Letter from the President

INVESTMENT INDUSTRY ASSOCIATION OF CANADA

Repairing and Strengthening the Capital-Raising Infrastructure in Canada for Small Business

Background Paper for Appearance Before House of Commons Standing Committee on Finance

Vol. 67

Overview

Canada saw a strong economic recovery in the wake of the 2008 financial crash. But over the past two years the recovery has run out of steam, as the Canadian economy has succumbed to weakening global conditions. The challenge for Canadian policy-makers is to re-ignite economic growth, in the context of ongoing fiscal restraint, by priming business investment spending through selective tax incentives. The approach should focus on policies that encourage the start-up and expansion of small and mid-sized businesses, the source of skilled jobs, broadly based economic activity across Canada's regions, and our economic future.

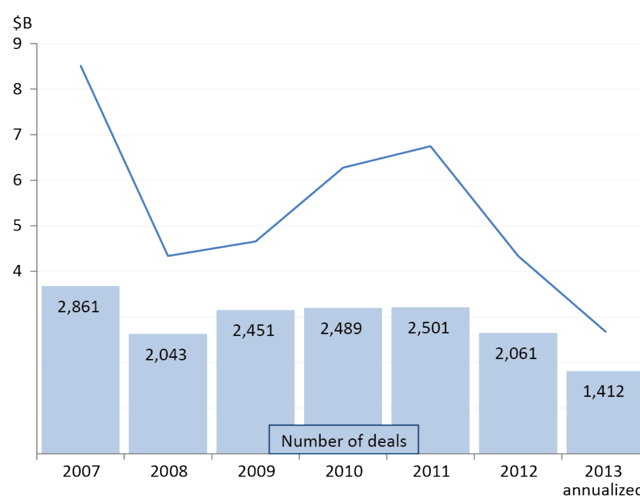
The timing of the policy approach to assist small business is propitious as resource markets have turned modestly positive, setting the stage for needed restructuring of massively over-extended and over-leveraged mining companies.

Capital-Raising Infrastructure for Small Business: The Challenges

The capital-raising infrastructure for emerging, small and mid-sized businesses in Canada provides the framework for distributing IPOs and secondary offerings in public markets through the two stock exchanges, TSX and TSX Venture, and private placement financings of these listed companies. Canada has an advantage in this area. Our capital markets for small business – in terms of the listing and trading infrastructure, regulatory framework and integrated architecture of registered investment dealer firms engaged in underwriting and trading, legal and accounting professionals – are better developed and more diversified than in most countries. Canada's vibrant public and private markets for small business are at the core of the capital-raising process for Canadian small business, and indeed at the core of our economic prosperity.

But the small business marketplace has fallen on hard times. In the past five years weaker business conditions and profitability, falling commodity prices, an over-leveraged mining sector, and recent tax changes that discourage investment in privately placed securities, combined with deep risk-averse sentiment among retail and institutional investors for small business shares, have pushed share values and liquidity to depressed levels.

Equity Capital Financing for Small Business
Volume and Value of Deals

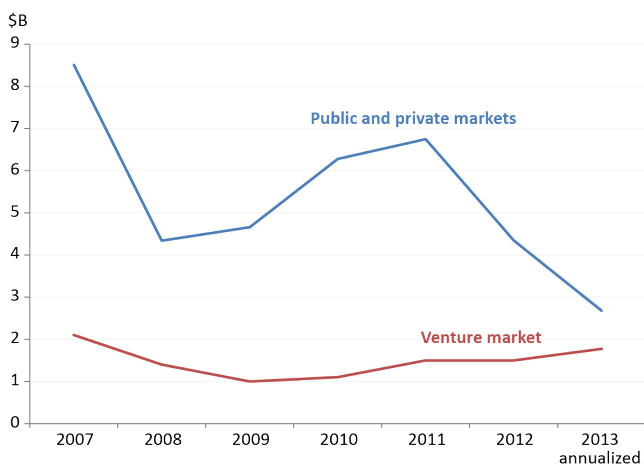


Source: IIAC

These factors have resulted in inhospitable conditions for issuing new shares in public and private markets. Small business equity financings (measured as offerings of $20 million or less) totaled $2.5 billion this year on an annualized basis, down 40% from 2012 levels, which was in turn down a further 40% from the previous year. Annual financings averaged $3.5 billion in 2012-13, roughly half the annual financing level in 2006-07. IPO financings in offering size of $20 million or smaller are roughly half the total financing value before the financial crash in 2006-07. In the last two years the number of financings has fallen by one-half to one-quarter the level in the pre-crash period. IPOs less than $5 million in size have collapsed dramatically in this period. While there has been an across-the-board fall-off in small business IPOs and secondary offerings,

the worsening conditions in the energy and mining sectors also contributed to the overall collapse in financings.

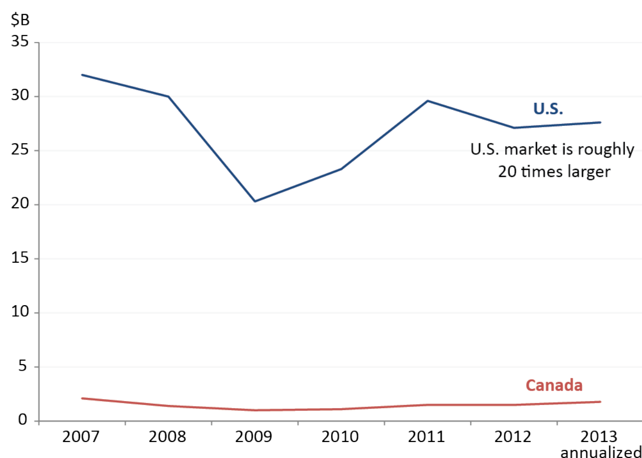
The public and private markets for small business in Canada dwarf in size the angel networks, venture capital, and private equity and hedge funds as a source of equity capital. Even in difficult times, these public and private markets have provided $2-4 billion annually in equity capital for emerging, small and mid-sized businesses, more than other sources of capital. As a result, when these markets for raising small business capital dry up, Canadian business has fewer places to turn. Venture capital funds, including domestic and foreign managed funds, totaled an estimated $1 billion in capital to emerging businesses in 2012 (with about one-third the total from foreign venture capital funds), relatively small compared with financings in public and private markets in Canada. Second, angel networks, while an important source of funds for start-up and early stage companies – often in the university-health care clusters across the country – are a similarly modest factor in overall junior company financing.



Sources: CVCA, IIAC

Canada's access to small business equity capital is far less diversified than the U.S. marketplace. Accordingly, when market conditions for raising equity capital become difficult, the lack of access to capital is particularly acute for small Canadian enterprise. Moreover, aside from reduced availability and higher priced equity capital, financing problems may end up starving Canadian companies into American hands, as U.S. technology and pharmaceutical companies are on the lookout for takeover candidates with profitable business opportunities. This outcome represents a significant setback for Canada's economic future.

Recent federal policy initiatives have focused on support for venture capital funds to assist financing for small business. The federal Venture Capital Action Plan, for example, is designed to provide capital to successful venture capital funds operating in the domestic markets. Recent research by the Canada's Venture Capital & Private Equity Association (CVCA), in conjunction with Industry Canada and Statistics Canada, indicates venture capital funds play a key role in the financing and management of small businesses, and companies supported by the venture capital industry promote economic growth, jobs and value creation for stakeholders.



Sources: CVCA, NVCA

While federal support for venture capital firms is laudable and will make a difference to capital availability, the federal government should also recognize the *greatest policy leverage* for capital-raising will come from incentives directed to the established capital-raising infrastructure – including the stock exchanges and private equity markets, the IIROC-registered dealer community that arranges public offerings and private placements, and trades and distributes shares to the investing public, the exempt market dealers, and ancillary legal and accounting communities.

Encourage Capital Investment Through Tax Incentives

Effective tax incentives will encourage demand for newly offered shares of small businesses, especially non-resource companies, and promote cost-effective capital-raising. An effective incentive will stimulate new financing activity among small business and breathe new life and vigour into the capital-raising infrastructure. A carefully designed incentive could not come at a better time.

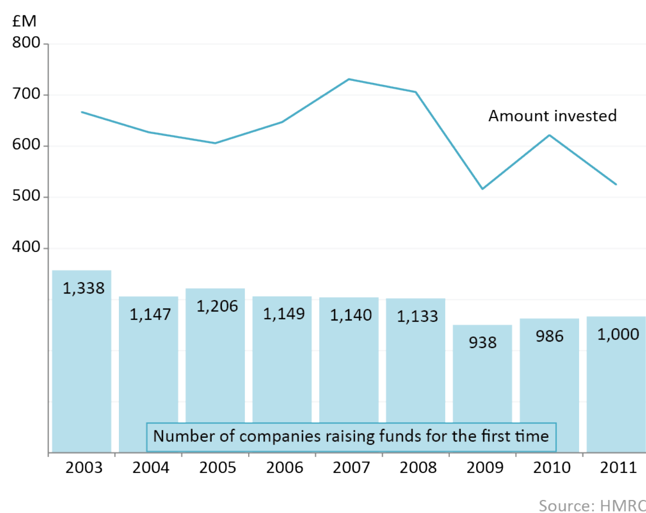
The federal government should promote federal tax-assisted support for the public and private financings of small business to raise after-tax return for new shares issued by small business through a selective reduction in capital gains tax.

Lower capital gains tax could take either of the following forms:

i) A tax-free roll-over provision of the sale of assets reinvested in qualified small business equity shares. This provision has the advantage of unlocking tied-up capital and redirecting it to investments in small business shares.

ii) A lower capital gains tax rate for qualified investments in small business equity shares.

The tax expenditures from either proposal could be carefully managed by limiting the applicability of the small business shares that qualify for special tax treatment. The federal government could also introduce a special tax incentive for start-up and emerging businesses modeled on the U.K. Enterprise Investment Scheme (EIS), a successful financing vehicle for small business for the past 20 years. The EIS provides a 30% deduction from income tax for eligible investments. In addition, capital gains on the investment are tax-exempt if the shares are held for three years.



Since its launch in 1993, 18,500 companies have raised 8.6 billion pounds sterling in equity capital. In 2010-11, 1,937 companies raised funds, 1,000 companies for the first time. The EIS was expanded in 2012 after an independent HM Treasury review of the impact of the incentive. Based on the U.K. experience we estimate a similarly structured EIS in Canada would cost approximately $240 million annually.

Reduce Regulatory Burden on Registered Dealer Intermediaries

The 185 boutiques in the Canadian investment industry are an integral and key component of the capital-raising infrastructure for small and mid-sized business. These firms are responsible for the underwriting and trading of small business shares in public and private markets, and in the distribution of these shares to institutional and retail investors. In the five years following the 2008 financial crisis, these boutique firms have been subject to extensive new rules and regulations covering market conduct and comprehensive disclosure in client dealings, as well as best execution rules required in the multiple market environment for equity securities.

The rapid pace of this rule-making has meant limited opportunity for rigorous cost-benefit analysis of the rules, and for post-implementation review of their impact. It is thus likely that the new rule framework for registered advisors and firms, compounded by new tax reporting requirements, has raised transactional costs, resulting in excess rules and compliance costs, and will lead to additional unintended consequences. In the existing regulatory regime, new rules and regulations routinely go out for public comment, but there is no concerted effort on the part of the regulators to justify the *cost-effectiveness* of these proposed rules and regulations.

It is important to keep in mind that the rule-making exercise has been extensive and fast-paced, even though the wealth management and institutional equities underwriting and trading businesses of registered dealers did not cause the 2008 financial crisis, and no recent major scandals can be traced to registered investment advisors and their firms. Moreover, independent surveys indicate that the clients of registered dealers have a high level of trust and confidence in their advisors.

These facts give rise to several observations:

i) The pace of rule-making has been too fast to ensure cost-efficient and targeted reform of the rule framework.

ii) Efficiencies could be gained if regulators placed less emphasis on the regulatory framework and conduct of IIROC-registered advisors and firms with high standards of proficiency and self-regulatory oversight, and more on the lightly regulated firms and employees.

iii) Duplication and overlap in rule-making could be avoided, and efficiencies gained, by better allocation of responsibilities between the provincial commissions and self-regulatory bodies in the securities industry.

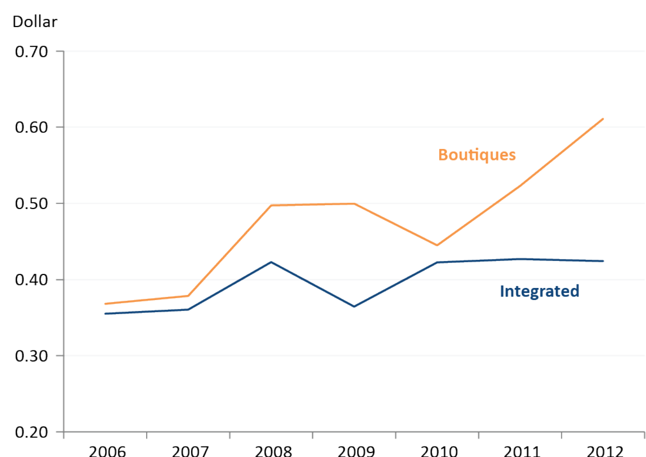
The resulting weak earnings from difficult business conditions, in both financing activity and trading, faced by retail and institutional boutique firms has been aggravated by the heavy compliance burden placed on these firms with limited business scale. The regulatory burden is particularly severe on dealers focused on fee-based advisory brokerage, and with limited business scale to absorb the cost impact, precisely those firms responsible for nearly all financing and distribution of small business speculative shares in publicly listed markets and private placement markets.

Industry operating costs have increased 15% in the past five years, and the costs per dollar of revenue at the boutique firms rose more than 50% in the same period.

The dramatic squeeze in margins reflects the relentless increase in operating costs in this period and the collapse in business revenue. Statistics indicate that *more than half* of the boutiques have been losing money fairly consistently in the

past two years.

Operating Cost per Dollar Revenue



Source: IIAC

The weakened earnings performance of these firms has exacted a heavy toll on the capital-raising infrastructure for small and mid-sized businesses by handicapping the financing, distribution and advisory services performed by these struggling dealers. Reflecting poor profit performance, many firms in the industry are now considering, or have actually undergone, wind-up, merger and amalgamation, removing participants and competition for the capital-raising process in the marketplace. Eleven dealers resigned from IIROC in the first half of this year – either going out of business, merging with or selling out to other firms – *four times* the typical resignation pace. The loss of these boutique firms reduces the efficiency and competitiveness of capital markets for small Canadian business.

The Cooperative Capital Markets Regulator

The federal government has entered into agreements with the provincial governments of Ontario and British Columbia to establish a cooperative regulatory system. The plan is to attract the remaining provinces into the cooperative arrangement to replace the existing provincial regulatory regime with a national regulator. The Agreement of Principle between the three governments establishes a comprehensive oversight framework of a Council of Ministers and expert Board of Directors for rule-making and compliance. The proposed oversight mechanism for the cooperative regulator is far more extensive than the existing regulatory regime, embracing business expertise to assess the rule-making process and compliance practices, and more open and extensive transparency.

More proactive and transparent oversight and accountability, bringing greater business expertise to bear in the formal regulatory oversight process, and more interactive public engagement, will contribute to more efficient and cost-effective rule-making and new rule compliance, with the rules designed to meet identified regulatory gaps, and subject to rigorous cost-benefit analysis and post-implementation rule review. Better accountability will also encourage forward-thinking regulation, such as placing more emphasis on measuring the effectiveness of registrants in meeting professional obligations and ethical awareness.

We recommend the House of Commons Standing Committee on Finance publicly support the proposed cooperative securities regulator and encourage all Canadian provinces to integrate their existing provincial regulatory bodies into this cooperative regulatory framework. A more accountable regulatory system will contribute to better regulation. Further, the construct of the cooperative regulator itself will contribute to more cost-effective regulation through reduced direct fees, reflecting federal government compensation to smaller participating provinces for regulatory fees and revenues foregone. These lower regulatory fees should translate into savings for dealers and other market participants, all other things being equal. As well, the cooperative regulator should result in lower compliance costs for dealers and reporting issuers through more streamlined regulation.

Conclusion

In the past 20 years Canada has built one of the most effective and envied infrastructures in the world for raising equity capital for emerging, small and mid-sized businesses. The strength of this infrastructure has been the availability of deep pools of equity capital, versatility and innovation in financings, cost-efficiency of the capital-raising process, and appropriate disclosure and exchange listing standards to safeguard investors. Finally, and importantly, most decisions on access to capital and price of capital are made by the marketplace – the amalgam of retail and institutional investors in small-cap markets – and not by individual fund managers selecting the particular investment. This gives greatest assurance that the best ideas and business operations are financed.

Canada can ill afford irreparable damage to this financial infrastructure. But the difficult financing climate for small companies, the weakened financial position of the dealer underwriters and distributors, and the regulatory burden across all market participants, has weakened the underpinnings of this financing infrastructure. Federal incentives to promote small business investment and a full-court press to implement a cooperative regulator for Canada may be small steps to shore up the financing infrastructure, but they will be important steps.

Special recognition to Eon Song, Capital Markets Analyst, for analytical and technical support.

Yours sincerely,

Ian C. W. Russell, FCSI
President & CEO, IIAC
November 2013