Letter from the President

INVESTMENT INDUSTRY ASSOCIATION OF CANADA

Missing From Federal Budget: A Much Needed Helping Hand for Small Business Capital-Raising

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For nearly three years, share prices for small public companies in Canada have tumbled to near lows; market liquidity has dried up; and the volume and value of small business financings, both for secondary offerings and IPOs, have collapsed. The dearth of financing activity is evident right across the small business marketplace as the lack of public market access for capital has made angel networks and venture capital funds reluctant to fund early stage and emerging businesses. We have discussed the reasons for the prolonged malaise in small business capital markets in past Letters from the President.

Small Business Can Make a Big Difference for the Canadian Economy

The freezing of capital access for small business comes at a critical time for our country. A strengthening economic recovery has not materialized, largely because of weak commodities markets, and the consensus outlook for economic growth is in the paltry 2.5% range. In some ways, this is the "Michael Corleone economic slowdown": Much like Al Pacino's character in the *Godfather* movies, "every time we think we're out, it keeps pulling us back." The best vehicle to turn this around is small business – the engine of growth, key to job creation and economic diversification, and a key source of innovation and technology.

The purpose of this Letter is to examine through the lens of the recent federal budget the policy challenge of stimulating small business capital-raising. The budget was billed beforehand as a "stand pat" exercise; in fact, that is how things turned out. The policy centerpiece was the commitment to edge closer to budget balance targeted for next year. Prudent finances signal stable and predictable tax rates, boosting confidence among domestic and foreign investments. This approach is consistent with past budgets that have improved general business conditions though a steady reduction in corporate tax rates to stable and competitive levels, streamlined review of major project investment and international trade and tax agreements to promote more open markets.

But is the Canadian economy really so strong that we can afford to stand pat? While it continued a number of sound policies, what the federal budget did not do is introduce an incentive to help small business access capital for start up and expansion. Throughout the mandate of this government the IIAC has advocated either i) a preferred capital gains tax rate for treasury offerings and secondary market transactions for the shares of small business, or ii) a tax-free capital gains rollover provision for purchases of eligible small company shares. The rollover provision has several appealing attributes. It would unlock significant amounts of invested capital that could flow to productive investment without attracting tax. Further, the rollover provision would simply be the deferral of capital gains tax that will increase over time with the compounding of investment returns, and eventually be subject to tax once the investment is cashed out. Rather than a tax cut, it is a long-term revenue enhancement.

Federal Leadership Needed

Some form of a tax incentive for small business would have been timely given the evidently difficult financing conditions faced by small companies. The federal government's Venture Capital Action Plan introduced in last year's budget is a helpful measure, but limited in scope. Venture capital funds account for a very small share of overall small business financing, compared with angel investors and the listed venture capital markets. Moreover, moribund public markets with limited appetite for small business IPOs actually discourage venture capital financing that relies on public markets as the investment exit vehicle.

While the federal government has given priority to balancing the books over additional tax expenditures, many provincial governments now find themselves in even more serious fiscal straits. These governments are desperate for small business investment and growth to offset the contractionary impact of budget restraint, and would be supportive of a federal investment incentive for small business.

Finally, the prolonged weak conditions for small business, particularly small resource companies, is seriously undermining the structural underpinnings of the venture capital markets. Share prices have collapsed, along with trading and financing activity. If these conditions continue much longer we will witness a significant erosion in TSX Venture listings, and the listings of small companies on the TSX stock exchange. Further, the fall-off in financial activity in venture markets has weakened the profitability and effectiveness of both investment dealers and exempt dealer registrants in the markets, as well as the economic underpinnings of ancillary market participants such as law and accounting firms, engineering firms, etc. A federal tax incentive aimed at listed venture companies would not be a panacea but would improve receptivity for newly offered shares. Canada can ill-afford the loss of this critical incubator for small business.

Collapse in Share Prices
TSX v. Venture

Source: S&P

A Subtle But Important Step: A National Cooperative Securities Regulator

More Streamlined regulations

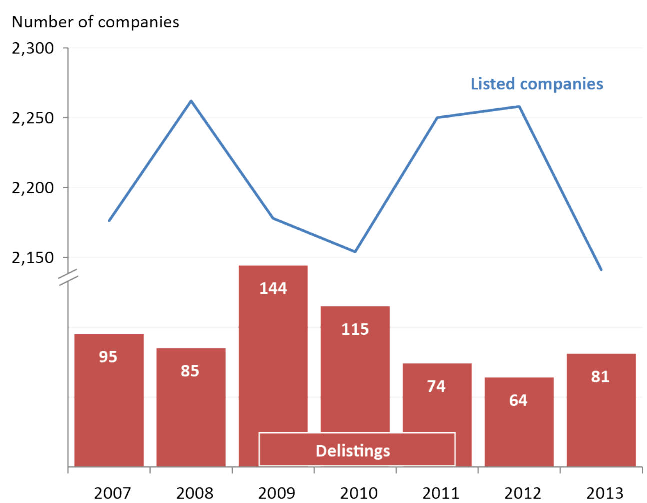
A more subtle measure in the federal budget to assist small business is the continued financial support for the Canadian Securities Transition Office working with interested provinces to design a national cooperative securities regulator. The cooperative regulator will benefit small companies and investment dealers in the venture markets. First, the move to a national securities act and single rulebook under the cooperative regulator will streamline regulation and alleviate costs for market participants. The difficulties encountered by small business in accessing capital has triggered an array of new prospectus exemptions, ranging from different types of offering memorandum and existing shareholder exemption, to facilitate more cost-effective capital-raising. Unfortunately these exemptions have not been developed in a consistent harmonized approach across the Canadian jurisdictions. This will add costs and inefficiencies for small companies that access exempt markets on a national basis, requiring careful application of the exemption among the jurisdictions.

Better accountability

Second, the cooperative securities regulator will be more accountable than the existing regime, reflecting oversight of a nationally representative board of directors with required business expertise. This board will provide guidance to regulators in developing principles and practical rules, ensuring proper balance between financial stability, investor protection and market efficiency. For example, one of the serious unintended consequences of recent reform is increased scrutiny of investment suitability, particularly the enhanced suitability requirements in CRM Part 1. While the new suitability rules are well intentioned, the unforeseen negative consequences pose challenges for regulators.

The regulatory assessment of ex ante suitability decisions is difficult as the decision involves the interaction of investment objectives, investment opportunity, and investor experience and risk tolerance. This assessment leaves advisors and dealer firms exposed to regulatory and civil risk from a differing interpretation of what constitutes a suitable investment. The risk is heightened for speculative investments with high variance in return. While the investor recognizes that risk is essential for higher investment return, the regulatory bias is not similarly symmetric, but leads to lower risk to limit investor loss. These perceived regulatory risks discourage investment dealer compliance departments and their advisors from recommending speculative investments and specialized speculative investment funds. This outcome seriously limits the financing and trading of listed equities on the venture markets.

TSX Venture Listings



Source: TSX

The remedies to the suitability dilemma are complex. One approach could be to define the suitability review of investments as a core principle, requiring investment dealers to have in place specific policies and procedures to ensure proper compliance. These policies and procedures would be subject to frequent regulatory audit and further, the firm would be required to justify the suitability decision in the event of client complaint. This approach would avoid reliance on mechanical factors such as age and experience to reinterpret suitability decisions.

A second approach could establish a defined percentage of the individual portfolio as exempt from the suitability requirement. This would provide a safe harbour for speculative investments and give more flexibility to advisors to recommend speculative investments, as well as simplify the auditing of the suitability requirement by the regulator.

In a cooperative regulatory regime, the oversight of the experienced board would be helpful in assisting regulators to find the practical and effective approach to audit suitability and avoid the described unintended consequences.

Strengthen Ottawa's capital markets expertise

The cooperative securities regulator has one further attribute benefitting small business. The involvement of the federal Department of Finance as a participant in the cooperative regulator and capital markets regulation would increase the knowledge and understanding of Finance officials in the functioning of public and private capital markets. This knowledge will translate into more effective federal tax and regulatory policies that impact the capital markets. For example, a greater awareness of the breadth and depth of the venture marketplace, and the serious financing predicament of many small businesses, may have resulted in a broadly based tax incentive for capital-raising put in place in the last couple of years.

Conclusion: The IIAC Continues to Make the Case For Direct Incentives

The federal budget has had a positive indirect impact on business, instilling confidence of continued low corporate tax rates and continuing efforts to build a single cooperative securities regulator. But direct incentives to help small business raise equity capital are still needed – urgently. The IIAC will continue to advocate for an effective tax incentive and for a single regulator, to streamline regulation and provide increased accountability and oversight. We are hopeful both initiatives will be in place by the time next year's budget rolls around.

Yours sincerely,

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