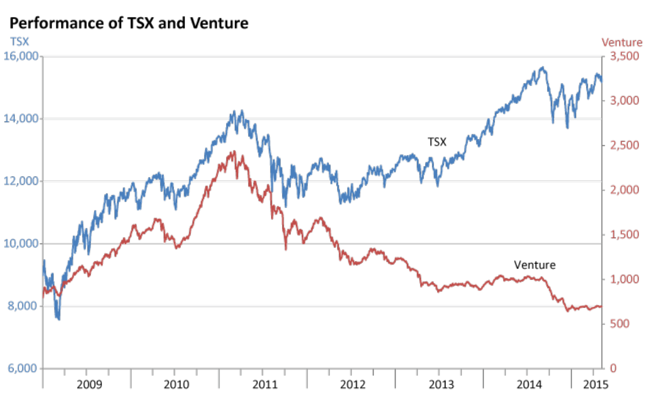
Letter from the President

Saving the Canadian Venture Markets Before It's Too Late

Vol. 84

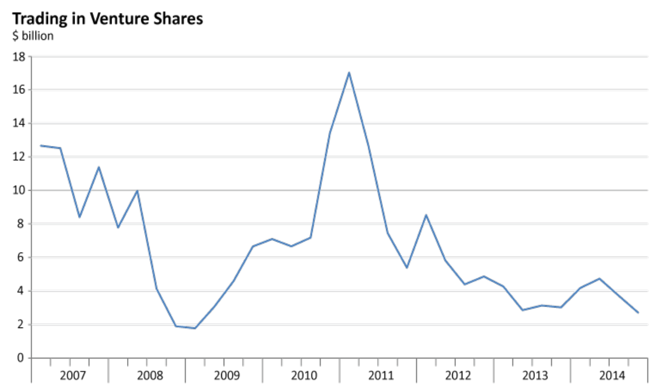
The past five years have provided a ring-side seat to the epic collapse of the Canadian venture capital markets, the most important source of funding for high-potential small and medium-sized businesses. Except for a brief interlude in 2010-11, trading in venture shares since the 2008 financial crisis fell by one-third, while small cap equity financings dropped by more than one-half. Not surprisingly, new listings for the TSX Venture Exchange have plummeted. In 2007, the year before the financial crisis hit, the value of financings on the TSX Venture Exchange exceeded $11 billion. In 2014, just $5.2 billion was raised.

In Canada, equity capital sourced by small and mid-sized businesses through the publicly listed venture capital markets has historically dwarfed financing provided through angel networks and traditional venture capital funds. But while in 2007, TSX Venture financings were almost one-quarter of TMX financings, in 2014 they came to only one-tenth as much. Moreover, a majority of the smaller listings on the Toronto Stock Exchange faced a similar fall-off in secondary trading and financing activity.



Source: S&P, IIAC

Canada's venture capital markets are crucial to the global growth of Canadian industries, especially global leaders like Canada's mining sector with more than 1,200 companies listed on the Venture Exchange. But at a time when Europeans (through the EU "Capital Union" initiative), and Americans (through the "Jobs Act", and a recent two-year program launched by the SEC to boost investor interest in smaller stocks), are focused on building active tradable venture markets for small and medium-sized enterprises, Canada is at serious risk of losing its respected small and mid-cap venture marketplace.



Source: IIAC

The search for solutions begins with a diagnosis of the problem. It is not enough to blame weak economic conditions and poor resource markets. Whistling past the graveyard is no answer. The problems affecting financing and trading on the venture markets are multi-dimensional, including:

i. changing demographic patterns, with aging investors shifting from speculative equities to balanced portfolios that emphasize dividend and income streams;
ii. heightened regulatory scrutiny of suitability standards, confusing speculative investments with speculative portfolios and discouraging investment;
iii. lessened institutional interest as foreign investments have replaced speculative equities to achieve alpha returns;
iv. market structure changes that have escalated trading and dealing costs;
v. competitive regulatory advantage of the lightly regulated Exempt Market Dealers (EMDs);
vi. increased support of viable early stage issuers by private equity companies, thereby allowing issuers to defer listing

until they are at a more mature stage, or avoid the listing process if they are acquired by a larger entity.

The continuation of these negative trends would mean a substantially reduced volume of equity capital intermediated between savers and corporate issuers in the Canadian market. Small businesses will still find access to capital through angel networks and venture funds, and mid-sized businesses through private equity funds and direct placement through agents like EMDs and other registrants. But as domestic institutional boutiques are squeezed from the market (21 boutique firms, or 13 percent, have disappeared in the past two years), the underpinnings of the venture markets will collapse. Financing activity will detour around the publicly listed venture markets – the “after-market” in venture shares that is the catalyst to promote vibrant capital-raising, especially for mid-sized businesses that depend heavily on external capital and have outgrown their original investors. This loss of liquidity for potential investors in the venture markets hits right at the Achilles heel of Canada’s business sector – the inability of mid-sized Canadian businesses to grow and expand and become global leaders and innovators.

	2007	2008	2009	2010	2011	2012	2013	2014
Trading ($B)	45.0	23.8	16.1	34.4	42.5	23.6	13.3	15.3
Financings ($B)	11.1	5.5	5.5	9.8	10.1	6.0	3.8	5.2
New Listings	273	233	107	185	216	161	76	56

Source: S&P, IIAC

How to fix the problem? As befits its complexity, the solution involves many players. First, regulators need to examine closing the regulatory gap between SRO-regulated dealers and EMDs, raising the standards of the latter group and strengthening investor protection. Regulators also need to re-think market structure. Is a central order book for venture shares more effective than multiple marketplaces? Should all multiple markets benefit from protected market status? Should securities of venture issuers only be able to be traded on their listing exchange, and not on any other ATS?

Second, marketplaces need to re-consider their listing and trading practices. Should the quality of venture issuers be raised to a more consistent level through higher initial and ongoing maintenance requirements, designed to ensure that the venture boards represent a certain quality of issuer, and that companies that have failed in their efforts and don’t exist as a going concern are delisted? Should auctions for thinly traded small cap equities be arranged intermittently through the day rather than through continuous trading? Should mandated bid-offered spreads exist in multiple markets similar to the SEC pilot project in the U.S.? Should the uptick rule on short sales be reinstated?

Third, governments have an important role in promoting a more innovative economy by providing the investment, resources and policy framework needed for high-potential small and medium-sized business to grow. The federal government could stimulate venture markets by introducing a capital-raising incentive such as a deferred capital gains tax for reinvestment of proceeds into small business shares, effectively channeling locked up capital earning uncompetitive returns into the shares of small enterprise.

There are several options, but one thing is certain: We must tackle the underlying causes of deteriorating liquidity and the financing in venture markets soon, or run the risk of losing the best source of capital to grow small and medium-sized Canadian businesses into globally competitive enterprises that drive job creation, innovation and economic growth.

Canada’s situation can be fixed. We need to put our best minds together to create a strong and sustainable venture capital marketplace.

Yours sincerely,

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June 2015