Interim Report of the Standing Senate Committee on Banking, Trade and Commerce

AN ENVIRONMENT FOR PROSPERITY: FACILITATING THE GROWTH OF SMALL AND MEDIUM-SIZED BUSINESSES IN CANADA

Chair
The Honourable E. Leo Kolber

Deputy Chair
The Honourable David Tkachuk

September 2002

THE SENATE

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MEMBERSHIP

The Honourable E. Leo Kolber, *Chair*

The Honourable David Tkachuk, *Deputy Chair*

and

The Honourable Senators:

Angus	Kroft
*Carstairs, P.C. (or Robichaud, P.C.)	*Lynch-Staunton (or Kinsella)
Fitzpatrick	Meighen
Furey	Oliver
Hervieux-Payette, P.C.	Poulin
Kelleher, P.C.	Setlakwe

**Ex Officio Members*

Note: The Honourable Senators Austin, P.C., Banks, Callbeck, Gustafson, Kenny, Kirby (as Chairman) and Mahovlich were members of the Committee at various stages during the course of this study.

Staff from the Parliamentary Research Branch, Library of Parliament:

Ms. June Dewetering, Acting Principal and Mr. Alexandre Laurin, Researcher Economics Division.

Note: Mr. Gerald Goldstein, Director, Economics Division, Mr. Marion Wrobel, Senior Analyst, Economics Division and Ms. Margaret Smith, Researcher, Law and Government Division were researchers of the Committee at various stages during the course of this study.

Staff from the Committees and Private Legislation Directorate:

Denis Robert, Clerk of the Committee

Note: Mr. Gary Levy was Clerk of the Committee up to June 30, 2000.

ORDER OF REFERENCE

Extract from the Journals of the Senate, Tuesday, March 20, 2001:

The Honourable Senator Tkachuk for the Honourable Senator Kolber moved, seconded by the Honourable Senator Cohen:

"That the Standing Senate Committee on Banking, Trade and Commerce be authorized to examine and report upon the present state of the domestic and international financial system;

That the papers and evidence received and taken on the subject during the First and Second Sessions of the Thirty-sixth Parliament and any other relevant Parliamentary papers and evidence on the said subject be referred to the Committee;

That the Committee be empowered to permit coverage by electronic media of its public proceedings with the least possible disruption of its hearings;

That, notwithstanding usual practices, the Committee be permitted to deposit an interim report on the said subject with the Clerk of the Senate, if the Senate is not sitting, and that the said report shall thereupon be deemed to have been tabled in the Chamber; and

That the Committee submit its final report no later than March 31, 2002.

After debate,

The question being put on the motion, it was adopted."

Extract from the Journals of the Senate, Wednesday, March 6, 2002:

The Honourable Senator Kolber moved, seconded by the Honourable Senator Maheu:

That the date for the presentation by the Standing Senate Committee on Banking, Trade and Commerce of the final report on its study on the present state of the domestic and international financial system, which was authorized by the Senate on March 20, 2001, be extended to Thursday, March 27, 2003.

The question being put on the motion, it was adopted.

Paul Bélisle
Clerk of the Senate

RECOMMENDATIONS

The inclusion rate on capital gains be further reduced from the current 50% established in the October 2000 Economic Statement and Budget Update of the Minister of Finance.

The federal government undertake activities designed to coordinate better existing matchmaking services, such as the Canada Community Investment Plan sponsored by Industry Canada, as a means of ensuring that willing investors are matched with entrepreneurs who need financing.

The federal government convene a meeting with provincial securities regulators with a view to ensuring that minimum purchase requirements and tax impediments do not unnecessarily deter investment.

The federal government, in contemplating future legislative and regulatory initiatives, consider any negative impact on Labour-Sponsored Funds.

The federal government study the issue of venture investments by pension funds, including an examination of tax, regulatory, structural and other impediments to such investments, including to Labour-Sponsored Funds.

The federal government, through its legislative and regulatory function, foster an environment that enables the development and prosperity of stock exchanges in Canada.

The Federal government undertake a study of any barriers or impediments affecting the ability of the venture capital operations of banks to compete in the marketplace on the same basis as their competitors. Barriers or impediments identified during the study should then be removed.

The federal government initiate a dialogue among stakeholders with respect to a national escrow regime. Moreover, the extent to which escrow requirements may inhibit public offerings should be examined, with a view to eliminating any unnecessary requirements.

The Department of Finance review the associated company rules under the *Income Tax Act* with a view to exempting from their application shares owned by venture capital organizations.

The federal government take actions to implement fully the recommendations made by the Standing Senate Committee on Banking, Trade and Commerce on the issue of directors' liability.

The federal government amend the *Income Tax Act* to reduce further the rate of capital gains taxation.

The federal government study the impact of business taxes, with a view to reducing or eliminating the federal share of such taxes.

The federal government undertake a study of existing tax and other incentives and determine if they are achieving their goals in a manner that does not distort investment decisions.

The federal government study possible incentives for skills development and lifelong learning among Canadian entrepreneurs and management. These incentives must recognize the particular skill needs and challenges faced by these Canadians as distinct from the government's more general focus on skills development and lifelong learning.

AN ENVIRONMENT FOR PROSPERITY: FACILITATING THE GROWTH OF SMALL AND MEDIUM-SIZED BUSINESSES IN CANADA

> *"In the United States, when they do an incentive, they do it in a way that would encourage the growth of firms, such as encouraging initial public offerings (IPO). When Canada offers incentives, we do it to keep firms small." (J. Mintz, Evidence, 36th Parliament, 1st Session, Issue 52)*

I. Introduction

During the 1990s, access to financing for small and medium-sized businesses had become an important public policy issue in Canada. With Statistics Canada's data showing a decline in bank financing for the small business sector, and numerous complaints from small businesses, it appeared that access to capital had declined substantially after the recession in the early part of the decade.

What became evident to this Committee, and to others, is that debt is only one part of the financing equation for small businesses. Indeed, the over-emphasis on debt financing masked the fact that the source of many financing woes of small business stemmed from a lack of equity. Part of the reason that small businesses could not access bank financing was that they were not "bankable." In other words, their balance sheets did not contain sufficient equity to make them eligible for additional bank loans.

This point was stressed by the Canadian Federation of Independent Business. "Bank debt is one part of the equation, but equity capital is the other part. We tend to focus very much on bank debt, but if we do not concentrate on equity capital, we will always be concentrating on bank capital. I think that if we want to grow firms in this country at the rate that we had hoped, we have to realize that we must examine the equity capital provision for the SME [small and medium-sized enterprises] market and bring tools to that sector that currently do not exist." (*B. Gray, Evidence, 36th Parliament, 1st Session, Issue 50*)

This is precisely what the Committee wishes to do with this report. We wish to move the focus of attention away from debt financing and towards equity financing. Indeed, it is apparent that debt financing for SMEs is made available in a well-developed and highly utilized market. On the other hand, "early stage equity financing" is accessed in a market that is less well-developed. Why is that so, and what can be done about it? The Committee hopes that this report will help to provide some of the answers.

The barriers to equity financing for SMEs originate from a variety of sources. Some are due to the nature of the market. There is asymmetric information between entrepreneurs and financiers. On the one hand, from the investors' perspective, equity financing is highly risky. On the other hand, the poor understanding by entrepreneurs of financing leads them to have unrealistic expectations about the value of their enterprises, leading them to think that equity financing is too expensive. Coupled with the natural desire of entrepreneurs to maintain ownership and control, it is not surprising that it is often difficult to conclude an agreement between those with capital and those who need it.

But the existing barriers to equity financing are not due just to characteristics of the market and its participants. Governments, both federal and provincial, are themselves responsible for some of the barriers. Some of the impediments are tax-related, while others are regulation-related.

In the discussion that follows, Section II explores the growth of small businesses, while Section III examines capital market issues regarding start-up and early stage equity investment. Section IV concentrates on regulatory barriers which are hindering small business equity financing activities. Section V explores the taxation of investment income and its effect on investment behaviour. Finally, Section VI deals with issues related to entrepreneurs, such as culture, education and skills.

II. Poor Growth Performance of Small Businesses

Small and medium-sized enterprises (SMEs) make up a significant portion of the Canadian economy. They account for 50% of all private sector employment and nearly 43% of gross domestic product. [1] Seventy-eight per cent of all firms in Canada have five or fewer employees; about 94% have 20 or fewer employees, while 97% have 50 or fewer employees. (*Evidence, 36th Parliament, 1st Session, Issue 50*) Since the 1980s, the small business sector has created 87% of all new jobs in Canada. [2]

There are plenty of entrepreneurs in Canada. According to a 1999 Statistics Canada's study, self-employment accounted for about 80% of the net employment gain in Canada between 1989 and 1997, in contrast to only 1% in the United States. About 40% of these new jobs were in the higher-paying service industries. [3]

Although the importance of SMEs to the economy is well documented, the Committee felt that not enough attention had been directed towards the growth of small businesses in Canada in particular, and the impact on Canada's economic well-being in general.

According to Dr. Jack Mintz, President of the C.D. Howe Institute, a number of studies have shown that Canadian entrepreneurs created many new small businesses in the 1980s and 1990s, but the record of those enterprises in the years following their creation shows only little growth. He told the Committee that one of his main concerns is that the Canadian system may provide attractive incentives for the creation of small businesses, but the system is not supportive of the growth of those SMEs.

> *For example, … if one looks at … companies with employment in 1985 that were less than five employees, eight years later [by 1993] only 1.1% of those businesses actually grew to have more than 20 employees. … Also, if one looks at the category 5 to 19.9 employees in 1985, by 1993 only 12% grew to have more than 20 employees. … This is well substantiated in a number of studies. (J. Mintz, Evidence, 36th Parliament, 1st Session, Issue 52)*

Thus, Canadian SMEs appear to be growing rather slowly, especially in the high-tech sector which constitutes Canada's emerging economy. New ventures, particularly in the new economy, have the greatest potential to enhance Canada's growth. Equity financing is the most appropriate tool for them. Vernon Lobo, Managing Director at Mosaic Venture Partners, told the Committee that:

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[1] The Conference Board of Canada. "What's New in Debt Financing for Small and Medium-Sized Enterprises." 1997, p. 2.

[2] *Ibid.*

[3] Garnett Picot and Marilyn E. Manser. "Self-employment in Canada and in the United States." *Perspectives on Labour and Income*, Autumn 1999, pp. 37-44.

> *In the U.S., the emerging economy has created more than 25 times the economic wealth that it has in Canada. If we exclude the largest companies in each country, the ratio grows to 48 times. That is in nominal dollars; if we were to put it in equivalent dollars, it is something like 75 times. (V. Lobo, Evidence, 36th Parliament, 1st Session, Issue 50)*

Enhancing access to external financing is essential if the rate of growth of SMEs in Canada is to increase. Smaller firms do not enjoy the same financial flexibility as do larger firms. They represent greater risks for traditional creditors. This is especially true in knowledge-intensive industries, where newly-created firms are essentially the product of innovative ideas and human capital — traditional sources of debt financing are not suited to support these entrepreneurial firms if they do not have sufficient equity or machinery to use as collateral. But whether new-economy or old-economy firms, many small businesses are simply not "bankable" because of the condition of their balance sheets. In short, there is not enough equity.

> *The primary source of financing for all [small business] activities is equity. However, investments in knowledge assets, such as R & D and technology acquisition, are more often financed through equity than are physical assets. Investments in physical assets, such as machinery, equipment, land and buildings, which are usually less risky, are more often financed with long-term debt than investments in knowledge assets. Consequently, firms must have a high degree of equity to invest in knowledge.*
>
> *The importance of equity for financing knowledge activities is also evident from differences in financial structure across industries. Firms operating in dynamic, high-knowledge industries (industries where R & D spending, technology use and/or use of skilled workers is high) use relatively more equity capital. Conversely, firms in low-knowledge industries rely more heavily on debt financing.* [4]

The importance of equity capital for new-economy firms is not surprising. Whereas physical assets can provide some security for debt financing, intangible assets are less well suited to this. With the evolution of the Canadian economy, access to equity becomes ever more important. Gordon Thiessen, the predecessor of David Dodge as Governor of the Bank of Canada, said recently that major technological change is taking place around the world. It is certainly happening in Canada and, indeed, it appears to be very significant. For the firms in the "new economy," the use of knowledge and technology makes up a significant portion of their production process. And this is why equity financing is central to the development of the new economy in Canada.

Although Canada is doing better than several other countries in terms of the new economy, there is much room for improvement, especially in the high-tech sectors. Denzil Doyle, Chairman of Capital Alliance Ventures Inc., told the Committee that:

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[4] J. Johnson, J.R. Baldwin, and C. Hinchley (1997) *Successful Entrants: Creating the Capacity for Survival and Growth*, Catalogue No. 61-524, Ottawa: Statistics Canada.

> *[According to] an Industry Canada document from 1995 that looks at the information and communication technology industry … our exports in that sector were $19.5 billion, which was an increase of approximately 7.5% over the previous year. The imports, however, were $35.6 billion, for an increase of 16.7%. … Back in 1972, … Canada enjoyed approximately 4% of the market demand for high-technology products. … Today, its share is less than 1.5%. Therefore, [Canada] is actually losing market share in the new economy. … We are not a new economy country. (D. Doyle, Evidence, 36th Parliament, 1st Session, Issue 50)*

The financing of young, small Canadian technology companies, however, appears to be heading in the right direction. Mary Macdonald, President of Macdonald & Associates Limited, informed the Committee that in recent years there has been a real shift towards technology financing in the venture capital industry.

> *We have, unquestionably, seen a transition over the last five years in Canada to a venture industry that really funds many innovative companies. You can see that two-thirds of the money is effectively going into what we call "IT"; that is, information-technology-based businesses, ranging from networking and communications to software, electronics and semiconductors. It is very diversified across that group of sectors.*
>
> *If we were to actually unravel the industry across the country, we would see that there has been very strong capability building over the last five years in particular, both on the venture capital industry side and on the company side, the receptors of that capital. There is also reasonable strength in the biotech sector. (M. Macdonald, Evidence, 37th Parliament, 1st Session, Issue 25)*

The standard of living of Canadians depends critically upon the ability of firms in Canada to grow at a pace that is at least equal to the performance of foreign producers. The fastest growing industries in the world are the knowledge-based industries of the new economy. As Roderick Bryden, President and Chief Executive Officer of World Heart Corporation, indicated to the Committee, Canada should recognize that and attempt to ensure that we are not only a major consumer of those services but also a major producer. If Canada continues to lose market share in those high growth sectors, the standard of living in Canada will suffer. It certainly happened here in the 1990s.

> *(I)f we want to grow firms in this country at the rate that we had hoped, we have to realize that we must examine the equity capital provision for the SME market and bring tools to that sector that currently do not exist. (B. Gray, Evidence, 36th Parliament, 1st Session, Issue 50)*

One might ask: Why is it so important that SMEs have access to capital? Fundamentally, it is to help small businesses grow and create jobs in the economy. But most importantly, SMEs are a significant source of commercial innovation. Throughout the world, they are the best suited vehicle through which basic research is turned into applied research and development (R&D) that will ultimately lead to a commercial product. The organisational structure of large corporations makes entrepreneurship and flexible applied research for new products more difficult. According to an article in the *Harvard Business Review:*

> *[Large corporations] typically invest in and protect their existing market positions; they tend to fund only those ideas that are central to their strategies. The result is a reservoir of talent and new ideas, which creates the pool for new ventures.* [5]

The innovation process that comes out of small businesses then spills over to the rest of the economy, and productivity gains are registered. The U.S. venture capital industry is envied throughout the world as a powerful engine for economic growth and innovation. The Committee wants to address, in this study, the best way to improve Canada's growth potential. Equity financing is likely the most appropriate financing tool to achieve this in the new economy.

[5] Bob Zider. "How Venture Capital Works." *Harvard Business Review*, November-December 1998, p. 138.

III. Capital Market Issues

This section examines four issues facing capital markets, including early stage financing, Labour-Sponsored Funds, institutional and foreign investment, and the scale and liquidity of stock exchanges (with a focus on exit opportunities).

A. Financing Early Stages of Firms' Development

> *"The goal of promoting start-up and expansion SMEs is a key objective of Canadian economic policy because small business is the engine of economic growth." (J. Oliver, Evidence, 36th Parliament, 1st Session, Issue 46)*

Generally, small businesses at the start-up or early expansion stages do not have sufficient collateral (equity, land or physical assets) required by traditional banks to finance their activities and growth. Those businesses rely almost exclusively on two sources of funding: outside private equity financing and retained earnings. Very young companies, however, tend to have little revenue and even fewer profits. Therefore, outside financing is crucial.

Outside private equity comes from formal and informal sources. The very early stages tend to be financed informally, by family and friends ("love money") or by sophisticated investors (angels) who are often local business owners themselves. These angels bring more than financing to the table; they bring expertise and advice, business contacts and mentoring. This early stage financing is often in smaller amounts.

Larger amounts are traditionally provided by venture capital funds, which are typically private or publicly-sponsored pools of capital that invest in a business in return for an equity stake. As they are also providing financing at an early stage, high rates of return are expected. Riding and Orser suggest that returns equivalent to 30%-40% compounded annually are typical over an investment period ranging from three to seven years or more.[6] Unlike informal investors, venture capital funds tend to concentrate on larger investments, typically above $1 million. While improving, there is the sense that the market for seed and early stage investment financing is still largely under-developed in Canada.

> *While there are more funds in the market now and there is more capital than ever, it remains significantly more difficult for a start-up or early stage business in Canada to*

[6] Allan L. Riding and Barbara J. Orser. *Beyond the Banks: Creative Financing for Canadian Entrepreneurs.* John Wiley & Son Canada, Ltd., 1997, p. 17.

attract the amount of equity capital that a competitor in the U.S. may have available to it. (B. Laver, Evidence, 36th Parliament, 1st Session, Issue 50)

The provision of seed capital is critical for entrepreneurs. It finances the R&D phase where potential products are being developed and tested for their market potential. This is a risky stage of investment. "Love money" sources are rarely sufficient to lay the groundwork for the company and establish a sound business plan. Once this capital has been exhausted, successful entrepreneurs will seek the help of more formal sources of private investment.

Traditionally, venture capital funds invest at a later stage of the product cycle. In recent years, however, several seed capital funds have emerged and venture capital commitments for start-up businesses have risen from about 30 per cent of new investments to about 60 per cent. A "start-up" is a company that is not in full commercial production, yet it is actually ready to market and sell. This phase comes after a seed deal was made (probably with informal investors) when the company did not have a management team in place, was still at the R&D stage and has not beta-tested its product. This very early stage of development is critical to the success of a company, and to the quality of start-up companies that venture capitalists would eventually finance.

According to Professor Allan Riding of Carleton University, angel investors are the single largest source of early stage equity capital in Canada. Angel investors are individuals with high net worth who invest their personal capital in businesses owned by others. Amounts invested generally range from $10,000 to $500,000, although the Committee was told that some angels invest up to $4 million or $5 million. The average investment is approximately $100,000.

Their investment profile differs from traditional venture capital firms. "Approximately 60% of investments made by angels come before the firm's product hits the market." (*A. Riding, Evidence, 36th Parliament, 1st Session, Issue 47*) For angels, these investments are a sideline, not a primary business. "They have business experience. Most angels are people who have succeeded at building a business in the past." (*A. Riding, Evidence, 36th Parliament, 1st Session, Issue 47*) They invest in the sector and business in which they themselves are experienced. Therefore, along with seed capital, they contribute advice and management support. Because they come from a wide variety of industries, their financial support is vital for industries that are not currently in favour among the venture community.

Angels like to remain anonymous. There is no public listing of angels and there is no marketplace. "They tend to syndicate, usually with each other. The networks are local and personal; they operate by word of mouth, by referral." (*A. Riding, Evidence, 36th Parliament, 1st Session, Issue 47*) Therefore, it is often difficult to match angels with entrepreneurs. Professor Riding stressed the need to mobilize angel money through matchmaking. He strongly urged the coordination of existing matchmaking services, such as the Canada Community Investment Plan (CCIP) sponsored by Industry Canada.

In his studies, Professor Riding estimated the Canadian angel market to be about $1 billion, although it could potentially be as high as $10 billion to $20 billion. But while angels are a vital source of financing for early stage businesses, they face a variety of barriers and disincentives. One issue which received particular attention at the time of the hearings – but has since been addressed to some extent – was that securities regulations in a number of provinces are complex and make it difficult for angels to legally make investments in small businesses. According to Joseph Oliver, President and Chief Executive Officer of the Investment Dealers Association of Canada, many SMEs and small entrepreneurs "lack the financial and human resources to comply with a complex regulatory regime." As Jacques Sayegh, President and Chief Executive Officer of the Royal Bank Capital Corporation, puts it:

> *(T)here is a critical need to remove the barriers of … multiple jurisdictions, … provincial barriers for listing and for raising capital. It seems that every province has got its own securities rules. The various exemptions … required for a small company to raise small amounts of capital, whether it is from angels, traditional venture groups or ourselves, are very complex and require significant legal costs. (J. Sayegh, Evidence, 36th Parliament, 1st Session, Issue 51)*

As mentioned above, however, many issues that were raised during the Committee's early hearings on this topic have since been addressed by several provincial regulators. For example, one of the provincial securities rules that was the most criticized by witnesses was the minimum purchase requirement.[7] Under private placement exemptions, small issuer companies can sell equity to any private investor and venture capital fund. However, there is a minimum investment threshold, designed to limit these offerings to "sophisticated" investors, that defines a legal investment. The thresholds vary by province and range from $97,000 to $150,000.

The Committee heard its testimony in 1999. In November 2001, the Ontario Securities Commission (OSC) adopted a proposal based on recommendations contained in the OSC Task Force Report. The new rule introduces two new exemptions that replace the private placement exemptions, including the $150,000 exemption:

- The Accredited Investor Exemption: This exemption permits issuers to raise any amount at any time from an "accredited investor." Accredited investors meet specified qualification criteria, among which are included individuals who

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[7] The minimum purchase requirements have been set by securities commissions to protect "unsophisticated" investors who, without the benefit of advice from a registered dealer, are unable to assess correctly the risk associated with certain investments. But as Joseph Oliver pointed out, the size of investment is only a very rough measure of sophistication. Wealth can come from a variety of sources, such as inheritances. The fact that an individual has $150,000 to invest in a business does not necessarily constitute a guarantee that this person is a sophisticated investor i.e., that this investor has enough business knowledge or has sought the appropriate advice to properly assess the risk associated with the investment.

According to Mr. Oliver, "minimum purchase thresholds are generally considered to be an inefficient approach which unduly restricts small business access to capital." (*Evidence, 36th Parliament, 1st Session, Issue 46*) Some sophisticated investors, such as angels, would prefer to invest in smaller amounts because they would like to diversify their risk. (It should be remembered that these early stage investments are very risky.) Secondly, Gordon Sharwood, Chairman of Sharwood and Company, told the Committee that many new technology companies need only small amounts, $20,000 to $40,000 to start with. This was illegal under the Ontario Securities Commission rules, which required a minimum investment of $150,000. The rules, therefore, were clearly out of line with the needs of the economy.

themselves, or jointly with a spouse, have a net worth above $1 million or whose net income exceeds $200,000 annually ($300,000 if jointly with spouse), and individuals who are related by family to an officer, director or promoter of the issuer company.

- The Closely-Held Issuer Exemption: This exemption permits small issuers to raise a maximum of $3 million, through any number of investments, from no more than 35 investors other than family members, accredited investors and employees, provided that an information statement is distributed to the purchasers at least four days prior to the date of the trade and that no promotional expenses are incurred.

These new exemptions will greatly facilitate the issuance of equity to private investors, such as angel investors, and family members. Therefore, the new OSC rules respond to many of the concerns (for the province of Ontario) that have been raised by various witnesses before this Committee. The Alberta Securities Commission and the British Columbia Securities Commission have recently published, for comments, a proposed rule based on the new Ontario rules.

Other than legal barriers to investing, angel investors also face tax impediments. The most prominent disincentive is the capital gains tax. John Cranston, President of the Alberta Capital Market Foundation, told the Committee that “it is the millionaires who are the angels, who start the companies, who create the jobs.” (*J. Cranston, Evidence, 36th Parliament, 1st Session, Issue 50*) For the most part, those angels hold their money in equity. In order to invest in a new project, they have to sell a portion of their assets and pay tax on the capital gains, even though the proceeds are never used for consumption — it is just a shift of wealth from one asset to another. The federal Minister of Finance, in the October 2000 Economic Statement and Budget Update, reduced the capital gains tax rate in Canada by further reducing the inclusion rate from 67% (reduced from 75% in the February 2000 Budget) to 50%, and by expanding the scope of rollover provisions for shares held in small businesses. Section V of this report examines the issue of capital gains taxes in more detail. The Committee is of the view that capital gains taxation in Canada remains an impediment to the mobilization of capital towards small businesses, especially at the angels level.

> *If you look at [the Canadian] investment spectrum, the front end of it (early stages investment) is as dead as a doornail and the back end of it (late stages investment) is overheated. The front end of it is as dead as a doornail because we have chased those angels off the scene with our obscene capital gains tax situation in the country. (D. Doyle, Evidence, 36th Parliament, 1st Session, Issue 50)*

In the last three years, the Canadian venture capital industry has experienced phenomenal growth. By the beginning of 2001, the amount of venture capital under management in Canada had risen to $18.8 billion, up 50% from the $12.5 billion under management one year earlier, and up 88% from the $10 billion under management two years earlier. However, the formal venture capital market in Canada tends to concentrate on investments above $1 million.

> *Large pools of venture capital are building up in Canada now, some of those pools being as high as $700 million or $800 million. In the case of a venture capital company that is trying to move $800 million, if, say a young team of entrepreneurs from Carleton University comes along and says it needs $200,000, the venture capital company would tell them to get lost, because they must invest that money in chunks of $2 million or $3 million at a time. (D. Doyle, Evidence, 36th Parliament, 1st Session, Issue 50)*

It is worth noting that by giving particular focus to small and mid-sized financings, labour-sponsored venture capital corporations (LSVCCs) are disproportionately helping to finance start-up companies that may otherwise not have received financing from traditional venture capitalists. This point was emphasized by the Association of Labour Sponsored Investment Funds and various representatives of those funds.

> *In 2000, [Ontario] LSVCCs were responsible for … 50% of the flows to deals sized less than $1 million. In the most challenging deal size segment of them all – those of less than $500,000 – Ontario LSVCCs were truly pivotal, providing 55% of all dollar amounts.* [8]

Venture capital funds typically invest at the expansion stage of a business. However, the Committee heard that there is actually not enough good, well-managed "expansion stage" prospects, with a good track record, to finance. On the other hand, angel investors and seed venture capital funds are operating below their true potential. According to Denzil Doyle, the consequence is that too few start-ups are being financed. This leaves too few deals later on for venture capitalists to invest in and creates excessive competition among venture capital corporations.

The Committee is of the view that not enough entrepreneurial activity is being financed at the start-up and early stages of businesses, in part because the taxation of capital gains in Canada is still a deterrent to the mobility of capital gains from successful investments to promising risky ventures. In order to facilitate the financing of the early stages of firms' development, the Committee recommends that:

> **The inclusion rate on capital gains be further reduced from the current 50% established in the October 2000 Economic Statement and Budget Update of the Minister of Finance.**
>
> **The federal government undertake activities designed to coordinate better existing matchmaking services, such as the Canada Community Investment Plan sponsored by Industry Canada, as a means of ensuring that willing investors are matched with entrepreneurs who need financing.**
>
> **The federal government convene a meeting with provincial securities regulators with a view to ensuring that minimum purchase**

[8] Association of Labour Sponsored Investment Funds (ALSIF). Submission prepared for the SSC on Banking, Trade and Commerce, 21 November 2001, p. 7.

requirements and tax impediments do not unnecessarily deter investment.

B. The Special Case of Labour-Sponsored Funds

The venture capital market is an important link in the financing chain for small business, as it represents one of the earliest stages at which formal sources of equity capital become available to entrepreneurs. The state of the venture capital market has changed enormously in Canada over the past decade, largely as a result of government tax incentives available for investors in labour-sponsored venture capital corporations (LSVCCs). While there was no significant venture capital market ten years ago, in 1999 it exceeded $12 billion, with about one-half being provided by LSVCCs. At the start of 2001, the pool of venture capital had reached almost $19 billion, according to Macdonald and Associates Limited, with the LSVCC share declining to about 40%. According to Ron Begg, President of the Working Ventures Canadian Fund Inc., LSVCCs raised 80% of all new venture capital in 1995-96. LSVCCs have clearly been the most important source of funds for venture capital investments in recent years, and it is only in the last three years that a significant amount of private money has been forthcoming.

Where the venture capital industry was investing $200 million to $300 million annually in the early 1990s, it is now investing billions of dollars annually in small businesses. In 2000, for example, $6.3 billion was invested. In the first nine months of 2001, disbursements were only 15% lower than in the previous year, in sharp contrast to the American venture capital market where financings were down by almost two-thirds.

Canada's venture capital market has not only changed significantly over time, we have created a market that is very unique. However, this uniqueness presents its own set of challenges and opportunities.

Venture capital funds are typically financed in the United States by institutions and individuals with long time horizons and patience, and some market expertise which allows them to provide oversight in the way in which venture capital funds operate. While 60% of new venture capital in the U.S. comes from pension funds, only 6% comes from that source in Canada and, while almost 90% of the American venture capital industry is managed by private independent funds, only one-fifth is so managed here.

In Canada, anyone with a $500 lump sum payment or $50 per month to invest (not your typical venture capitalist) can become a venture capital financier. Indeed, without these investors, the supply of venture capital in Canada would be only one-half of what it is today. And without the tax credits [9] provided by the federal and most provincial governments, "… the capital raised by labour-sponsored funds would not have been raised." (*R. Begg, Evidence, 36th Parliament, 1st Session, Issue 47*)

[9] Originally, the federal government offered a tax credit of 20% on investments up to $5000. This was subsequently reduced to 15% on investments up to $3500, and later adjusted to 15% on investments up to $5000. Most provinces offer similar credits on similar terms.

However, having that many investors does pose its challenges. Denzil Doyle, the manager of an Ottawa LSVCC, describes a difficulty associated with this Canadian model:

> *It is a somewhat clumsy vehicle. For instance, I have 11,000 shareholders and every time you communicate with them it costs you $20,000. (D. Doyle, Evidence, 36th Parliament, 1st Session, Issue 50)*

In addition to this, there are other challenges. First, as Professor Jeffrey MacIntosh of the University of Toronto points out, there is a mismatch between investor type and riskiness of investment. Individuals with relatively modest wealth and small investment portfolios are investing a portion of their retirement funds in very risky securities.

Second, LSVCCs raise their capital in the retail market and, with the exception of the Solidarity Fund in Quebec, are as liquid as any other mutual fund, although investors must hold their investments for a minimum stipulated time to enjoy the tax credit. As a result, these LSVCCs must retain a large part of their assets in liquid form in order to meet withdrawals. While the extent of these liquid assets might be consistent with the rules of the federal and provincial governments providing tax incentives, this degree of liquidity is not required in more traditional forms of venture capital funds. Thus, LSVCCs must raise more capital than they can make available to small businesses and they must raise more capital than other venture capital financiers would need to raise.

Moreover, as the labour-sponsored model relies so heavily on up-front tax incentives to raise capital, the stability of the industry becomes tied to these incentives. Governments have a legitimate interest in ensuring that tax incentives are effective. But the 1996 federal and provincial budgetary measures that reduced the incentives for investments in LSVCCs had a significant, negative effect on the ability of these corporations to raise capital. In recognition of the adverse effect on the industry, the government subsequently modified those changes. In the words of Ron Begg, "continuity and certainty of this program are important, not only so that entrepreneurs have a continuous supply of risk capital they can depend upon, but also so that you have the infrastructure in the industry to serve these small- and medium-sized businesses. Venture capital is all about adding value, not just providing capital." (*R. Begg. Evidence, 36th Parliament, 1st Session, Issue 47*)

Finally, it is interesting to consider the origins of the LSVCC and the policy rationale for the tax credits associated with them. The concept originated with the Solidarity Fund in Quebec, whose mandate "… is to create and maintain jobs and provide a reasonable rate of return to their investors, which is not necessarily the same mandate that other labour funds or venture capital funds would have, which would be to maximize their IRRs [internal rate of return], so they can provide a reasonable rate of return and invest in infrastructure that is not driven exclusively by rate of return considerations." (*M. Macdonald, Evidence, 36th Parliament, 1st Session, Issue 50*)

LSVCCs also provide a regional dimension to the venture capital industry that might not otherwise exist. Provincial governments establish criteria that must be met for tax credit eligibility. Some provinces (British Columbia, for example) might set disbursement requirements that are more strict than the industry average, while others (Ontario, for example) might require a larger proportion of investments in start-ups or smaller-sized firms. In Manitoba, for instance, the fund is structured to allow owners to exit their investments while at the same time ensuring the continuation of local employment. Indeed, the Crocus Fund in Manitoba is providing about two-thirds of the venture capital in that province. Provincially-based LSVCCs also provide local venture capital financing even when a critical mass has not yet been established.

In general, LSVCC investments tend to be smaller than those of other venture capitalists, thereby filling a market void. Investments by firms not in the Association of Labour Sponsored Investment Funds average $8.4 million, whereas investments by firms in the Association average $1.6 million.

In short, the labour-sponsored venture capital model was originally intended to have “social” as well as “economic” goals, but is now used in most of the country as a straight venture capital vehicle. It has contributed to the development of a fairly mature venture capital market, something that did not exist a decade ago. As noted by Professor MacIntosh, it may be that “… the labour sponsored vehicle is a good one … in that it has poured a lot of new funds into SMEs and technology SMEs in particular. Technology SMEs are vitally important to the economy. In net, the benefit may be strongly positive.” *(J. MacIntosh, Evidence, 36th Parliament, 1st Session, Issue 50)*

Given the dominant position of LSVCCs in the venture capital market, a withdrawal of support by government could destabilize the industry. Nevertheless, it seems clear that Canada cannot rely solely on this approach to provide venture capital financing in the new economy. In recent years, such other players as private independent funds and corporate funds have been very active in raising new funds, and aggregate new commitments by each of these types of funds have equalled those of LSVCCs. According to Mary Macdonald, while labour-sponsored funds started to gain considerable momentum through the early to mid-1990s – a time when capital was very scarce to the point where other funds were having great difficulty in raising capital – the maturation of private independent funds and corporate funds provide for a stable venture capital industry in Canada. These three types of venture capital funds, together, are forming what Mary Macdonald referred to as “the three legs of the stool,” with the LSVCCs being a crucial part of this mix. The pool of capital in Canada is now quite diverse. This situation contrasts with that in the U.S., where private independent funds represent 90 per cent of the industry.

> *A stable industry in the Canadian context constitutes the labour-sponsored funds, the private independent funds and the corporate funds. Those three together make up the capital base and are the active players in the market. (M. Macdonald, Evidence, 37th Parliament, 1st Session, Issue 25)*

In times of economic uncertainty, this diversity serves us quite well, in that we are not reliant on one source. For example, in the U.S., the pension funds are currently reeling from some of the economic impacts of recent times. They are pulling back dramatically on their commitments to venture capital funds. In the Canadian context, as that happens within one group, the other groups may be better positioned to continue to raise capital. You do not have everything tied to one source of capital. (*M. Macdonald, Evidence, 37th Parliament, 1st Session, Issue 25)*

As long as the Canadian investment environment continues to be characterized by certain impediments to venture capital financing, LSVCCs will play an important role in the venture capital market, providing stability of supply, regional diversity, an emphasis on start-up financing and the provision of funds to niches that the rest of the industry fails to consider. The Committee supports a balanced approach to the provision of venture capital. In that vein, we believe that LSVCCs currently have a role to play in the market. From that perspective, the Committee recommend that:

> **The federal government, in contemplating future legislative and regulatory initiatives, consider any negative impact on Labour-Sponsored Funds.**

C. Institutional and Foreign Investment

The Committee has heard testimony that, unlike the situation in the United States, pension funds in Canada do not make venture investments a fundamental part of their portfolio. In fact, Mary Macdonald told the Committee that pension funds in Canada have shown only modest interest in venture capital. When it comes to institutional investors, only a "handful of very large pension funds invest directly. They tend to do larger merchant-banking style deals within the venture arena." (*M. Macdonald, Evidence, 37th Parliament, 1st Session, Issue 25)* In the United States, they have many more pension funds and endowments; for most of those, it is part of the asset allocation process to include private equity. In Canada, it is not part of the culture in the top six or seven funds. In the United States, the principal investors in venture capital funds are the pension funds and other institutional funds, because they have a tax advantage. [10]

For Mary Macdonald, the moderate institutional involvement in Canada reflects structural and educational issues:

> *The issue, in my view, is twofold: Step one is educational. Most pension fund managers intuitively think that venture capital is high-risk and that they have no business becoming involved in it with pensioners' money. Pension consultants, in this country in particular, do not see it as a legitimate part of the asset allocation process, although there are affiliates in the U.S. that automatically include it. The starting point, from the industry side, is to figure out how to raise that level of awareness and understanding so that private equity - whether venture capital, buyouts or mezzanine financing - is recognized as a legitimate part of the asset allocation process. A pension fund that has gone through that process will typically allocate 5 to 8 per cent of its assets to that category.*
>
> *Secondly, because of the size of the pension funds in Canada and their absolute number, there are some structural issues that we need to get around. In the U.S., those pension funds pool the capital, though they may have only $2 million each to put into venture capital. They cannot justify building the expertise in-house to make the investments, and you would not want them to do it directly. They have what they call "funds of funds," or advisers who informally pool them together to manage those accounts on their behalf.*
>
> *We have not created that infrastructure in Canada yet. When we divide the numbers by 10, it is difficult to determine how to do that economically. I strongly believe that we need to address the impediments that are stopping them from doing it, as opposed to telling them they have to do it. (M. Macdonald, Evidence, 37th Parliament, 1st Session, Issue 25)*

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[10] Comments by Mr. Chip Ruth, General Partner, Marquette Venture Partners. (Fact-Finding Mission to Chicago, 31 May 2000)

In an article published in the *Canadian Tax Journal*, Kirk Falconer, an associate of Macdonald and Associates, listed reasons why pension fund managers tend to avoid venture capital. He suggested that:

- investment is management-intensive and costly;
- there are not enough qualified investment specialists;
- there is a lack of critical market information;
- returns are inadequate and unreliable;
- it is difficult to measure long-term performance; and
- there is the potential for high-profile failures.[11]

One important regulatory issue that was pointed out by the Canadian Venture Capital Association (CVCA)—but was addressed to some extent in the December 2001 Budget—was related to pension funds' participation in private venture capital funds structured as limited partnerships. In the United States, a popular way for pension funds to provide venture capital financing is to invest in a limited partnership established just for that purpose. In Canada, investments in such limited partnerships are considered as foreign property. As a pension fund can invest no more than 30% in foreign property, any investment in venture capital through such a vehicle will inhibit the fund's ability to diversify its portfolio. From the perspective of risk management, this treatment is perverse – any pension fund wishing to invest in venture capital financing (a risky endeavour) must forego some other risk-reducing opportunities by losing foreign content room.

The measure introduced in the December 2001 Budget is intended to eliminate this impediment to the flow of venture capital investment by institutional investors. Currently, an interest in a partnership is regarded as foreign property unless the partnership is a qualified limited partnership (QLP). The CVCA noted, in its submission to the Committee, that the "definition of a QLP provides that no limited partner can hold more than 30 per cent of the units of the partnership. This limitation is often problematic given the relatively few institutions who invest regularly in venture capital opportunities." The Budget will eliminate the 30 per cent ownership limitation for QLPs, since it stipulates that, after 2001, "for the purpose of the foreign property rules, any limited partner or group that holds more than a 30-per-cent interest in a QLP will be treated as owning a proportionate interest of each property owned by the QLP, including any foreign property. An ownership interest of 30 per cent or less in a QLP will remain exempt from treatment as foreign property."[12] This recent Budget measure directly follows a recommendation of the CVCA and may have a significant impact on pension funds' commitments to venture capital, as John Eckert of the CVCA told the Committee:

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[11] Kirk Falconer, *Pension Barriers to Financing Small and Medium-Sized Businesses in Canada*, presentation made to the Canadian Labour Market and Productivity Centre, reproduced in Osborne and Sandler, "A Tax Expenditure Analysis of Labour-Sponsored Venture Capital Corporations," *Canadian Tax Journal*, 1998, 46, 499-774 at p. 563.

[12] Department of Finance, Government of Canada. *The Budget Plan 2001*, p. 226.

This is one recommendation that we feel, if addressed, could have a profound effect on the amount of money that those large institutions direct to our sector. (J. Eckert, Evidence, 37th Parliament, 1st Session, Issue 21)

One LSVCC, Retrocom Growth Fund Inc., receives 75% of its funds from pension plans, not the retail market. Pension fund contributions are not eligible for the tax credit, thereby saving tax dollars. Yet pension funds face additional tax penalties when investing in LSVCCs that they would not face if investing in other vehicles. This Fund would like the tax consequences of investments to flow through to the investor pension fund, something that is not now possible. Such a change would encourage pension fund investments in LSVCCs, reduce the need for up-front tax credits, and stabilize the financial position of LSVCC balance sheets.

One should note that Canadian institutional investors are playing an increasingly important role: they brought nearly one-quarter of all resources to venture capital deals in 2000. Those are mainly direct investments in ventures, as distinct from their making commitments to private funds, which is more common in the United States.

Canada is also making progress in attracting foreign investment into the Canadian venture capital market. In fact, the foreign share of total new venture capital investments in Canada rose from being nearly non-existent in 1998 to almost one-quarter of all new disbursements in 2000, and rose again to 30 per cent in the first nine months of 2001. As Mary Macdonald noted:

(W)hile the venture industry in the U.S. has declined by over 60 per cent year over year, the amount of money those same funds have invested in Canadian companies has increased by more than 40 per cent. We are seeing a strong recognition of the quality of technology companies in Canada, of the growing capabilities on the entrepreneurial management side, and the increasing size of the relationships between some of those U.S. players and Canadian players. (M. Macdonald, Evidence, 37th Parliament, 1st Session, Issue 25)

These new developments contrast with the evidence this Committee gathered during its fact-finding mission to Chicago in May 2000, and may be the result of taxation and other changes. On that occasion, angel investors and representatives from venture capital funds viewed Canada as a country with excellent technology-related business opportunities. However, the witnesses identified some barriers to investing in Canada. Several identified the much lower scale, liquidity and level of activity of Canadian capital markets as a "turnoff" for investing in Canada (discussed in Section III.D). Other obstacles were related to the Canadian regulatory and tax environments, which were perceived as "complex" and "unfriendly." In light of this newly-increasing participation by American venture capitalists in the Canadian market, it appears that some concerns that were raised are slowly disappearing. Possibly, the Canadian venture capital market has matured enough to be able to offer sufficient profitability and local expertise to attract foreign venture investments.

Canada has also made progress on the taxation side. The capital gains inclusion rate was reduced to 50 per cent in October 2000. As well, the December 2001 Budget included a measure aimed at reducing the complexity and uncertainty in the tax treatment of foreign passive investments in Canadian venture capital funds. Currently, Canada's tax laws limit access to foreign sources of venture capital. In both the United States and Israel, foreign investors who do not incorporate domestically are exempt from tax on capital gains. Israel receives more foreign venture capital than does Canada, and the CVCA believes that current Canadian rules constitute a barrier to foreign capital, despite the fact that Canada has made some reforms in this regard. The December 2001 Budget responded to this issue by clarifying and simplifying the process through which a foreign investor can invest in the Canadian venture capital market and avoid double taxation.

The Budget measure is intended to make it easier to invest in venture capital through a venture capital fund manager in Canada. Clarifications to section 115.2 of the *Income Tax Act* provide that a "qualified non-resident" is not considered as carrying on business in Canada solely because a Canadian fund manager provides administration services to the non-resident or to a partnership of which the non-resident is a partner. Because investment income is covered by tax treaties between Canada and a number of countries in order to avoid double taxation, the capital gains generated through a fund managed in Canada flowing back to the qualified non-resident investor is not taxed in Canada. This measure takes effect starting in the 2002 taxation year.

A wide variety of other investment barriers, related to the application of the withholding tax and the extension of treaty protection to limited liability companies, among others, have been identified by the CVCA. However, to date these barriers have not been eliminated.

The Committee believes that the federal government must be ever-vigilant in ensuring that its actions create an environment in Canada that fosters – rather than erects barriers to – the investments needed to ensure the prosperity of firms and thereby the Canadian economy. It is for this reason that the Committee recommends that:

> **The federal government study the issue of venture investments by pension funds, including an examination of tax, regulatory, structural and other impediments to such investments, including to Labour-Sponsored Funds.**

D. Scale and Liquidity of Stock Exchanges and Exit Opportunities

Ultimately, successful small firms will graduate to "mid-size" and then raise capital through public equity markets. Brien Gray, from the Canadian Federation of Independent Business, and Professor MacIntosh stressed the importance of healthy capital markets to the growth of the economy by contributing to the expansion of businesses. The more effective are capital markets, the more quickly can firms go public and thus raise public funds at an earlier stage. In addition, healthy capital markets stimulate private equity financing at the angel and venture capital levels because they enhance liquidity in capital markets. Usually, the preferred method of exit for those investments is an Initial Public Offering (IPO). Other methods include merger, acquisition and management buyback. Angel investors and venture capital corporations are provided with an additional incentive to invest in a business if they reasonably expect that the company could count on a securities exchange that would enable the firm to go public quickly with a strong market valuation.

Witnesses pointed to two essential features of good capital markets: liquidity and scale. Liquidity is directly related to investors' ability to trade shares on secondary markets. Both regulation and the size of the market have an impact on liquidity. Securities legislation, such as escrow rules (discussed in Section IV.B), tends to reduce the level of liquidity, whereas liquidity increases with the size of the market. There are also economies of scale that come with large market size. With a larger market, more capital is available to businesses in any particular sector.

> *It is not a criticism of the Canadian market to recognize that there are about ten times as many people, a percentage wealthier at the upper end than Canadians, in the United States, so the pool of capital in any category is more than 10 times larger. That means, if you have the same percentage of people prepared to take a risk with their capital with an early stage company, there are 10 times more of them in the United States. It is not necessarily that [Canada is] more conservative, it is only that we are not as many as in the U.S. (R. Bryden, Evidence, 36th Parliament, 1st Session, Issue 52)*

To improve access to public capital for SMEs, one should therefore work on the liquidity and scale of Canadian equity markets. Some witnesses told the Committee that the creation of a national junior securities exchange is one way to achieve this goal. Indeed, a significant benefit of the creation of the Canadian Venture Exchange (CDNX) has been the greater depth, liquidity and transparency it provides, offering a broader market for junior companies attempting to raise capital in Canada. Created at the end of November 1999, the CDNX is the result of the merger of the Vancouver and Alberta stock exchanges. In March 2000, the Winnipeg Stock Exchange endorsed a proposal to consolidate its trading and listing services with those of the CDNX. The Montreal Stock Exchange decided to maintain the listing of junior securities and to continue to provide the services associated with that, but the exchange also agreed to enter into outsourcing arrangements with the CDNX.

With the establishment of Nasdaq Canada, in November 2000 in Montreal, Canadian stock markets are facing a new competitor. Currently, brokers can only trade a few limited companies out of Montreal, but Nasdaq plans to allow trading in Canadian dollars and to compete for IPOs of Canadian firms. The province of Quebec has actively supported the creation of Nasdaq Canada by providing a friendly regulatory environment and tax incentives to favour its development.

William Hess, from the Alberta Securities Commission, Douglas Hyndman, from the British Columbia Securities Commission, and Roderick Bryden all mentioned that, historically, small issuers were getting a better price by listing on SmallCap Nasdaq than on the Vancouver and Alberta stock exchanges.

> *One would hope that the creation of a national venture exchange would give a higher profile to the market here [in Canada]. (D. Hyndman, Evidence, 36th Parliament, 1st Session, Issue 48)*

> *Venture capital group[s] or angel investor group[s] … are interested in getting into companies at a relatively early stage, once those have established themselves to the point of having a business plan and some prospects. Those investors want to ride up with those companies to the point where the company goes public and ultimately provides an exit route for the venture capitalists. They want liquidity down the road. It is in their interest to see a national venture capital market as a place for their exit strategy on their investment. It gives them more scope to get into deals with the knowledge that ultimately they can get out. (D. Hyndman, Evidence, 36th Parliament, 1st Session, Issue 48)*

In the Committee's view, it is of paramount importance that Canadian capital markets be healthy in order that they can contribute to economic growth through business expansion. Recognizing the importance of liquidity and scale in ensuring the health of capital markets, the Committee recommends that:

> **The federal government, through its legislative and regulatory function, foster an environment that enables the development and prosperity of stock exchanges in Canada.**

IV. Regulatory Distortions

This section examines four regulatory issues facing the suppliers of venture capital: the banking sector, escrow requirements, associate company rules and the liability of directors.

A. Banking Regulatory Problems

Several witnesses told the Committee that Canadian chartered banks are subject to a number of regulations which do not apply to other venture capital corporations. These regulatory constraints impede the provision of equity capital to SMEs from Canada's largest financial institutions, the banking sector. Venture capital subsidiaries of Canadian banks, such as the Royal Bank Capital Corporation, RoyNat Inc. or CIBC Capital Partners, provide less than 20% of total venture capital commitments. Yet these specialized financial institutions have the potential to supply a larger piece of the venture capital pie. On the one hand, they are part of very large financial institutions; on the other hand, traditional banking practices are, for the most part, inadequate for the financing needs of the emerging knowledge-based economy.

There are fundamental differences between the business and investment activities of a bank and its venture capital arm. David Pakrul, from the Bank of Montreal Capital Corporation, and Jacques Sayegh, from the Royal Bank Capital Corporation, told the Committee:

> *[The] impression of us as bankers comes because we are owned by a bank. None of us is bankers. I have never been a banker. I have been an investment banker for 20 years, and I am a venture capitalist. Bankers and their culture basically do not work in the venture capital operation. So while some people may switch between organizations, venture capital and the skills and tools associated with it are very different. Different people are hired to fulfil that role, although we are owned by a bank. (D. Pakrul, Evidence, 36th Parliament, 1st Session, Issue 51)*

> *The Royal Bank has recognized the importance of differentiating between the cultures of the banking world and the investment world. Our organization is operated as a subsidiary, with its own board of directors. It has a different investment process than the debt process. There are Chinese walls with other parts of the bank. The people we hire come from the investment side of the business, and we do compete with the McLean Watson's and other independent funds. … We are constrained by some of the banking rules, in terms of having some of the regulatory aspects around our business that are specific to banks and, yet competing with the other side of the world. (J. Sayegh, Evidence, 36th Parliament, 1st Session, Issue 51)*

There are several impediments affecting banks' venture capital arms that restrict their ability to operate in that marketplace on the same basis as their competitors. One impediment is the amount of equity capital a bank subsidiary might offer. Jacques Sayegh told the Committee that one of the key elements is in the *Bank Act* of 1993. The Act limits, to 5% of total regulatory capital, the amount that a bank may commit to equity financing, although the creation of bank financial holding companies could mitigate the need for these types of restrictions.

> *In terms of other jurisdictions, in particular Europe and Asia, there are significantly larger amounts of capital available from the banking sector to the venture capital industry. (J. Sayegh, Evidence, 36th Parliament, 1st Session, Issue 51)*

Not only is the amount of equity financing restricted, so is the type and duration. Banks' venture capital subsidiaries are restricted from owning more than 25% of the equity of the companies in which they invest. Furthermore, they are required by law to terminate their investment in ten years, imposing what might be a sub-optimal exit strategy on the venture capital arm. Other types of venture capital corporations do not face these constraints.

Finally, and perhaps most importantly, financial institutions—including their venture capital arms—are taxed fully on their capital gains, unlike regular corporations, for which 50% of the gains are taxable. For a bank subsidiary to achieve its desired after-tax rate of return, it must limit itself to higher-return investments.

> *If venture capitalists that are financial institutions were treated like other corporations ¾ that is, that [50%] of the gain is taxable ¾ it would encourage us to look for a lower pre-tax return on our investments. That translates directly into a lower percentage ownership of the company, which may address the problem of the small businessman believing we are asking for too much ownership. (R. Reynolds, Evidence, 36th Parliament, 1st Session, Issue 51)*

In short, witnesses from the investment banking sector told the Committee that the regulatory environment creates a playing field tilted against venture capital corporations that are subsidiaries of banks. This is unfortunate, as it limits the ability of the banking sector to finance the new economy in a way that is appropriate to that economy. This Committee supported the creation of financial holding companies precisely because it would help to free up the activities of what are now bank subsidiaries. This would not only allow bank financial groups to compete better with unregulated financial institutions, it would help to better serve those who need financing. From this perspective, the Committee recommends that:

> **The federal government undertake a study of any barriers or impediments affecting the ability of the venture capital operations of banks to compete in the marketplace on the same basis as their competitors. Barriers or impediments identified during the study should then be removed.**

B. Escrow Requirements

Generally, securities laws contain escrow provisions which require certain shareholders of a company (such as promoters, directors, officers, and shareholders who own more than a specified percentage of shares) to file an initial prospectus to hold their shares in escrow for a period of time. Once escrowed, the shares cannot be sold, assigned or transferred unless certain conditions have been met. Over time, shares held in escrow are released.

The Ontario Securities Commission (OSC) Task Force on Small Business Financing pointed out that escrow requirements have traditionally served two purposes: (i) to ensure that the promoters of a share offering did not benefit at the expense of the public investors; and (ii) to lock in management to ensure that they had the incentive to devote their time and attention to the business. [13]

Douglas Hyndman described the purposes of escrow requirements in the following manner:

> *The primary purpose is to tie the founders of a company to the company for a reasonable period so that the investors who are participating in the initial public offering have some assurance that the people they are relying on and investing in will be there for a reasonable period of time. It does not say what a reasonable period of time is, but it generally takes at least four or five years to bring a non-resource junior company to a point where it is making profits and perhaps providing a reasonable return to the shareholder.*
>
> *Traditionally, in the pricing of securities, escrow also tried to balance the interests of the people who bought before the company went public and the initial public offering. In designing the current proposal, we gave up on that second aspect and focused on tying the principals to the company. The debate will go on about whether that is necessary and, if it is necessary, what period is required, but that is essentially what we are focused on. When investors go into a start-up company in an initial public offering, they are really betting on the management because there is not much else there. We should like some assurance that the management will be there the day after the offering is completed and money is put in. (D. Hyndman, Evidence, 36th Parliament, 1st Session, Issue 48)*

The OSC Task Force noted that venture capital investors are sometimes caught by the escrow requirements because the rules apply to significant shareholders who provide substantial amounts of pre-public offering capital. The Task Force was of the view that "the escrow release schedules under the existing regulatory regime are longer than necessary and pose a significant and unwarranted cost and disincentive on public offerings in Ontario." [14]

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[13] Ontario Securities Commission Task Force on Small Business Financing (1996), p. 89.

[14] *Ibid.*, p. 93.

Although the proposal was subsequently changed in a manner that made it more acceptable to investors, in 1998 the Canadian Securities Administrators (CSA) put forward a proposal for a national escrow regime that, according to the CVCA, would have materially changed the current escrow rules by significantly lengthening the escrow periods that apply to emerging companies that are doing an initial public offering. The CVCA believed that venture capital organizations would have been caught by the escrow proposal and recommended that such organizations be exempt from its application.

The CVCA pointed out to the Committee that a venture capital fund will have typically held an investment in a company doing an IPO for some three to eight years prior to the public offering. It went on to note that the imposition of an escrow requirement of up to six years over and above the period during which a venture capital fund has already held an investment would have diminished liquidity and negatively affected SMEs. [15]

However, in March 2000, the CSA released a revised proposal for a national escrow regime that would, among other changes, introduce shorter escrow periods and faster escrow releases. For established issuers, escrow releases in equal tranches at 6-month intervals over 18 months would be allowed, while for emerging issuers escrow releases in equal tranches at 6-month intervals over 36 months would be permitted. The proposed regime would reduce escrow periods from a 6-year maximum period to a 1½-year to 3-year maximum.

The national escrow regime proposed in 1998 generated considerable comment before the Committee. Many witnesses thought that the suggested six-year escrow period was too long and supported the recommendation of the CVCA calling for an exemption for venture capital funds.

One witness thought that the proposed 1998 escrow rules would make it more difficult for businesses to attract capital. Barrie Laver, Managing Partner with CastleHill Ventures, told the Committee:

> *(t)he proposed new escrow rules for initial public offerings will have a severe, detrimental impact on the industry. A clear achievable exit strategy is the necessity for venture capital investors. The proposed escrow rules will influence access to capital for a number of reasons. For example, the ability of new funds to raise capital will be reduced as the proposed escrow rules will undoubtedly impact the return on capital and impede the return of capital to investors.*
>
> *Entrepreneurs are more likely to start a business in the U.S. instead of Canada knowing that the escrow rules will make it more difficult to attract capital in Canada and are more onerous upon the founders and other management. Companies based in Canada will be more likely to have access to public markets in the U.S. than in Canada or look to be sold as an alternative to going public, often to a company not based in Canada.*

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[15] Canadian Venture Capital Association. Brief submitted to the SSC on Banking, Trade and Commerce, 16 March 1999, p. 12.

The proposed escrow rules must be altered so that they are not materially worse than those in the U.S. while still respecting the primary need to align investor interests with those of management. (B. Laver, Evidence, 36th Parliament, 1st Session, Issue 50)

Another witness - Loudon F. Owen, Managing Partner with McLean Watson - was adamant in his opposition to the proposals when he told the Committee:

We would point out, however, that we think that the proposed escrow rules are shocking, counterproductive, and that they will send a cold chill across the venture capital community in Canada such that you will not have a single, credible venture capital firm taking a company public in Canada, nor will you have many entrepreneurs seeking, as their end game, public listing in Canada.

My wording could be much stronger, but I think the rules are a complete non-starter and should not even be considered. The fact that the rules have been put forward has added fuel to the fire, certainly within our company, about discussing whether we should stay in the country and whether we should continue to be based here. (L. Owen, Evidence, 36th Parliament, 1st Session, Issue 51)

Yet another witness - Brad Ashley, Managing Director with Priveq Capital Fund - suggested that the IPO market would likely die in Canada if the original 1998 proposal for a national escrow regime was to go forward. (*B. Ashley, Evidence, 36th Parliament, 1st Session, Issue 50)*

As mentioned earlier, the 1998 proposed escrow regime did not go forward and was revised to incorporate much shorter escrow periods and faster escrow releases. In June 2001, the CSA announced its intention to implement soon the new uniform escrow regime given its widespread application by Canadian exchanges.

The Committee believes that escrow requirements may act as a disincentive with respect to public offerings, and feels that more discussion is needed about a national escrow regime. For this reason, the Committee recommends that:

The federal government initiate a dialogue among stakeholders with respect to a national escrow regime. Moreover, the extent to which escrow requirements may inhibit public offerings should be examined, with a view to eliminating any unnecessary requirements.

C. Associated Company Rules

A number of witnesses identified the associated company rules under the *Income Tax Act* as a potential barrier to the development of small and medium-sized businesses. These rules set out the circumstances in which a person is deemed to control, and therefore be associated with, a corporation.

The Canadian Venture Capital Association (CVCA) believes that the application of these rules to venture capital companies can deprive early stage companies of many tax-related advantages designed to foster their growth and development. The CVCA noted that in order to protect capital invested in early stage companies, venture capital investors often impose investment terms that will include a clause transferring control to a group of venture capital investors if the investee company does not meet certain milestones.

According to the CVCA, the *Income Tax Act* requires that any outstanding options or other forms of obligation to transfer control be considered in determining whether an option holder should be deemed to control a corporation. In a deemed control situation, venture capital corporations can be held to be associated with the companies in which they invest. The CVCA also pointed out that the *Income Tax Act* provides that when a group of venture capital investors collectively controls two companies, the two companies will be deemed to be associated even if there is no relationship between them.

The CVCA maintained that the application of the associated company rules can deprive early stage companies of a number of tax-related advantages, such as:

- loss of enhanced R&D tax privileges;
- sharing amongst all associated companies of the $10 million ceiling on taxable capital for the calculation of large corporation tax; and/or
- loss of the use of the small business deduction of 16% to 21% on the first $200,000 of taxable income annually. [16]

The CVCA presented two recommendations to the Committee: first, that the current exemption to the application of the associated company rules be extended to the shares owned by prescribed venture capital organizations; second, and alternatively, that prescribed venture capital organizations be exempt from the application of the "group of persons" definition in the associated company rules.

Associated company rules are largely designed to prevent taxpayers from using corporate structures and other complex arrangements to circumvent the intent of government legislation, especially the *Income Tax Act*. The Committee notes that venture capital corporations are essentially financial institutions providing equity capital for a fairly long, but limited, period of time. When they hold a stake in a company, it is with the intent

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[16] Canadian Venture Capital Association, 1999, p. 14.

to provide financing, not to create some sort of conglomerate structure. Thus, the Committee believes that there is no need to include venture capital companies in the associated company rules and we further recognize that doing so impedes the access of SMEs to equity capital. It is for this reason that the Committee recommends that:

> **The Department of Finance review the associated company rules under the *Income Tax Act* with a view to exempting from their application shares owned by venture capital organizations.**

D. Directors' Liability

A continuing challenge for corporations is attracting and retaining qualified directors. This is particularly important for small and medium-sized companies where the presence of experienced directors can be vital to the survival or expansion of a business.

In its brief to the Committee, the Canadian Venture Capital Association noted that the marked increase in the liabilities to which directors are exposed has created problems in recruiting effective directors and has fostered excessive conservatism in corporate decision-making. [17] Other witnesses echoed this view, including Denzil Doyle, who felt that directors' liabilities were a significant impediment to angel investors. He told the Committee that:

> *First, the government must stop loading so many liabilities on to directors' shoulders. Every time a budget comes out, a director finds that he has more liabilities. Whether it be in regard to unremitted GST or some new environmental legislation, ... They pierce the corporate veil and go right after the director. It is a huge problem. It is a major impediment to angel investing because they simply do not want to take on directors' liabilities. Yet, without forming an official board of directors, you cannot enforce the discipline on the kids. (D. Doyle, Evidence, 36th Parliament, 1st Session, Issue 50)*

The directors' liability issue is not new to the Committee. In our August 1996 report, *Corporate Governance*, we expressed our concern about the expansion of directors' liability over the past two decades and its impact on corporate governance and the conduct of business. At that time, the Committee strongly supported amending the *Canada Business Corporations Act* (CBCA) to provide a due diligence defence for corporate directors. Moreover, in our March and September 1998 reports, *Joint and Several Liability and Professional Defendants* and *Modified Proportionate Liability*, respectively, the Committee recommended that the modified proportionate liability regime apply to claims for financial loss arising by reason of any error in financial information required under the CBCA.

The Committee also looked at directors' liability in a broader context, and expressed concern with the manner in which such liability has developed and its extent. It appeared to us that directors' liability had been implemented on a statute-by-statute basis without consideration of its cumulative impact. We took the position that legislation should not include a directors' liability provision unless it could be clearly demonstrated that the provision would have a positive impact on corporate conduct and would advance the purpose of the legislation.

Recently, Bill S-11 amended the CBCA to provide corporate directors with a due diligence defence and establish a proportionate liability regime for claims for financial loss. These amendments are in line with some of the recommendations made by this Committee.

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[17] *Ibid.*, p. 12.

The Committee is of the opinion that companies of all sizes – but particularly small and medium-sized businesses – need experienced directors. Believing that the liability to which directors may be exposed could be a barrier to recruitment and lead to unnecessary conservatism in decision making, the Committee recommends that:

> **The federal government take actions to implement fully the recommendations made by the Standing Senate Committee on Banking, Trade and Commerce on the issue of directors' liability.**

V. Tax Incentives

Governments not only influence business decisions through laws and regulations, they also have a significant impact on investment decisions through the tax system as investors are mainly concerned about their after-tax returns. This section discusses several taxation-related issues and their influence on the provision of equity capital to small and medium-sized businesses.

A. Taxation of Capital Gains

The capital gains tax is a disincentive to the supply of equity capital to SMEs. Taxing capital gains has a detrimental effect on the ability of capital to finance the most profitable investment opportunities.

In Spring 2000, this Committee heard testimony from experts in Canada and the United States on the taxation of capital gains. Based on this evidence, the Committee released *The Taxation of Capital Gains*, which concluded that a capital gains tax is an impediment to the creation of new economic capacity. Investment decisions are distorted, leading to under-investment in new businesses and knowledge-intensive projects because such undertakings depend critically on the financing by taxable individuals. Perhaps more importantly, this system does not recognise the cumulative negative effects on the financing of SMEs, especially knowledge-based businesses, and on entrepreneurship.

According to a recent Canadian study, the capital gains tax influences a firm's cost of capital by changing the rate of return required by investors who purchase the firm's equity. If the tax changes the required return, then the price investors are willing to pay for a share of the future stream of the firm's earnings will change. Because of this, the capital gains tax is capitalized into the price of the share. [18]

This means that if the capital gains inclusion rate was reduced, the interplay of market forces would allow the share price of promising small ventures to increase to a level that would compensate for the entire future benefit of the tax to investors. Equity financing would become less expensive for new and potentially more productive ventures because of higher share prices and thus a lower corporate cost of capital. This has been substantiated in a number of studies. [19]

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[18] Kevin Milligan, Jack Mintz and Thomas A. Wilson. "Capital Gains Taxation: Recent Empirical Evidence." Background Material for the SSC on Banking, Trade and Commerce, September 1999.

[19] In particular, see David A. Guenther and Michael Willenborg. "Capital Gains Tax Rates and the Cost of Capital for Small Business: Evidence from the IPO Market." *Journal of Financial Economics*, 53, 1999, pp. 385-408. See also Mark H. Lang and Douglas A. Shackelford. "Capitalization of Capital Gains Taxes: Evidence from Stock Market Price Reactions to the 1997 Rate Reduction." *National Bureau of Economic Research*, WP 6885, January 1999.

In addition to enhancing the willingness to invest in riskier projects, a lower cost of capital stimulates the market for Initial Public Offerings (IPOs). These effects lead to productivity gains. The impact of capital formation and productivity enhancement is cumulative, so that even very small annual increases can have a dramatic impact over time.

In our report on the taxation of capital gains, the Committee recommended that the capital gains inclusion rate be immediately reduced to 50% to match the average top marginal rate on capital gains in the United States. The Minister of Finance, in the October 2000 Economic Statement and Budget Update, responded favourably and lowered the inclusion rate to 50%. However, in our recommendation, we also noted that such a reduction, although quickly needed, is probably insufficient. From this perspective, the Committee recommends that:

> **The federal government amend the *Income Tax Act* to reduce further the rate of capital gains taxation.**

B. Profit-Insensitive Taxation

The *Report of the Technical Committee on Business Taxation* reported a significant shift in the kind of taxes that businesses pay. Corporate income taxes now account for less than one-quarter of total taxes on business activity.

> *There has been movement over the years from profit-sensitive taxes (corporate income taxes and profit-based resource taxes) to capital, property and payroll taxes, and sales and fuel excise taxes on business inputs. In 1950, just under 60% of such business taxes were profit related but by 1995, this ratio fell to about 25%. In part, this shift is due to the decline in corporate profits relative to business net value-added, but it also reflects the increase in rates and the corresponding growth in revenues from these profit-insensitive taxes.* [20]

Brien Gray indicated that small businesses rely extensively on retained earnings to build their equity base. The growth in capital and payroll taxes has made it more difficult for small firms to retain earnings.

> *Profit-insensitive taxes … have increased dramatically while the profit-sensitive taxes have gradually declined. The impact on firms that depend on retained earnings to build up their equity base and finance growth is obvious: lower profits, less retained earnings, restricted ability to build up the equity base of the firm, restricted ability to grow.*
>
> *No doubt one of the reasons the job-creation, post-recession period fell below governments' expectations is that those firms that had been lucky enough to survive the recession had to eat deeply into their equity base. Increased reliance on taxes unrelated to profits will make it harder for those firms to replenish those stock bases. (B. Gray, Evidence, 36th Parliament, 1st Session, Issue 50)*

The Committee believes that taxes paid by businesses that are unrelated to their profitability could limit their growth, and supports much of the discussion contained in the *Report of the Technical Committee on Business Taxation*. It is for this reason that the Committee recommends that:

> **The federal government study the impact of business taxes, with a view to reducing or eliminating the federal share of such taxes.**

[20] *Report of the Technical Committee on Business Taxation*, Submitted to the Minister of Finance, December 1997, p. 2.15.

C. Up-Front and Broad-Based Tax Incentives

Most witnesses told the Committee that the provision of up-front tax breaks and industry-related tax incentives to investors tends to skew investment decisions, creating distortions. In general, they believed this approach to be ineffective and inefficient.

John Cranston told the Committee about such government initiatives as Stock Savings Plans and scientific research and tax credits, particularly in Alberta and Quebec. In his view, up-front tax breaks do not necessarily encourage investment in more productive ventures. Because of the tax reduction, investors can enjoy artificially high returns even if their investments perform relatively poorly. Moreover, they can enjoy the breaks even if they do not allocate the money to the kind of projects that the government wants to encourage. Secondly, risky investment projects are "sold on the basis that the government is taking your risk." (*J. Cranston, Evidence, 36th Parliament, 1st Session, Issue 50)* This then becomes the primary reason for many investors to buy higher risk investments. However, investors can still lose; the risk is shared with the government, but the total risk remains unchanged. Vernon Lobo informed the Committee that:

> *More than half of the [venture] capital managed in Canada was generated through up-front government tax incentives [mostly LSVCCs] designed to encourage capital formation. The government was obviously successful in rapidly creating large pools of capital to be deployed for SMEs through this initiative. Although this has helped get us going, however, it will not create a sustainable angel network, venture capital market, and technology sector. Virtually none of the funds raised in the U.S. were a result of tax incentives. They were raised based on the skills, experience and track record of the fund managers. (V. Lobo, Evidence, 36th Parliament, 1st Session, Issue 50)*

Vernon Lobo and John Cranston both stressed that people should take risks appropriate to their circumstances. Up-front tax incentives are tantamount to giving awards at the beginning of the race rather than to the winners. Rather than providing up-front tax breaks, the system should work on the "end of the race" side, i.e., the rewards. The tax system should ensure that investors are appropriately rewarded for their risk-taking.

> *[Canada] must create an attractive tax and market environment and let market forces drive capital to entrepreneurs and investors who are successful at creating wealth. (V. Lobo, Evidence, 36th Parliament, 1st Session, Issue 50)*

Essentially, a significant reduction in the capital gains inclusion rate would contribute to the achievement of this goal. It would provide investors with a suitable risk profile and expertise to be appropriately rewarded for investment success. This will ensure the build-up of a sustainable and stable market for the supply of risk capital to SMEs.

Moreover, incentives should be broad-based, and not restricted to certain industries.

[Canada] should not be providing selective tax breaks. Government, frankly, is lousy at picking businesses. We believe the market should determine which business ideas should move forward. (J. Cranston, Evidence, 36th Parliament, 1st Session, Issue 50)

Brien Gray told the Committee that it is vital to the small business community that incentives for the provision of equity capital should be inclusive and available to all sectors. Rod Bryden pointed out the pitfalls of allocating a disproportionate share of available resources to particular sectors.

If we take a disproportionate share of our resources and try to have a higher share at the front edge [leading technologies], we will have a problem matching the employment opportunities with the people who need to be employed, and we will be, disproportionately, funding the ones with a higher miss rate. (R. Bryden, Evidence, 36th Parliament, 1st Session, Issue 52)

A more balanced approach is needed. Moreover, "at the early stage, it is impossible to predict which firms will grow quickly and which ones will follow paths of lower growth." (*B. Gray, Evidence, 36th Parliament, 1st Session, Issue 50)* The system should let the market freely decide which sector, industry or firm holds the greatest growth potential. A policy of targeted incentives distorts investment decisions. If investors are rewarded for their risk-taking, it is in their self-interest to invest in ventures they are confident hold the greatest growth potential. Furthermore, by providing across-the-board incentives, the investment community will more likely support high-growth businesses which otherwise would not have been targeted to receive preferential tax treatment.

This approach is precisely the one endorsed by the Committee in the study of capital gains taxation. Believing that tax and other incentives provided by the federal government should not skew investment decisions, the Committee recommends that:

The federal government undertake a study of existing tax and other incentives and determine if they are achieving their goals in a manner that does not distort investment decisions.

VI. Entrepreneurial inadequacies

Impediments to the financing of entrepreneurial activity can also reside with the entrepreneurs themselves. This section examines three different areas of entrepreneurial and cultural deficiency in this regard.

A. Reluctance of Management to Give Up Equity

Obstacles to accessing equity financing can originate with entrepreneurs themselves. Several witnesses told the Committee about the reluctance of entrepreneurs to give up share ownership in their companies. Rod Reynolds, President and CEO of RoyNat Inc., put it this way:

> *There seems to be a distinct Canadian psyche that is reluctant to share in the equity of a company. We often see a scenario of an owner being much happier being 100% owner of a small business than 80% owner of a larger business. Interestingly, from our evidence, it seems to be considerably different from the attitude in the United States, where there is more will to give up some of the equity to achieve growth. One of the reasons for that reluctance, we believe, is a fear of venture capitalists, a fear of control, and certainly we need to address how we can overcome that fear. (R. Reynolds, Evidence, 36th Parliament, 1st Session, Issue 51)*

Another witness described some Canadian entrepreneurs as "control freaks" who would rather stay smaller and in control than have a smaller piece of a much larger pie.[21] Yet another reinforced this point by noting that some entrepreneurs view their firms as lifestyle businesses rather than as vehicles to create wealth.

Elsewhere in this report the Committee discussed the implications of regulatory impediments to the supply of venture capital. We also discussed the role of the capital gains tax. In both cases, a restriction in the supply of equity financing increases the price of that financing. Canadian entrepreneurs may be reluctant to give up some control because they feel that they must give up too much control for the amount of equity financing they receive. Americans might seem more receptive to equity injections, not because they have a different outlook than Canadians, but because that equity financing is less expensive.

[21] Gordon Sharwood. Brief to the SSC on Banking, Trade and Commerce, 18 April 1999, p. 7.

B. Lack of Management, Sales and Marketing Skills

A 1998 study prepared for the Canadian Bankers Association revealed that entrepreneurs' lack of management knowledge and managerial ability are among the main barriers to investment. [22]

A number of witnesses told the Committee that one of the most common reasons why investors decline an investment is the perception of management deficiencies.

> *As regulators we see lots of money around looking for good investment opportunities, but a shortage of promising well-managed small businesses to invest it in. … The real problem [for venture capital companies] is not a surplus of investment opportunities; their problem is finding good, young companies with good business concepts and solid management to put their money in. (D. Hyndman, Evidence, 36th Parliament, 1st Session, Issue 48)*

Other witnesses argued that Canadians are relatively weak in sales and marketing. One witness from the venture capital industry told the Committee that a B concept with A management is more likely to be funded that an A concept with B management. The difference between an A and a B business plan is often the quality of sales and marketing people. Another witness stressed that Canada produces many excellent engineers, but that it should also be producing a similar number of great marketing and sales persons. "That is where Canada is lacking, and that is where it is at the greatest competitive disadvantage." (*D. Latner, Evidence, 36th Parliament, 1st Session, Issue 50*)

According to most witnesses, the problem is not that Canada does not produce good managers. There are many aspects to this problem, ranging from educational flaws to economies of scale. The U.S. economy is at least ten times larger than Canada and this has a significant impact on the scale of sales and marketing efforts in the two countries.

> *The most important point is that we should try to keep our good people and give them incentives to stay in the country. … Many of the best people I know have left Canada and will not come back. This includes developers, marketers and CEOs. A major difficulty for business in Canada is finding qualified people because some of the most successful entrepreneurs have made their money and left. They do not return, in large part because of the tax environment. My comments are anecdotal, not based on statistics, but it is something we certainly noticed. (L. Owen, Evidence, 36th Parliament, 1st Session, Issue 51)*

It is not within the scope of this report to further analyze the "brain drain" issue, but the perception that Canada is losing many of its best managers and successful

[22] Thompson Lightstone & Company Limited. "Small Business in Ontario: An Assessment of Access to Capital." 1998, p. 130.

entrepreneurs—and thus potential angels—to the United States was echoed by many witnesses.

> *Another point that highlights our loss of talent is the fact that several executives of some of the largest U.S. Internet success stories are Canadian. Jeff Mallett is the president and COO of Yahoo. Paul Gauthier, a Halifax native, is co-founder of Inktomi, which is a $7 billion search engine company. Jeff Skoll, a Montreal native, was one of the founders of eBay. Rob Burgess is the chairman and CEO of Macromedia, multimedia software developer. All of them are originally Canadian. There are many stories like this, and this loss of our top talent needs to be addressed. (V. Lobo, Evidence, 36th Parliament, 1st Session, Issue 50)*

C. Business Culture and Education

Several witnesses pointed out to the Committee that Canada has a very different cultural background regarding business activity than one finds in the United States. The general perception among Canadians is that business and profit are improper. John Cranston and Brien Gray told the Committee that:

> *There is something really wrong in the way we in Canada look at business. Business is wrong, if you listen to a large part of the population. We all depend on it for what we do, and yet somehow it is wrong. (J. Cranston, Evidence, 36th Parliament, 1st Session, Issue 50)*
>
> *In Canada we have a cultural problem. Historically, the United States has celebrated free enterprise and their entrepreneurs. I noticed a remarkable change in the Province of Québec when magazine covers no longer showed politicians or the archbishop and they started to celebrate the entrepreneurs.*
>
> *The rest of the country has not picked that up. We tend to denigrate, not celebrate our entrepreneurial class in this country. I am not referring only to the role we play and that of the media, but I am also referring to the role of political leaders. They must begin to recognize and understand the importance of the entrepreneurial equation, that is, its contribution to the economy and its ability to assist in delivering all kinds of other benefits or goods in society. We often say that the best social program is a job and that, if you inhibit the creation of wealth and jobs and, then you cannot be any further ahead. (B. Gray, Evidence, 36th Parliament, 1st Session, Issue 50)*

According to John Cranston, there is a lack of knowledge of fundamental economic and business issues among the educational and media masses. "They cannot pass to their students, to their readers, to their listeners, a better understanding of economic issues than they have themselves. This lack of knowledge leads to suspicion, because if one does not understand something, they are suspicious of it." *(J. Cranston, Evidence, 36th Parliament, 1st Session, Issue 50)* If people do not understand how business works, they cannot do the math and make the connections. "It also causes them to look to government for solutions in areas where … it is not appropriate for government to be." (*J. Cranston, Evidence, 36th Parliament, 1st Session, Issue 50)*

Gordon Sharwood spoke to the Committee about flaws in academic programs offered to business students attending Canadian universities:

> *On the university side, we have found that for business planning the focus is not on entrepreneurship; I think Brien Gray talked earlier about the business schools leaving a legacy of being focused on the non-entrepreneurial sector. Nobody teaches how to write a business plan to raise equity. Not a single [academic institution] that we know of ¾ I think Queen's is just beginning to do it ¾ teaches how to write a business plan to raise*

equity, which is very different from writing a business plan to do debt. (G. Sharwood, Evidence, 36th Parliament, 1st Session, Issue 50)

According the Loudon Owen, first-time entrepreneurs seeking equity are sometimes poorly educated and ill-informed about obtaining it. This is a concern echoed by many other witnesses.

The Committee firmly believes that our economic success as a nation is directly tied to the success of our businesses. For business success, several key ingredients must exist: entrepreneurial ability; a varied skill set that includes experience and expertise in management, sales and marketing; a commitment to continued skills development and lifelong learning; and an appropriate organizational culture. Believing that some of these ingredients are innate while others can be learned, the Committee recommends that:

The federal government study possible incentives for skills development and lifelong learning among Canadian entrepreneurs and management. These incentives must recognize the particular skill needs and challenges faced by these Canadians as distinct from the government's more general focus on skills development and lifelong learning.

VII. Conclusion

Increased globalization, and advances in both technology and communications, are leading to major structural changes in economies around the world. This creates a whole new set of growth opportunities for the future. Most nations have now recognized the immense potential that the emerging knowledge-based economy represents for the wealth, the standard of living and the quality of employment of their citizens, and they are moving to take advantage of it.

Although no one knows what the future holds, Canada certainly appears to be well positioned to enjoy these benefits. Canada is a small, open economy, with a great deal of individual talent and wealth. Sixty-seven universities and colleges produce more than 25,000 graduates per year in mathematics, engineering, and pure and applied sciences. Canada has much to offer in the new, emerging global economy. It also has a lot to lose, as resources become increasingly mobile. If Canada is not an attractive place for these resources, they will go elsewhere.

> *Technology and globalization are combining to create a new world from which we cannot insulate ourselves. We are seeing an increasing number of Canadian companies going down to the U.S. if the capital is available there. … The world's capital markets are rapidly changing. Some of the implications of the changes will clearly relate to small businesses. (J. Oliver, Evidence, 36th Parliament, 1st Session, Issue 46)*

In the context of the new economy and the expansion of global markets, the potential for economic growth is enormous. Certainly, the most successful nations will be those with the ability to look forward, spot new trends and capitalize on them before their competitors do. This Committee believes that the next challenge for Canada is to build a solid and sustainable equity market environment structurally adapted to the growth and the financing of entrepreneurial activity. We believe that the implementation of the recommendations contained in this report will contribute to such an environment.

ADDENDUM

Chicago Roundtables on Equity Financing of Small Business

Summary of the Evidence

Roundtable #1

Government and Associations

The venture capital industry is booming in the state of Illinois. In the last 12 months, the amount of venture capital invested in Illinois increased by 850%, from $63.17 million committed in the first quarter of 1999 to $600 million in the first quarter of 2000 [David Weinstein]. The Committee heard that there is actually more venture money than venture projects [David Weinstein].

There has been a major turn-around in the last three years. If not for community and government actions, the region could have lost its whole high-growth "knowledge-based" industry [Candace Renwall].

In order to create this dynamic and self-sustainable investment climate for venture capital, a region needs:

(i) technology-based infrastructure;

(ii) a solid financial system;

(iii) an active angel community;

(iv) state sponsorships of entrepreneurial activity; and

(v) generous tax incentives [Shayne Mandle].

The key role for the government is to provide strong leadership, with investment in infrastructure, research and development (R&D) and education. Generally, it is to give businesses the best opportunities to grow [Shayne Mandle].

Attracting Technology-Driven Companies

1. Building a Competitive Environment

At the state level, the emphasis has been the creation of a competitive environment for businesses and financiers by:

- Putting in place programs to enhance companies' access to a rich labour pool. The state government provides R&D tax credits, grants and scholarships, and financial aid to educate the unemployed [Mary Reynolds].

- Providing tax incentives to technology-driven firms. The objective is to give these firms a "competitive edge" [Mary Reynolds].
- Greatly diminishing the financial burden of complex form filings, and other government-related paperwork, on small businesses [Mary Reynolds].
- Promoting technology-related trade associations. They can advance government policy by providing a touch point with the technology sector [David Weinstein]. They also help start-ups by holding conferences, generating public interest and networking among the angel community. They also fulfill an educational role [Candace Renwall]. The Illinois Coalition is a good example. This not-for-profit association pulled together the entire chain of participants: governments (all levels), university research departments and the industry. They act together and develop policy plans which are then submitted to the governments [Shayne Mandle].

2. Building Technology-based Clusters (Ecosystems)

The role of the city of Chicago was to create the "ecosystem" conducive to its technological development. By creating a dynamic and viable business environment for start-ups, the city has encouraged technology-based enterprises to locate in Chicago and financiers to invest in local businesses. This has been achieved by:

- Using public funds to secure real estate facilities for promising start-ups. For example, Ethnic Grocer was required to provide $2 million in collateral to secure convenient real estate. This would not have been possible without the help of the city. It is also important to note that the city gets its investment back if the companies they sponsor prove to be successful [Jim Dispensa, Katherine Gehl].
- Changing the building codes when problems arise with hi-tech real estate mega projects [Jim Dispensa, Katherine Gehl].
- Providing adequate power distribution. Internet-based companies need high power distribution and adequate redundancy in case of failures [Jim Dispensa, Katherine Gehl].
- Converting empty manufacturing buildings into modern facilities for high-growth companies [Jim Dispensa, Katherine Gehl]. Old manufacturing buildings are attractive because of huge floor space, big enough for gyms and other recreation rooms which are becoming the "norm" in the hi-tech work environment (because of very long hours).

Government Leadership and Marketing

The key government role is to show leadership [Shayne Mandle]. For example, Governor George H. Ryan has let entrepreneurs and investors know that he is strongly committed to the growth and prosperity of the local hi-tech industry [Mary Reynolds]. Marketing is also crucial. According to the Illinois Coalition, good marketing of the programs in place and the commitment of the city have been the key to the success of Chicago. There is thus an ongoing need to compile detailed statistics on the sector, and then use those as a powerful marketing tool [Candace Renwall]. The state of Illinois recently put up a $20 million marketing program that will "promote the role of Illinois in the new economy and attract businesses and investors to the region" [Mary Reynolds].

Attracting Capital

The state of Illinois has been extremely successful in attracting early stage capital. Again, the fact that governments and associations worked in tandem to facilitate the growth of technology-based businesses, in conjunction with a good marketing and communication strategy, helped draw the attention of the venture community to the region. Other factors also played a role:

- The favourable tax environment for technology-driven small business investments played a major role in the success of the region [David Weinstein].
- Not-for-profit trade organisations, such as the Illinois Coalition, contributed a great deal to the establishment of networks of angel investors. The Illinois Coalition operates several programs designed to meet the capital needs of seed and early stage technology companies statewide. These programs include a seed venture fund and a capital matching/referral network. There are approximately 250 angels participating in this matching/referral network. The role of the Illinois Coalition is to "syndicate the deal": entrepreneurs coming to the Illinois Coalition with the intention of raising seed capital can be given the opportunity to present their business plan to a group of angels, who will then choose to invest or not. On average, angels ask for a 20% equity stake [Shayne Mandle]. Finally, the Illinois Coalition also acts as the local network operator for ACE-Net.
- The city of Chicago has set up a government-based venture capital fund. However, the results of this initiative have not been convincing. The major problem was the lack of competition from other similar funds [David Weinstein].
- There are ways through which the banking industry can significantly contribute to the financing of technology-based ventures. For example, linked deposit programs (state programs that deposits funds in banks at below market rates under the condition that the banks use the money to make loans that encourage economic development) have been successful [David Weinstein].

Roundtable #2 and Roundtable #3

Angel Investors and Venture Capitalists

In the U.S., angel investors are actively funding the very early stages of business development. *Forbes* magazine estimated that angels invested more than $50 billion in 1997 alone. The U.S. Small Business Administration (SBA) reported that, in June 1996, the number of angels was conservatively estimated at 250,000, investing in more than 30,000 businesses.

"There is a dramatic revolution. The capital formation process is now really happening at the very small business level" [William Lederer]. Small business created all of the net new jobs in the U.S. since the 1991 recession. Angel investors are playing a crucial role in the continuum from very small start-ups to publicly listed companies, because they are at the beginning of the financing process. Companies with sufficient start-up dollars available to them are likely to move up to venture capital financing and public financing very quickly, thus growing at a very fast pace. Most of the companies that are under-funded at the start-up level usually do not grow fast enough and thus cannot move up to the next level of venture capital financing.

Angel Investors

- Angel investors operate in local networks (social clubs, groups, etc.). Members meet periodically—every 3 to 4 months—to hear and select companies in which to invest. The investors with whom the Committee met are part of a group of 30 to 40 angels [Steve Miller and Mark Glennon].
- The success rate for angels has been excellent [Steve Miller].
- In general, angels hold strong geographic preference (100 miles radius from home) [Mark Glennon].
- The time to exit an investment is a crucial decision factor [Mark Glennon].
- The final decision to invest is primarily made on intangibles (as opposed to tangible factors, such as valuation and sales projections) [Bob Geras].
- In the process of evaluating a project, the principal factors considered are:
  - (i) who is the referral;
  - (ii) entrepreneurs' backgrounds;
  - (iii) sales and marketing potential;
  - (iv) track record of the company;
  - (v) management team's potential; and

(vi) valuation of the company [Bob Geras].

Venture Capital

- The average venture capital deal in the U.S. is about $15 million.
- Venture capitalists invest primarily in good management teams; that is, managers with many relationships and contacts and a great knowledge and experience of the market [Chip Ruth]. It is a challenge to find good experienced managers [Michael Gray]. For example, Chip Ruth reported that, in Chicago, they have not been able to hire the top qualified managers. However, he also mentioned that because stock options in the U.S. have a tax advantage (over salary and wages, for example), it is easier to attract and hire the most talented people.
- The principal investors in venture capital funds are the pension funds and other institutional funds because they have a tax advantage [Chip Ruth].
- Venture capitalists typically invest at the expansion stage or the product's mass marketing and distribution stage. They tend to prefer companies with global views and large scale market potential.

Comments About Canada

Canada was viewed as a country with excellent technology-related business opportunities. For example, some panelists had already done some business in Canada, or had thought about it. Also, in the 1999 Chicago Venture Capital Conference, ten out of 35 companies presenting were from Canada [Steve Miller]. This shows that Canada is definitely a leader in technology development, and that many investors are aware of it.

However, the panelists identified some barriers to investing in Canada. First, "Canada will have a tough job attracting U.S. investors" [Bob Geras] because of the much lower scale, liquidity and level of activity of Canadian capital markets. It follows that the profitability of exits in the U.S. is much higher, and the time to exit is quicker. In the U.S., venture capital is literally pulled by the IPO market [Bob Geras]. Mark Koulogeorge and Chip Ruth also identified the lack of liquidity in Canadian capital markets as a turnoff for investing in Canada.

Another obstacle is that investors have to deal with different "unknown" legislation [Bob Geras]. It becomes even more of an obstacle because Canadian rules are complex, which means expensive legal costs.

Many panelists told the Committee that Canada needs to be creative to attract investors' interest. Canada must put in place the right climate conducive to the equity financing of entrepreneurial activity, which means:

- a tax-friendly environment for angel investments;
- diminishing the regulatory burden on such investments—one panellist mentioned that the $150,000 minimum threshold rule in Ontario played a role in his decision not to invest in Toronto;
- additional incentives to investors and commitment to the growth of small businesses; and
- establishment of local networks of angel investors.

According to Mark Koulogeorge, Canada's problems with the equity financing of small businesses are symptoms that can be cured by putting in place the right conditions: an environment conducive to wealth creation. If one makes Canada a place where money can grow and where investors can make money, then the rest will fall into place. Currently, investors do not perceive "Canada as a place where they will make money: you have to let people become wealthy" [Chip Ruth].

Mark Koulogeorge also said that Canada cannot get the critical mass and investments with a tax disadvantage and a lack of business opportunities. To get more foreign investment, Canada needs to "knock down the barriers for capital flows." Capital is the most fluid resource, and it tends to flow where it can grow to its fullest. William Lederer also identified capital flight as a major challenge for Canada's future. Anton Simunovic told the Committee that Canadians like him, who moved to the U.S. looking for challenge and opportunities, do not go back to Canada to re-invest in the Canadian economy, even if they move back to Canada.

Another panellist told the Committee that the amount of venture capital available to a Canadian business start-up is greatly inferior to what an equivalent U.S. start-up can obtain. This is putting Canadian businesses at a competitive disadvantage vis-à-vis American competitors [William Lederer]. "In Canada, business plans are for the most part flowing to the big investment banks, whereas in the U.S. they flow to independent venture capital corporations" [Anton Simunovic].

There was a general perception that Canadians hold a defensive attitude towards risks and rewards on capital markets. Moreover, the spirit of enterprise in the United States is much more oriented towards risk-taking than it is in Canada. "Canada does not have a tradition of celebrating the winners" [William Lederer].

Finally, venture capitalists are looking for large-scale distribution channels and market access. Canada lacks large scale partners and top managers with a global vision to take over the U.S. and world wide markets [Mark Koulogeorge and Anton Simunovic]. There are also some geographical management issues because investors prefer investing in the vicinity of their home.

Government Initiatives and the Small Business Administration (SBA)

The role of the Small Business Administration (SBA) is to identify and change legislation that hinders the growth of small businesses [Terry Bibbens].

The SBA created ACE-Net (Angel Capital Electronic Network), which enables entrepreneurs to reach a nation-wide network of angel investors on the Internet. Since its inception in 1996, ACE-Net has been a great success, although it is not as valuable as local networks [Terry Bibbens].

A great challenge for ACE-Net has been to campaign for harmonizing state securities laws. As a result of these efforts, the North American Securities Administrators Association (NASAA) developed a "Model Accredited Investor Exemption" for ACE-Net in 1997 which has been adopted by 40 states. The NASAA includes Canada and Mexico as members. ACE-Net currently operates in 46 states [Terry Bibbens].

Under the "Model Accredited Investor Exemption," entrepreneurs can raise up to $1 million in a 12-month period, with no information disclosure requirements, little solicitation and few resale restrictions, plus no limit on the number of investors. However, sales of securities must be made only to accredited investors (a natural person whose net worth exceeds $1,000,000, or whose income exceeds $200,000 [$300,000 jointly with spouse]; or institutional investors such as a bank, broker or dealer, insurance company, investment company, SBA-licensed Small Business Investment Company, or other investment funds). There is no minimum purchase requirement.

ACE-Net offers a "short form" option to entrepreneurs wishing to be listed on ACE-Net. The short form consists of a subset of questions that are designed to provide the most fundamental information about the company. The short form works in conjunction with both the "Model Accredited Investor Exemption" and the more conventional regulation D, rule 504, exemption.

Finally, in 1997 the U.S. government introduced a 50% exemption on the capital gains tax rate for small business investments held for more than five years (but with unlimited tax-free rollovers allowed). Additionally, the general tax rate on capital gains has been reduced to 20%. These developments literally drove the growth of the venture capital industry [Terry Bibbens and Chip Ruth].

Roundtable #4

Directors of Incubators

The Committee heard from a variety of incubation firms operating in the Chicago area. They all differ fundamentally in their operations, either from the development stages of the companies they seek to incubate or from their sources of funding and revenue.

The "Pre-incubation" Period:
The Technology Commercialization Laboratory (Ann Hammersla)

The Technology Commercialization Laboratory (TCL) focuses on technology transfer; that is, the research and development of commercial applications out of government-funded, university-based R&D. The TCL is an initiative of the University of Illinois. The TCL's mission is to create an environment that will attract, assist and encourage entrepreneurs in commercializing technologies generated at the University of Illinois and to enhance economic development at the University, within the community and throughout the state of Illinois.

Participants in the TCL must be conducting research and development leading to commercialization of technology. When the research and development phase of a project has been completed, the participant should graduate from the TCL and seek other facilities, such as incubators.

Ann Hammersla added that the support of universities to technology start-ups is an important impetus to local economic development. In fact, 77% of start-ups locate near the University.

"Government-assisted" Incubator:
The Evanston Business and Technology Incubator (Thomas Parkinson)

The Evanston Business and Technology Incubator (EBTI) has grown up as a part of Northwestern University and the City of Evanston research park. Consequently, the incubator was able to take advantage of some of the development programs offered by the research park instead of having to create them. This allowed the incubator to focus on developing space or physical infrastructure that connects clients to these existing programs. Initially, the incubator had about 2,000 square feet of space, which has grown to nearly 50,000 square feet.

The services offered by the incubator include flexible space at expensive rates, a range of business services, access to seed capital (city loans and Thomas Parkinson's Evanston Business Investment Corporation), mentoring and networking services. Of particular importance is the nature of the networking approach utilized. The incubator fosters networking between companies in the incubator and those in the research park, as well as with the contacts of these companies so that these contacts also become an extension of the network. Also, existing tenants can network with incubator graduates as well as with the graduates' contacts, thus providing leverage.

The entry and exit criteria are very subjective but essentially boil down to an element of fit between the incubator services offered and the clients' needs. The focus is more on trying to ascertain the nature of the business or technology the applicant is trying to develop and how appropriate the facility is.

It is a not-for-profit incubator. The EBTI does not take equity from client-companies; it is essentially a landlord. The EBTI accommodates start-ups until they reach the point of 15 to 20 employees. The success rate of incubated companies ranges from 75% to 80%.

Market-based Incubator: Dotspot Divine (Rick Powell, Mike Jasso, Jim Bower)

Dotspot Divine develops, markets and manages economic office facilities (approximately 1,000,000 square feet for all of its facilities) to maximize the growth of associated companies and non-affiliate businesses. Outfitted with superior information technology and telecommunications infrastructure, Dotspot Divine facilities provide a "cost- and time-effective" means for associated companies to establish themselves. Facilities offer amenities that could include daycare, health clubs, office hoteling, videoconferencing, organized events and food services.

Dotspot Divine is a subsidiary of Divine InterVentures (a Chicago-based venture capital corporation). It is a for-profit company, and takes an equity stake in the companies it incubates. The first concern is to provide real estate of the highest quality to clients, and to create an environment that is conducive to technology-based entrepreneurial firms. Secondly, it takes care of everything incubated firms are not good at, on an individual basis.

The "Post-incubation" Period: Andersen Consulting Dot-com Launch Center (Bill Shipley)

Andersen Consulting Dot-com Launch Centers provide initially-funded e-commerce start-ups and spin-offs with management, marketing, finance, administration and technology expertise needed to scale rapidly and become viable businesses. Unlike a traditional incubator, which typically works with businesses in their first days of existence, the Andersen Consulting Dot-com Launch Centers work with e-businesses that already have in place a nucleus of management and financial support.

There are 17 Launch Centers in different cities around the world (America, Europe, Africa and Asia). In Chicago, the Launch Center currently has 38 companies "accelerating." The Center helps companies in many ways, including technology development. Also, client companies benefit from the wide expertise of Andersen Consulting (tax expertise, marketing, administration, etc.). Andersen Consulting also manages a venture fund, which can benefit client-companies.

Andersen Consulting said it will take up to $1.2 billion in equity over three years from the start-ups as partial compensation for its services.

Roundtable #5

Businesses Benefiting from Start-up Financing

Circle Group Internet (Greg Halpern)

- Circle Group Internet (CGI) is a multi-service business development firm focused on the growth of pre-IPO technology-driven companies. The firm primarily helps client-companies to raise capital through a Direct Public Offering (DPO). Other services include technology, internet, management and marketing support.

Note: A Direct Public Offering (DPO) is the newest method of raising equity capital in the United States. This kind of offering is commonly conducted over the Internet. The shares (non-tradable, in practice) are sold directly to accredited investors, without the supervision of a trading market. DPOs are raising a number of regulatory issues for both federal and state regulators. In that respect, Greg Halpern deplored the tightening regulatory environment for DPOs, making it more difficult to initiate DPOs in the United States. Besides, the level of investor acceptance for DPOs is still unknown. For all of these reasons, DPOs are being carried out with a high degree of uncertainty.

- CGI conducted a DPO from June 1998 to January 1999. CGI raised $2.5 million in a Regulation A Offering entirely over the Internet, and became the first company to complete an end-to-end stock offering on the Internet without the help of a venture capitalist or investment banker. Generally, each investor puts $10,000 to $40,000 in the company.
- CGI recently had a Canadian client-company that wanted to initiate a DPO in Canada – a copy of the CGI's offering in the United States. However, different securities legislation in Canada prevented CGI from implementing a similar offering in Canada. The main obstacle was the minimum investment threshold ($97,000 to $150,000) required by provincial securities law.
- In the U.S., CGI has organized DPOs over the Internet for other companies as well. Generally, investors who bought shares in the companies were already users of the offering companies' technology. In exchange for their services, CGI usually takes a 4% equity stake in their client-companies.

Coolsavings.com (Steven M. Golden)

- Coolsavings.com is a web site where advertisers can deliver a broad range of "savings opportunities" to targeted segments of the company's "membership" base who have registered their demographic profiles on Coolsavings.com. Savings products include printed and electronic coupons, personalized e-mail, loyalty points, category newsletters, rebates, samples, sales notices, gift certificates, etc.
- The company's first round of financing was $10 million to $15 million from angel investors. The company had previously solicited venture capital corporations, but Steven Golden said that they wanted too much equity.
- The firm became CoolSavings.com (from "Interactive Coupon Marketing Group") in November 1999 following a second round of funding from Australian-based Lend Lease: they invested $18.5 million for a 30% stake and took a seat on the Board.
- Now, the company is building "strategic partners alliances" with major clients (advertisers), such as Visa. Strategic partners invested in the company as well.

Perceptual Robotics (Paul Cooper)

- Perceptual Robotics developed an imaging web technology where users interact with telerobotic web cameras to view whatever they would like, just as if they were actually present in that place. TrueLook software allows multiple users to experience a single location at once, up to the limits of the network bandwidth.
- Paul Cooper is Canadian. He was a faculty member at Northwestern University prior to founding Perceptual Robotics.
- Government intervention played a big role in the formation of Perceptual Robotics, and "all the way through each round of financing."
- The company first received a Small Business Innovation Research (SBIR) grant from the federal government.

Note: The Small Business Innovation Research (SBIR) Program is a $1 billion federal program which funds R&D and technology commercialization. It was established to open the door for small businesses to federal research and development and to speed the conversion of their research findings into commercial products.

- The company was nurtured by the Evanston Business and Technology Incubator, and received $500,000 from angels in exchange for a 5% to 10% equity stake.
- In a second round of financing, the company received $2 million to $3 million from venture capitalists. It then received financing from InterVenture and Motorola.

Ethnic Grocer (Parry Singh)

- Ethnic Grocer sells ethnic food and ingredients on the Internet.
- After a $1 million investment by the founders, Ethnic Grocer received $2 million venture capital financing from KB Partners. In exchange, the company gave up 33% equity.
- In its second round of financing, the company received $12.5 million from Silicon Valley's venture capital corporations (Kleiner Perkins Caulfield & Byers and Benchmark Capital).
- The company received advantageous lease arrangements from the city of Chicago to occupy space in one of the city's high technology facilities. The city made available $2.47 million for the company's facility. The money will be held in escrow for up to two years. If EthnicGrocer.com grows as expected, the money will return to the city.

WITNESSES

Name of Organization and/or Witness,
Date of Appearance and Issue Number

Alberta Capital Market Foundation:
Mr. John Cranston, Chairman. (Ottawa, April 27, 1999, Evidence, 36th Parliament, 1st Session, Issue 50)

Andersen Consulting:
Mr. Bill Shipley, Director of Business Development. (Fact-Finding Mission to Chicago, May 31, 2000, 36th Parliament, 2nd Session)

Association of Labour Sponsored Investment Funds:
Mr. Dale Patterson, Executive Director;
Dr. Calvin Stiller, CEO, Canadian Medical Discoveries Fund Inc.;
Mr. Ken Delaney, President & CEO, First Ontario Fund; and
Mr. Michael Steplock, President & CEO, Retrocom Growth Fund. (Ottawa, November 28, 2001, Evidence, 37th Parliament, 1st Session, Issue 25)

Bank of Montreal Capital Corporation:
Mr. David Pakrul, Senior Vice-President, Bank of Montreal. (Toronto, April 29, 1999, Evidence, 36th Parliament, 1st Session, Issue 51)

Bank of Nova Scotia:
Mr. Rod Reynolds, President and Chief Executive Officer, RoyNat Inc. (Toronto, April 29, 1999, Evidence, 36th Parliament, 1st Session, Issue 51)

Blue Meteor, Inc.:
Mr. David Weinstein, Chief Executive Officer. (Fact-Finding Mission to Chicago, May 30, 2000, 36th Parliament, 2nd Session)

British Columbia and Alberta Securities Commissions:
Mr. Douglas M. Hyndman, Chair, British Columbia Securities Commission; and
Mr. William L. Hess, Chair, Alberta Securities Commission. (Ottawa, by videoconference, March 23, 1999, Evidence, 36th Parliament, 1st Session, Issue 48)

Business Development Bank of Canada:
Mr. Michel Ré, Senior Vice-President, Emerging Markets; and
Ms. Mary Grover-LeBlanc. (Ottawa, March 18, 1999, Evidence, 36th Parliament, 1st Session, Issue 47)

Canadian Federation of Independent Business:
Mr. Brien Gray, Senior Vice-President, Legislative Policy. (Toronto, April 28, 1999, Evidence, 36th Parliament, 1st Session, Issue 50)

Canadian Venture Capital Association:
Mr. John Eckert, President; and
Mr. John Bradlow, Director and Chair of the Public Policy Committee. (Ottawa, November 21, 2001, Evidence, 37th Parliament, 1st Session, Issue 21)

Capital Alliance Ventures Inc.:
Mr. Denzil Doyle, Chairman of the Board. (Ottawa, April 27, 1999, Evidence, 36th Parliament, 1st Session, Issue 50 and October 17, 2001, Evidence, 37th Parliament, 1st Session, Issue 19)

CastleHill Ventures:
Mr. Barrie Laver, Managing Partner. (Toronto, April 28, 1999, Evidence, 36th Parliament, 1st Session, Issue 50)

Chicago Software Association:
Ms. Candace Renwall, Executive Director. (Fact-Finding Mission to Chicago, May 30, 2000, 36th Parliament, 2nd Session)

Chicago Technology Park &Research Center:
Mr. Jim Peters, Research Center Coordinator. (Fact-Finding Mission to Chicago, May 31, 2000, 36th Parliament, 2nd Session)

CIBC Capital Partners:
Mr. Ian Kidson, Managing Director. (Toronto, April 29, 1999, Evidence, 36th Parliament, 1st Session, Issue 51)

Circle Group Internet:
Mr. Greg J. Halpern, Chief Executive Officer. (Fact-Finding Mission to Chicago, May 31, 2000, 36th Parliament, 2nd Session)

City of Chicago:
Mr. Jim Dispensa, Assistant Commissioner, Department of Planning and Development; and
Mr. Dan Lyne, Assistant to the Mayor. (Fact-Finding Mission to Chicago, May 30, 2000, 36th Parliament, 2nd Session)

Coolsavings.com, Inc.:
Mr. Steven M. Golden, Chairman and Chief Executive Officer. (Fact-Finding Mission to Chicago, May 31, 2000, 36th Parliament, 2nd Session)

Crocus Investment Fund:
Mr. Doug Davison, Senior Vice-President. (Ottawa, November 7, 2001, Evidence, 37th Parliament, 1st Session, Issue 22)

Divine InterVentures:
Mr. Anton Simunovic, Managing Partner; and
Mr. Michael Gray, Partner. (Fact-Finding Mission to Chicago, May 31, 2000, 36th Parliament, 2nd Session)

DotSpot Divine:
Mr. Rick Powell, President and General Manager;
Mr. Mike Jasso; and
Mr. Jim Bower, Director of Real Estate. (Fact-Finding Mission to Chicago, May 31, 2000, 36th Parliament, 2nd Session)

Epigraph, Inc.:
Mr. Josh Schneider, Chief Executive Officer. (Fact-Finding Mission to Chicago, May 31, 2000, 36th Parliament, 2nd Session)

Ethnic Grocer, Inc.:
Mr. Parry Singh, Chief Executive Officer and President. (Fact-Finding Mission to Chicago, May 31, 2000, 36th Parliament, 2nd Session)

Evanston Business Investment Corporation:
Mr. Thomas E. Parkinson, Executive Director. (Fact-Finding Mission to Chicago, May 31, 2000, 36th Parliament, 2nd Session)

First Analysis Venture Capital:
Mr. Mark Koulogeorge, Managing Director. (Fact-Finding Mission to Chicago, May 31, 2000, 36th Parliament, 2nd Session)

Growth Works Capital Ltd (Working Opportunity Fund):
Mr. David Levi, President and Chief Executive Officer; and
Mr. Murray Munro, Senior Vice-President, Marketing and Operations. (Ottawa, November 7, 2001, Evidence, 37th Parliament, 1st Session, Issue 22)

Investment Dealers Association of Canada:
Mr. Joseph Oliver, President. (Ottawa, March 4, 1999, Evidence, 36th Parliament, 1st Session, Issue 46)

Illinois Coalition:
Mr. Shayne Mandle, President. (Fact-Finding Mission to Chicago, May 30, 2000, 36th Parliament, 2nd Session)

State of Illinois, Office of Governor George H. Ryan:
Ms. Mary Reynolds, Chief Technology Officer. (Fact-Finding Mission to Chicago, May 30, 2000, 36th Parliament, 2nd Session)

LaSalle Investments:
Mr. Bob Geras, President. (Fact-Finding Mission to Chicago, May 30, 2000, 36th Parliament, 2nd Session)

Macdonald & Associates:
Ms. Mary Macdonald, President. (Toronto, April 28, 1999, Evidence, 36th Parliament, 1st Session, Issue 50 and Ottawa, November 28, 2001, Evidence, 37th Parliament, 1st Session, Issue 25) and
Mr. Kirk Falconer, Director, Research and Analysis. (Ottawa, November 28, 2001, Evidence, 37th Parliament, 1st Session, Issue 25)

Professor Jeffrey G. MacIntosh, University of Toronto:
(Toronto, April 28, 1999, Evidence, 36th Parliament, 1st Session, Issue 50)

Marquette Venture Partners:
Mr. Chip Ruth, General Partner. (Fact-Finding Mission to Chicago, May 31, 2000, 36th Parliament, 2nd Session)

McLean Watson:
Mr. Loudon F. Owen, Managing Partner. (Toronto, April 29, 1999, Evidence, 36th Parliament, 1st Session, Issue 51)

Minotaur Partner:
Mr. William Lederer, Partner. (Fact-Finding Mission to Chicago, May 30, 2000, 36th Parliament, 2nd Session)

Professor Jack M. Mintz, University of Toronto:
(Ottawa, May 6, 1999, Evidence, 36th Parliament, 1st Session, Issue 52)

Mosaic Venture Partner:
Mr. Vernon Lobo, Managing Director. (Toronto, April 28, 1999, Evidence, 36th Parliament, 1st Session, Issue 50)

Nibiru Investments:
Mr. Dave Smardon, Managing Director. (Toronto, April 29, 1999, Evidence, 36th Parliament, 1st Session, Issue 51)

Office of Advocacy:
Mr. Terry Bibbens, The Entrepreneur in Residence. (Fact-Finding Mission to Chicago, May 30, 2000, 36th Parliament, 2nd Session)

Origin Ventures, LLC:
Mr. Steve Miller, Principal. (Fact-Finding Mission to Chicago, May 30, 2000, 36th Parliament, 2nd Session)

Perceptual Robotics:
Mr. Paul Cooper, Chief Executive Officer and President. (Fact-Finding Mission to Chicago, May 31, 2000, 36th Parliament, 2nd Session)

Priveq Capital Fund:
Mr. Brad Ashley, Managing Director. (Toronto, April 28, 1999, Evidence, 36th Parliament, 1st Session, Issue 50)

Professor Allan Riding, Carleton University:
(Ottawa, March 16, 1999, Evidence, 36th Parliament, 1st Session, Issue 47)

Royal Bank Capital Corp.:
Mr. Jacques Sayegh, President and Chief Executive Officer. (Toronto, April 29, 1999, Evidence, 36th Parliament, 1st Session, Issue 51)

Sharwood and Company:
Mr. Gordon Sharwood, Chairman. (Toronto, April 28, 1999, Evidence, 36th Parliament, 1st Session, Issue 50)

Solidarity Fund FTQ:
Mr. Fernand Daoust, Special Advisor to the President;
Mr. Maurice Prud'homme, Group Vice-President, Partnerships; and
Mr. Guy Versailles, Vice-President, Communications, Marketing and Public Relations.
(Ottawa, November 28, 2001, Evidence, 37th Parliament, 1st Session, Issue 25)

University of Illinois:
Ms. Ann Hammersla, Associate Vice Chancellor. (Fact-Finding Mission to Chicago, May 31, 2000, Evidence, 36th Parliament, 2nd Session)

Vancouver Stock Exchange:
Mr. Michael Johnson, Chairman. (Ottawa, May 13, 1999, Evidence, 36th Parliament, 1st Session, Issue 52)

Venture Capital Online, Inc.:
Mr. Mark Glennon, Vice President – Venture Group. (Fact-Finding Mission to Chicago, May 30, 2000, 36th Parliament, 2nd Session)

Working Ventures Canadian Fund Inc. and **Canadian Venture Capital Association:**
Mr. Ron Begg, President. (Ottawa, March 16, 1999, Evidence, 36th Parliament, 1st Session, Issue 47)

World Heart Inc.:
Mr. Roderick Bryden, President and Chief Executive Officer; and
Honourable Senator Wilbert J. Keon. (Ottawa, May 13, 1999, Evidence, 36th Parliament, 1st Session, Issue 52)

XDL Capital:
Mr. David Latner, Counsel. (Toronto, April 28, 1999, Evidence, 36th Parliament, 1st Session, Issue 50)