LETTER FROM THE PRESIDENT

Vol. 91

Pulling out the stops to rescue the TSX Venture Exchange: a recipe for strengthening small business access to equity capital and promoting growth and jobs

HIGHLIGHTS:

Boutique firms under siege due to unprecedented rise in operating costs.

The plight of the small boutique firm has coincided with the collapse of the public venture market.

The Venture Exchange will collapse into insignificance unless remedial action is taken in fairly short order.

The federal government can play an important role in stimulating the small business private and public markets through carefully targeted tax incentives.

The singular event that has drawn considerable attention to the investment industry during the past year has been the steady withdrawal of boutique dealers from IIROC registration through mergers and amalgamations, the shuttering of operations or a shift to lighter registration, notably Exempt Dealer status. There were nine resignations in 2015, following a combined 25 in the preceding two years – accounting for 18 per cent of IIROC membership. Small dealer participation in the investment industry has shrunk 25 per cent. These dealers are active in publicly traded small cap markets, notably the TSX Venture Exchange (TSXV), in the underwriting and distribution of new shares and trading of existing shares of these companies.

Boutique firms under siege

Institutional boutiques accounted for about half of resignations last year, with the latest coming in mid-December with the closing of well-respected Salman Partners Inc. Difficult economic and business conditions, particularly the extended slump in resource markets, and the remorseless squeeze in operating margins and eroding capital pushed many institutional firms to the exits, and for the same reasons pushed retail boutiques in the same direction. Revenues from investment banking and securities trading in small and mid-sized corporate shares never recovered from the sudden collapse in energy and mining markets in early 2011, marking a four-year period of poor revenue and earnings performance.

Resource markets have not been the only factor. Many small and mid-sized firms have stayed private longer reflecting the costs of going public, postponing IPOs and follow-on public financings.

Finally, institutional boutiques have faced stepped up competition from the larger integrated firms that previously ignored the investment banking business of smaller firms in the $200-$500 million capitalization. Now these large firms are coming down the food-chain.

Relentless escalation in costs unleashes massive restructuring

There has been an unprecedented rise in operating costs at the boutique and integrated firms to fund compliance resources and technology in response to an onslaught of rule-making across the institutional and retail businesses. The larger fims have the benefit of scale to better absorb these costs.

Operating costs at the boutique firms escalated sharply at the end of the first decade of the 2000s, with the gearing up of compliance to meet best execution rules for multiple equity markets, and coping with the fall-out from narrowing of trading spreads from high-frequency trading and rising market access/execution costs and market data costs. A second round of regulatory cost increases followed stemming from the new rule framework, the Client Relationship Model. As most institutional boutiques carried retail accounts to complement their business, these firms were caught by the CRM rules. Technology costs have also escalated to meet compliance requirements and streamline operations.

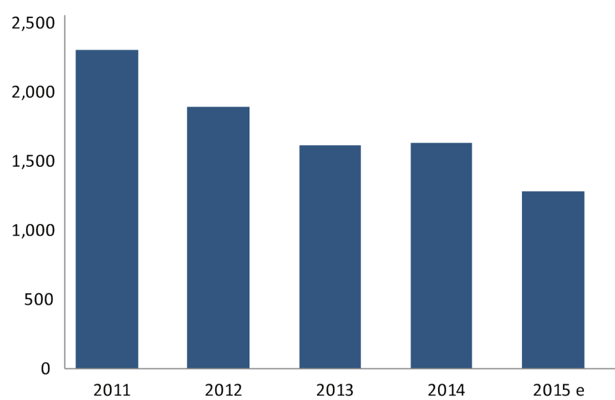
In the wake of these developments, and signs the rule-making will not let up, it is not surprising that one-third of CEOs of investment dealer firms in a recent IIAC survey expect industry consolidation to intensify in the next two years. Twenty-three per cent of CEOs surveyed said it will remain about the same, while the balance expect the rate of consolidation to slow.

The large number of firms with gross revenues below $10 million suggests many firms will succumb from limited business scale to absorb continually rising costs.

Canada's public venture market decimated in recent years

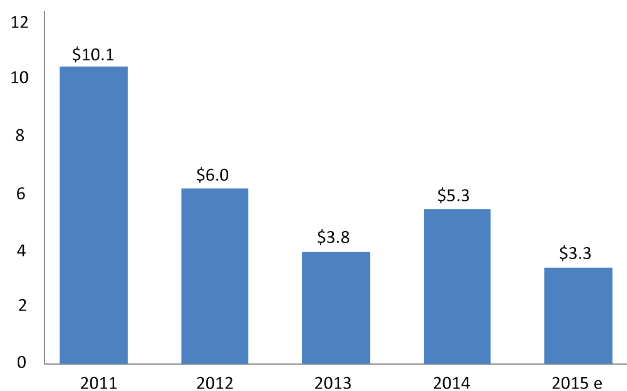
The plight of the small boutique firm has coincided with the collapse of the public venture market, the TSXV. The extended weakness in resource markets and recent structural changes in the small cap marketplace have battered boutique firms and the small cap marketplace alike. By any measure, the TSXV has deteriorated precipitously in the past five years, and is close to drawing its last breath.

TSX Venture Exchange
Total Number of Financings



e = estimate Source: TMX

TSX Venture Exchange
Total Financings Raised ($Billion)



e = estimate Source: TMX

Financing activity on the Venture Exchange plummeted steadily in 2011-2015, from over $10 billion in 2011 to roughly $3.3 billion last year. The S&P/TSX Venture Composite Index has been eviscerated over this period, now standing at one-fifth of the Index's peak level in early 2011. Trading activity has shrunk dramatically. Listings have stagnated on the Exchange and there are now an estimated 600 TSXV listed companies with less than one year of operating capital. The Toronto Stock Exchange (TSX) has fared better through the recent period. However, the S&P/TSX Composite Index remains below its 2011 peak, reflecting the generally poor earnings performance of the large number of small and mid-sized companies listed on the senior exchange.

The collapse of the TSX Venture Exchange would be an enormous loss for Canada and our capability to finance small and mid-sized businesses across the country. The TSXV proved over the years to be an innovative and effective source of external capital for small business. These businesses are the engine of economic growth and job creation in the country. The Venture Exchange is the most significant source of equity capital for Canadian small business, dwarfing the small business private equity markets, including the venture capital funds and angel networks. Even now the TSXV raises more capital than the venture capital fund industry. In 2014, the crippled TSXV raised $5.3 billion versus $2.4 billion for the VC firms, albeit the latter was better diversified.

Nearly $7 billion in capital has vanished from the small business sector in the past five years as activity on the Venture Exchange collapsed. In actual fact, the loss of capital available for small business through the Venture Exchange is much larger. The Venture Exchange is not only an effective incubator for raising capital to help small business expand operations, particularly companies in the resource sector, but an effective mechanism for recycling invested capital across the small business sector as a whole. As listed companies expand, benefitting from rounds of public and private funding, share values typically increase. These businesses were frequently sold with the proceeds then re-invested in newly listed companies, or in listed Junior Capital Pools (JCPs), or to already listed companies through reverse takeover transactions (RTOs), or in private businesses, in the resource and non-resource sectors.

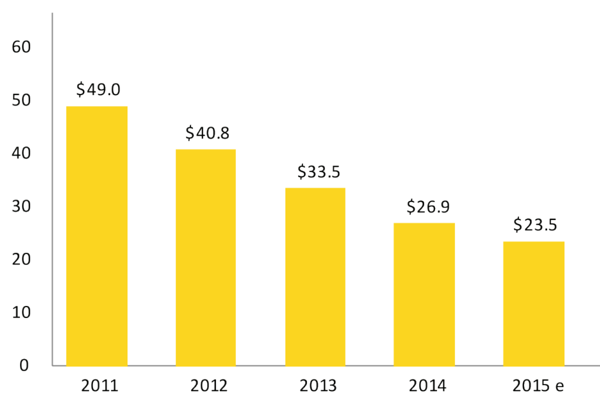
Venture market attacked from all sides

The factors contributing to the prolonged collapse of the public venture market are numerous. First and foremost, given the resource orientation of the exchange, the collapse in the mining sector in 2011 triggered the initial market meltdown. The subsequent fall in global oil and gas prices reinforced the earlier blow to exchange share values and trading activity. However, structural factors have also been responsible for the blood-bath on the TSXV. The traditional channels for the distribution of new and existing shares of listed TSXV companies, and indeed small company shares listed on the TSX exchange, have been severely damaged.

The institutional appetite for speculative shares has shrunk dramatically. With the removal of the foreign property rule and need for large transaction size, the large institutional funds turned away from small speculative equities and focused on an array of foreign equity and alternative investments. Additional negative factors include the increased focus on market returns and liquidity concerns shifting institutional focus to ETFs and investor interest to

balanced mutual fund investments (tripling since 2005) for stability and consistent income. Smaller funds specializing in speculative securities are now less prevalent in the financial landscape, reflecting the difficulty attracting capital and an increased focus on benchmark investing. Further, institutional funds have focused on private equity investments related to buyout transactions.

TSX Venture Exchange
Market Cap Listed Issues ($Billion)



e = estimate

Source: TMX

In past years the retail investor provided significant demand for listed shares of small and mid-sized businesses. The retail appetite has dampened considerably reflecting the greater risk aversion of investors, from an uncertain financial environment and aging demographic, and the interest in managed investment products and market benchmark returns for greater stability and predictability of return. The increased regulatory compliance focus on suitability of investments has also made firms more cautious recommending listed small business shares to clients.

Finally, the steady disappearance of the small dealer boutique firms further undermines the TSXV, as well as the listed small companies on the senior TSX. These dealers provide the research, traded markets and distribution of shares of small listed companies. Exempt Market Dealers certainly contribute to cost-effective distribution of these shares, but they do not have the infrastructure to provide vital research and due diligence, and the secondary market trading in these shares. The contribution of the exempt dealers to the welfare of the TSXV and market for small cap equities, other than complementing new share distribution, is marginal compared to the multi-faceted role of investment dealers. Any remedial action such as limiting the ability to use the accredited investor exemption, should take this important distinction into account.

Revitalizing the TSX Venture Exchange

The Venture Exchange will collapse into insignificance unless remedial action is taken in fairly short order. Even though economic and financial conditions are unlikely to improve much over the next year or so, steps can be taken by the TSXV, regulators and governments to strengthen the Venture Exchange and preserve the financing and capital recycling engine to benefit Canadian small businesses.

The TSX Venture Exchange has just announced a comprehensive strategic plan to help support, revitalize and grow its marketplace. The plan is an effective one, but should have been launched much sooner. The plan has three key elements: to reduce administrative and compliance costs for listed small companies, to expand the base of investors and draw capital to the TSXV, and to diversify the listings away from natural resource stocks.

It will not be easy to attract new investors and diverse companies to the TSXV. However, the Exchange has some attractive financing innovations for small business. As a starter, the Venture Exchange provides a sound and effective oversight of listing standards and disclosure requirements. Second, the mechanisms for raising capital are unparalleled: the TSXV Capital Pool is an effective mechanism to obtain capital through a listed shell company to acquire a private businesses within two years through a “qualifying transaction”; the Prompt Offering Qualification System (POP System) provides unparalleled “deal” certainty and swift secure access to capital; the multi-jurisdictional disclosure system (MJDS) provides unequalled access to U.S. capital pools and the debut of Special Purpose Acquisition Corporations (SPACs) on the TSX permit a holding company to list on the TSX and raise capital to acquire private businesses.

The regulators can also contribute to restoring the health of the Venture Exchange. First, the regulators should dispense with the “crowd-funding” initiative. The TSXV is a far more effective vehicle for raising capital than crowd-funding, and provides far better protection for investors. Second, the regulators should work with the TSXV to reduce and streamline administrative and regulatory costs for small listed companies, and assist in initiatives to attract capital to the Venture Exchange. Third, regulators should continue efforts to improve and harmonize prospectus exemptions. In particular, the accredited investor exemption should be restricted to investment dealer registrants that are subject to vigorous SRO oversight of know-your-client and suitability obligations. Investor protection would be improved through greater assurance that accredited investor standards are properly met, and would give the dealers a justified edge to compete in the marketplace for share distribution. Finally, the new investment dealer exemption should be adopted by all jurisdictions. The exemption permits a dealer to distribute new offerings of securities without specific disclosure as long as the issuer has a record of continuous disclosure.

The federal government can play an important role stimulating the small business private and public markets through carefully targeted tax incentives. The government could introduce a Canadian version of the U.K. Enterprise Investment Scheme (EIS), providing a 30 per cent personal income tax credit for purchases of the shares of new and emerging business. This measure would complement the Lifetime Capital Gains Tax Exemption applying to the majority owners of small business. It would provide an incentive to invest in these risky start-up enterprises. The scheme

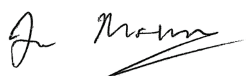
would also facilitate capital raising as the economy expands, and eventually lead to companies getting listed on the Venture Exchange. The EIS has had great success in the United Kingdom.

Second, the government could introduce a carefully crafted tax deferral from capital gains taxation if the proceeds of the investment sold is reinvested in the listed shares of small business. The incentive is not a tax loss to the treasury unless the investment is sold. These investments are typically frozen to avoid the incidence of capital gains tax. Both incentives can be structured to limit the tax expenditure from the personal tax credit and the capital gains tax deferral.

A successful diversified remedial plan for the Venture Exchange involving some easing in the regulatory burden on listed companies and small dealers, bringing more investors (particularly U.S. investors) to the Canadian venture capital marketplace, diversifying listings to technology and other non-resource sectors, and providing a financing incentive to listed TSXV companies to offset risk, will revitalize the TSXV. These measures will also open up investment banking and trading and distribution business for the small boutique dealers.

It should be recognized that recovery of the TSXV will be slow, but those boutique dealers with a strategic vision, efficient operations and a diversified investment banking and trading business will benefit. More robust dealer participation will fuel a more effective Venture Exchange. Canada and Canadian small businesses will be the real winners.

Yours sincerely,



Ian C. W. Russell, FCSI
President & CEO, IIAC
January 2016