IIACACCVM
INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

LETTER FROM THE PRESIDENT

Vol. 98

Priority for the next federal budget: Facilitate small and mid-sized business access to equity capital

HIGHLIGHTS:

SMEs account for 70% of private sector employment in Canada and an average 30% of GDP.

SME access to equity capital in private and public markets has not increased nearly enough to meet the expanding needs of the country.

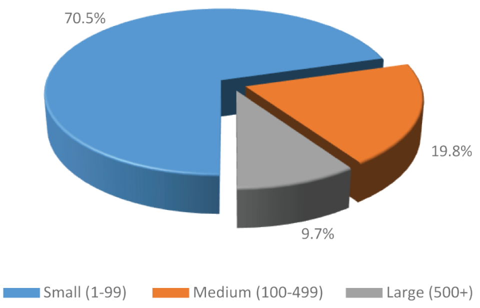
For effective results, incentives should be directed to specific SME investments determined by individual investors, not to funds that invest in SMEs.

Small publicly listed companies should qualify for incentives to invigorate listed markets. Well-functioning publicly listed markets are important for venture capital funds and angel networks to work effectively, providing an exit strategy for these investors.

The highest budget priority for the federal budget should be providing an incentive to help small business obtain needed equity capital.

Statistics Canada data indicate that small businesses in Canada (those with less than 100 employees) account for the lion's share of jobs in the country. As of December 2015, they employed over 8.2 million people, or 70% of the private sector labour force. By comparison, medium-sized businesses (defined as having 100-499 employees) employed 2.3 million individuals or 19.8% of the private sector workforce, while large businesses supported 1.1 million jobs and accounted for 10% of the private sector workforce. Small businesses operating in each Canadian province account for 30% of provincial GDP, on average.[1]

Share of Total Private Employment by Size of Business
2015



Data Sources: Statistics Canada, Labour Force Survey; Innovation, Science and Economic Development Canada calculations

In view of their important role in the Canadian economy, it is important that SMEs have access to the financing needed to grow and thrive. That is why the Investment Industry Association of Canada (IIAC) focused on the following recommendations in our pre-budget submission to the House of Commons Standing Committee on Finance (August 3, 2016):

i. Return to budget balance at the earliest opportunity.

[1] Data on small businesses' contribution to provincial GDP is compiled by British Columbia's Statistical Service. Small businesses are defined as businesses with fewer than 50 employees.

The focus on fiscal stimulus through infrastructure spending to ignite sluggish economic growth is the rationale for projected deficit financing over the next six years. Efforts should be made to rein in spending and improve efficiencies in government activities to reduce and eliminate deficits, and regain the fiscal flexibility to tackle concerns crucial to Canada's long-term competitiveness, such as lowering marginal personal income tax rates. Well-managed government finances and the prospect of maintaining competitive tax rates are the cornerstone of business and consumer confidence, and critical to robust private sector investment spending and overall economic growth.

ii. Explore financing mechanisms based on public-private partnerships (P3s) in infrastructure development to attract private capital and to identify economically viable projects and manage their effective build-out and development.

iii. Amend tax-assisted savings vehicles to complement the proposed modest enhancement to the CPP, enabling Canadians to build adequate savings for retirement. First, Group RRSPs should be given the same tax treatment as defined benefit pension plans, namely relieving employers' and employees' contributions to Group RRSPs from payroll taxes to encourage small business to offer these pension plans to their employees and to boost savings for individuals using these plans. For many Canadians, the Group RRSP is often the difference between having a pension plan and not having one, and is an important complement to the CPP. Second, many older Canadians approaching retirement have not saved enough for retirement and will have to work beyond normal retirement age. The expanded CPP will do little to help, given its gradual phase-in and small adjustment. The federal government should increase the eligible age for RRSPs contributions beyond 71 to enable these Canadians to continue saving in their RRSPs, as they stay in the work force and build savings. Finally, the rules mandating minimum yearly drawdowns from RRIFs should be eliminated to provide seniors greater flexibility to save for retirement and longer income tax deferral.

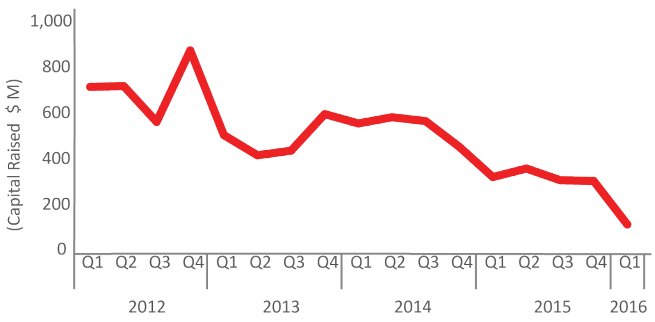
iv. Provide targeted incentives to assist small and mid-sized businesses attract equity capital to finance start-ups and expansion.

The Small Business Challenge: Attracting risk capital

It is generally recognized that small companies find it difficult to attract risk capital to finance expansion and business acquisition to help secure and build markets, talent and revenue—a chronic problem that plagues established operating small and mid-sized business, as well as business start-ups. Without access to equity capital, businesses cannot get established and existing businesses cannot expand, or may be forced into acquisition. In the tech sector, acquisition often means by a U.S. enterprise, resulting in economic loss to Canada.

Capital Raising by Small Businesses

Common Equity Financings Less than $10M



Data Source: IIAC

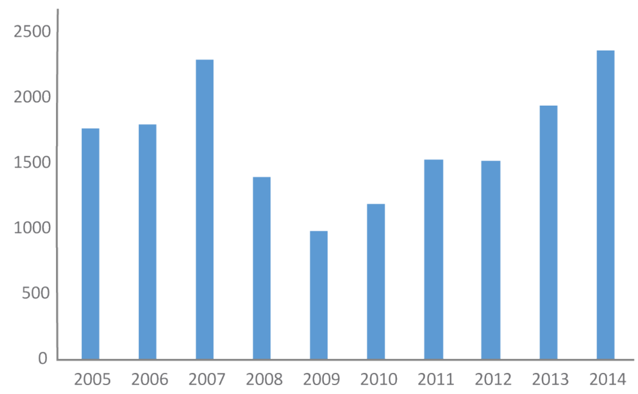
New and emerging small businesses rely mainly on informal financing sources, including networks of “angel investors”, ranging from family and friends, to more organized investor networks through formal “business incubators” often associated with universities and colleges.

In the last three years the dollar value of estimated financings in public and private markets for listed small businesses has fallen in half, to just over $1 billion a year. Equity financings for private small companies through the venture capital markets has increased steadily in this recent three-year period, but is still averaging just over $2 billion a year. The domestic venture capital funds are an important, albeit relatively modest, source of equity capital for small business, proving overall annual funding of about $1 billion a year, slightly less than U.S. venture capital investments in the Canadian market.

While there is general agreement that Canada suffers from a chronic shortage of equity capital for both business start-ups and emerging small business, there is little consensus on the right policy mechanisms to assist these businesses overcome the capital shortage.

It is interesting to note that, while the policy ideas for stimulating capital raising for small business have varied considerably, the policy approaches that have been adopted by government have illustrated a striking similarity. In all cases the incentive has been provided to a particular small business funding mechanism, such as the tax credit to investments in labour-sponsored venture capital funds or federal matching funds (up to $400 million) for investments in early-stage venture capital funds (i.e. Canada’s Venture Capital Action Plan). Officials from the Department of Finance indicated that the size of the market gap informed the size of the federal government’s investment in the Action Plan. The incentive has in effect been directed to the funds that identify and invest in early-stage firms. These funds have, at best, a mixed track record in identifying successful small businesses. Indeed, the record for labour-sponsored venture capital funds is dismal. The Auditor General of Canada (in its 2016 Spring Report) noted that there were problems with the way the government actually evaluated and chose the fund-of-funds managers and high-performance fund managers. This had a negative impact on fairness, openness and transparency.

VC Investments Per Year ($M)



Data Source: Thomson Reuters Canada 2015

A far better approach is to place the incentive on the investment, rather than the investor (fund manager). Let the marketplace of investors qualify for the incentive to invest in eligible businesses. The prospect for funding successful small businesses will be much greater.

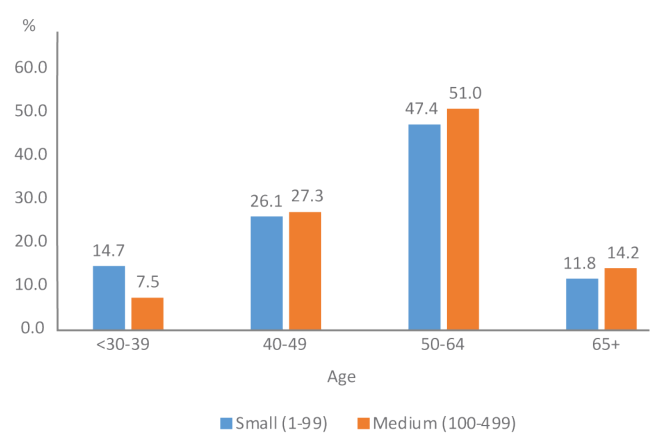
Focus on eligible investments, not funds

There may be two explanations why the government has opted for an approach that directs the incentive to a defined category of investor (or funds) and not the investment itself: 1) The influence of the funds themselves on the policy-making process, or 2) the fear that opening the incentive more widely to the marketplace will result in unexpectedly large tax expenditure. With respect to the latter, presumably the option always exists to terminate the incentive altogether. Moreover, a large tax expenditure means many small businesses are raising capital in the markets and expanding their businesses, a good outcome for the economy and for Canadians.

The Venture Capital Action Plan and the new Labour Sponsored Venture Capital Corporation (LSVCC) tax credit will have an incremental impact stimulating the flow of equity capital to small business. Similarly, the Bank of Canada proposal for an equivalent to the U.K. Business Growth Fund in which the banks would provide equity and debt financing to small business is a positive step. However, these targeted approaches have two drawbacks. First, the impact on the overall equity capital flows to small business will be relatively small, given the relatively large size of the small business sector. Second, there is the risk that the fund managers, who select the businesses to receive funding, will miss the best small business investment opportunities. The evidence from the U.K. demonstrates that a broadly-based tax incentive, available to investors across the markets for investment in many eligible small businesses, provides a deep and effective stimulus for small business equity financing.

A key reason incentives need to focus on eligible investments and not a specific fund or investor is to extend the incentive to small public companies listed on the TSX Venture and TSE stock exchanges. These listed companies are typically small and mid-sized operating companies in need of capital to expand business operations through organic growth and acquisition. The stock exchanges also provide access to the deeper capital pools needed for growing mid-sized businesses, a particular need for the country. Finally, incentives aimed at small public companies invigorate trading and financing for listed companies. Well-functioning listed markets are crucial for venture capital funds and angel networks, providing an exit strategy for investors.

Percentage of SME Owners by Age and Business Size
2014



Data Sources: Statistics Canada, *Survey on Financing and Growth of Small & Medium Enterprises,* 2014; Innovation Science & Economic Development Canada calculations

Broadly-based public offerings are also needed to pay out existing owners transitioning out of the business for retirement reasons. Forty-seven percent of small business owners and 51% of medium-sized enterprise owners are 50-64 years of age. The implication is that more than 550,000 business owners will exit their business or transfer control of their business within the next 15 years.

In recent years, the IPO market for small companies, particularly in the technology sector, has stagnated. This limited access to public markets leaves these companies with few options to tap large sources of capital, and often vulnerable to acquisition by U.S. companies—in the longer run detrimental to the Canadian economy.

The IIAC policy proposals

The IIAC has over the past several years put forward a range of recommendations as part of the pre-budget consultation process:

i. A lower capital gains tax rate for qualified investments in the shares of small business. Eligible companies would include small private companies (Canadian controlled private corporations) and small public companies listed on a recognized stock exchange, up to a defined revenue or asset threshold.

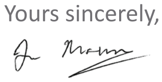
ii. A tax-free roll-over provision for the disposition or sale of assets reinvested in qualified small business equity shares. This would, in effect, unlock significant amounts of capital tied-up in low-return investments and would encourage investors to take advantage of opportunities offered by small-cap companies with faster growth potential. The proceeds not subject to capital gains tax could be capped out at a maximum amount.

iii. Introduce the equivalent of the UK Enterprise Investment Scheme (EIS) and Seed Enterprise Investment Scheme (SEIS). The EIS provides a 30% personal tax credit for the purchase of shares of eligible companies with gross assets less than £15 million and no more than 250 full-time employees. The SEIS provides a 50% tax credit for the purchase of shares of eligible companies with assets up to £200,000 and fewer than 25 employees. The shares must be held for at least three years or tax relief will be withdrawn. Eligible shares held for more than three years are also exempt from capital gains tax. The EIS and SEIS programs have been effective, with the EIS operational for over 20 years, partly responsible for the UK having the largest small business sector among the countries in the EU.

iv. An increase in the annual contribution amount to Tax Free Savings Accounts (TFSAs), conditional on the additional investment made in the shares of eligible small business. The TFSA throughout its seven-year existence has proven an effective savings vehicle for Canadians of all income levels, as individuals seize the opportunity to save through the instrument and shelter returns from personal tax. Since 2009, approximately $34 billion annually, on average, has been contributed to TFSA accounts (some $240 billion). A proportion of TFSA savings have been invested in the speculative shares of small business. The TFSA annual contribution limit was reduced from $10,000 to $5,500 for 2016. In 2016, the annual limit of $5,500 brings the cumulative total amount of contribution room to $46,500.

The goal of capital markets is to bring together people who need capital with those who wish to invest it. The IIAC proposals will help to achieve this goal, and strengthen the economy and create jobs.

Yours sincerely,



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