cont'd.)

SECTIONS OF THE INCOME TAX ACT RELATED TO THE PACING REQUIREMENTS OF A LABOUR-SPONSORED FUND

- (a) the corporation elects, in its return of information under section 11.4 for the year, to have this subsection apply to the corporation for the year;
- (b) this subsection has not applied to the corporation in any of its five preceding taxation years;
- (c) the net realizable value at the beginning of the year of the corporation's liquid assets, including marketable securities but not including eligible investments and assets required to meet current obligations other than obligations to redeem or repurchase shares, is less than 20% of the fair market value of the corporation's investment assets at that time; and
- (d) if this subsection previously applied to the corporation, the corporation would, if the definition "monthly deficiency" in subsection (1) were read without reference to clause (a), have had no monthly deficiency for a 12-month period after this subsection last applied to the corporation.

INTER-JURISDICTIONAL COMPARISON OF LEGISLATION

Appendix H

- In this section of the report we compare labour-sponsored legislation among a selected number of Canadian jurisdictions. In the case of Manitoba, Crocus was established under its own statute and subsequently ENSIS was created under The Labour-Sponsored Venture Capital Corporations Act which is also the statute under which other entities similar to Crocus and ENSIS could in future be formed. Thus in our comparison of legislation we included the legislation that applies to Crocus and ENSIS.
- A synopsis on the main content of the legislation is provided here.
- Figure 1 illustrates how the subjects covered under the legislation are for the most part the same. Likewise, our review of the content of the legislation reveals that the provisions themselves are essentially similar from one act to the next:
 - Objectives: typically, the legislation states that the objectives of labour-sponsored venture capital funds are to create, maintain and protect jobs within the jurisdiction.
 - Process for Registration: all the acts have a process by which an incorporated entity applies to be registered as a labour-sponsored venture capital fund corporation; and certain conditions must be met in order for approval to be granted.
 - Circumstances for Revocation of Registration: the approval once given can be revoked if the legislation is contravened.
 - Eligibility to Purchase Common Shares: any individual can purchase common shares from a labour-sponsored venture capital fund; only in British Columbia and Saskatchewan does the legislation restrict the purchase of such common shares to residents. (Note: in the case of Crocus, there is a Manitoba residency requirement although this is not a legislated requirement.)
 - Eligible Businesses: a labour-sponsored venture capital corporation can only invest in eligible businesses as defined in legislation. Typically, eligible businesses are those whose business activities are conducted within the jurisdiction, whose assets do not exceed \$50 million, with at least 50% of their employees working full-time within the jurisdiction.
 - Ineligible Businesses: are identified in legislation/regulations the most common ones being real estate and agricultural activities.
 - Eligible Investments: are also identified in the legislation/regulations and they are the permitted forms of investment that a labour-sponsored venture capital fund can make in relation to an eligible business – namely in capital stock and debt obligations of an eligible business. The minister or in the case of British Columbia, the designated Administrator can approve an ineligible investment as an eligible one subject to limits specified in the legislation.

Appendix H

(cont'd.)

INTER-JURISDICTIONAL COMPARISON OF LEGISLATION

- Limits on Investing: most jurisdictions have a limit on the amount that can be invested in any one eligible business although that amount is quite variable between jurisdictions – for instance, in Manitoba it is 10% of the fair market value of the Fund's assets; in British Columbia, investments by the Fund cannot exceed \$10 million over a 2 year period; and in Quebec the limit is 5% of the Fund's equity capital.
- Investment Advisory Committees: are not a requirement except in Manitoba. Their role is to provide advice to the board of directors regarding potential investments by the board. The advisory committee is chaired by a member of the board and the majority of the members cannot be directors, officers or employees of the Fund.
- Required Levels of Investing: all of the acts specify a required level of investment by the Fund in eligible businesses.
- Reserve Funds: among the sampled legislation the trend is not to require the establishment of reserve funds however most jurisdictions prescribe the eligible sources of investment of reserve funds.
- Valuation of Common Shares: all of the acts contain provisions requiring periodic valuation of common shares by qualified persons. In a couple of jurisdictions the legislation identifies who constitutes a qualified person - in British Columbia it is a member of the Canadian Institute of Chartered Business Valuators; in Quebec it is a person under the responsibility of a firm of chartered accountants. The method by which fair market value is to be arrived at is, in the case of Manitoba's legislation, prescribed whereas elsewhere it is not. Ontario directs that valuation be determined in accordance with mutual fund industry practice.
- Audits/Inspections: with one exception that being Quebec, all of the acts provide for audit and inspections whenever deemed necessary by the Minister or in the case of British Columbia by the designated Administrator; in the case of Quebec its independent financial regulatory body is to undertake an annual inspection and preparation of a report to be submitted to the Minister.
- Offences & Penalties: all of the acts establish penalties and offences. In the case of British Columbia, Saskatchewan, Ontario, and Quebec the legislation specifically states that if a board director, shareholder, officer, employee or agent of the Fund participates in or tacitly agrees (i.e., going along) with an action that is an offence, that person is liable to a fine on summary conviction.

INTER-JURISDICTIONAL COMPARISON OF LEGISLATION

Appendix H
(cont'd.)

Comparison of Topics Covered in Labour-Sponsored Venture Capital Legislation							
Provisions in the Legislation	MB (Crocus)	MB (Labour-Sponsored)	CA	BC	SK	ON	QC
Objectives of the Legislation	✓	✓	✓	✓	✓	✓	✓
Process for Registering a Corporation	✓	✓	✓	✓	✓	✓	✓
Conditions for Registration	✓	✓	✓	✓	✓	✓	
Situations Leading to Potential Revocation of Registration	✓	✓	✓	✓	✓	✓	No Provisions
Eligibility to Purchase Common Shares	✓	✓	✓	✓	✓	✓	✓
Eligible Businesses	✓	✓	✓	✓	✓	✓	✓
Eligible Investments	✓	✓	✓	✓	✓	✓	✓
Ineligible Investments	✓	✓	No Provisions	✓	✓	✓	No Provisions
Restrictions	✓	✓	No Provisions	✓	✓	✓	✓
Investment Advisory Committee	✓	✓	No Provisions	No Provisions	No Provisions	No Provisions	No Provisions
Situations Requiring Ministerial/Administrator Approval	✓	✓	No Provisions	✓	✓	✓	✓
Guidance to Minister/Administrator in Authorizing Exceptions or Exemptions	✓	✓	No Provisions	✓	✓	✓	✓
Maintaining a Reserve Fund	✓	✓	No Provisions	No Provisions	No Provisions	No Provisions	✓
Permitted Reserve Fund Investments	✓	✓	✓	✓	No Provisions	No Provisions	✓
Valuation of Common Shares	✓	✓	✓	✓	✓	✓	✓
Required Investment Levels	✓	✓	✓	✓	✓	✓	✓
Audits and Inspections	✓	✓	✓	✓	✓	✓	✓
Offences and Penalties	✓	✓	✓	✓	✓	✓	✓

Appendix I

SUMMARY OF REQUIREMENTS FOR CALCULATION OF NET ASSET VALUE

Summary of Requirements for Calculation of Net Asset Value Specified by The Crocus Investment Fund Act, Prospectus and Valuation Policies			
NAV Component	The Act	Prospectus January 21, 2004	Valuation Policies/By-Laws May 1, 2004
Assets with published market values.	Market value.	Last price at which the investment asset was traded in a recognized market.	Market value.
Assets with published market values but thinly or intermittently traded with price volatility so that daily stock price is not a reliable indication of value.	Not discussed.	Weighted average of the closing prices and closing volumes of such asset in the previous two month period.	Amount likely to be realized from sale.
Assets with published market values but cannot be readily sold.	Amount likely to be realized from sale.	Net realizable value (NRV) - Use a qualified person, who may be the staff valuation committee, to give an opinion of the fair value of the asset at the anniversary date of its acquisition or as of the financial year end of the investee company.	The two month weighted average stock price.
Published market values but to be held to maturity as fixed income security.	Cost adjusted to reflect the amortized portion of any discount or premium.	Cost adjusted to reflect the amortized portion of any discount or premium.	Cost adjusted to reflect the amortized portion of any discount or premium.
Assets with no published market values - First year.	Cost, unless the Board is aware of a material change.	Cost, unless the Board is aware of a material change.	Cost, unless a material change dictates earlier review.
Assets with no published market values - After first year.	NRV - At the anniversary date of the acquisition of the investment, a person qualified to evaluate the asset to prepare a report giving an opinion as to the fair value.	NRV - Use a qualified person, who may be the staff valuation committee, to give an opinion of the fair value of the asset at the anniversary date of its acquisition or the financial year end of the investee company.	NRV - At the anniversary date of the investment, or where the Act permits, within six months of the investee company year end.
Debt asset (that does not have a published market value or that is not required to be valued at its published market value).	Not discussed.	Unamortized principal amount at the relevant valuation date.	Unamortized principal, unless that amount exceeds the amount the Fund can reasonably expect to receive. Then value at the aggregate of all amounts expected to be received less costs incurred for collection.
Debt asset where there is doubt as to the ability of the debtor to make payments required under the debt instrument as they come due.	Not discussed.	Aggregate of all amounts that at the relevant valuation date the Fund can reasonably expect to receive in respect of the principal amount of the debt instrument, less any expenses that are reasonably expected to be incurred by the Fund in respect thereof.	Aggregate of all amounts that at the relevant valuation date the Fund can reasonably expect to receive in respect of the principal amount of the debt instrument, less any expenses that are reasonable expected to be incurred by the Fund in respect thereof.
Non-investment asset.	Cost less any applicable depreciation as determined in consultation with the Fund auditors.	Cost less any accumulated depreciation or amortization applicable to it as determined by the Board of Directors in consultation with the auditors of the Fund.	Cost less any depreciation applicable thereto as determined by the Board of Directors in consultation with the auditors of the Fund.
Sales commissions on sales of common shares.	Not discussed.	Defer and amortize to retained earnings on a straight-line basis over eight years.	Not discussed.

SUMMARY OF REQUIREMENTS FOR CALCULATION OF NET ASSET VALUE

Appendix I (cont'd.)

Summary of Requirements for Calculation of Net Asset Value Specified by The Crocus Investment Fund Act, Prospectus and Valuation Policies			
NAV Component	The Act	Prospectus January 21, 2004	Valuation Policies/By-Laws May 1, 2004
NAVPS calculation.	Unless the Board determines that since the preceding valuation date there has been no change in the assets or liabilities of the Fund which could have a material effect upon the manner of calculating the value of the Class "A" common shares, the Board shall cause a person qualified to make an evaluation of the Fund to prepare a report stating an opinion as to the manner in which the value of the shares should be calculated by the accountants to the Fund at such valuation date on the assumption that the values of the investment assets of the Fund at that valuation date are the values determined in accordance with the Act.	Unless the Board determines that since the preceding valuation date there has been no change in the assets or liabilities of the Fund which could have a material effect on the manner of calculating the fair value of a common share the Board will have an independent qualified person prepare a report setting out an opinion as to the manner in which the fair value of a common share should be calculated by the Fund's internal accountants as at such date.	Board to have a qualified person report on the suitability of the manner in which the value of Class "A" shares is calculated assuming the valuation rules have been followed. The Board is required to fulfill this obligation at every valuation date, but has the discretion to dispense with the report when there has been no change in the assets or liabilities that could materially affect the manner of calculating the value of Class A shares.
Revaluation.	If on any valuation date, the Board determines there has been a change that may have a material effect on the value of an investment asset, the Board shall cause a revaluation of the investment asset.	Where on any valuation date, the Board determines there is a change which may have a material effect on the value of any investment asset, it shall cause a revaluation of any such investment asset.	The Board may request a revaluation at any time it determines that there has been a change that may have a material effect on the value of any investment asset.