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

2013 Pre-Budget Recommendations

Remarks to:

The Chair and Members

House of Commons Standing Committee on Finance

By:

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I am pleased to provide the views and recommendations of the Investment Industry Association of Canada (IIAC) for the 2013 federal budget. The IIAC represents registered investment dealer members on securities regulation, tax and other public policy matters to improve the savings and investment process and to achieve efficient, liquid, competitive markets that benefit the investing and issuing public. Our more than 170 member firms range from regional institutional boutiques and small retail firms to large full-service companies employing thousands of Canadians across the country.

Before we begin our remarks, it is important to note that the interests of Canada's investment industry and the country's economy are aligned. In 2011, Canada's investment industry, which employs about 40,000 Canadians, raised nearly $129 billion in equity and debt capital to fund businesses and all levels of government. Given these figures, it is clear that a vibrant investment industry is vital to the economic health of our country and it is against this backdrop that the IIAC presents its views and recommendations.

As the members of this Committee know, Canada continues to face the challenge of a sluggish domestic economy and global recovery, a high Canadian dollar and turbulent capital markets. Individual investors remain skittish about participating in the markets – and corporations continue to hold capital, with cash reserves now amounting to 30% of GDP, three times the historical average. Capital spending on productive investment has declined. In the third quarter of 2012, there were only seven initial public offerings (IPOs), with a total value of $271 million, completed on Canadian stock exchanges, compared with 20 new offerings, valued at $537 million, a year ago.

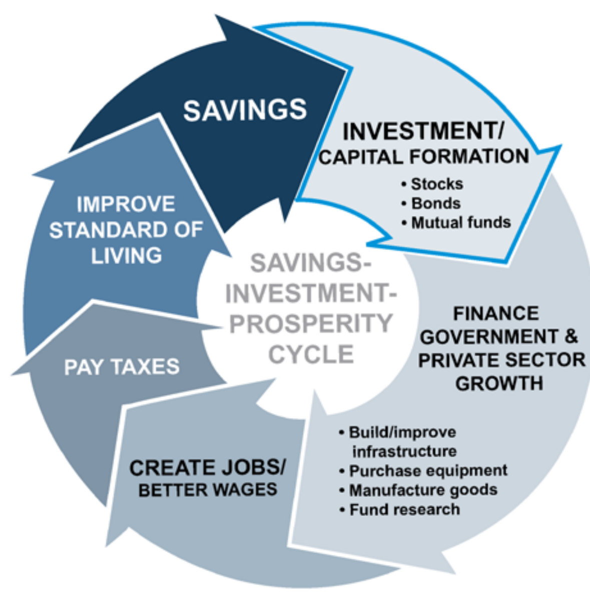
At the same time, household debt is increasing, and we face an enormous challenge in the years to come as demographic shifts will require new ways of thinking to provide health care and support systems to an aging Canadian population.

To cope with these challenges, the government must rely on robust revenue from sustained and strong economic growth, and continued efficient management of government programs. For this reason:

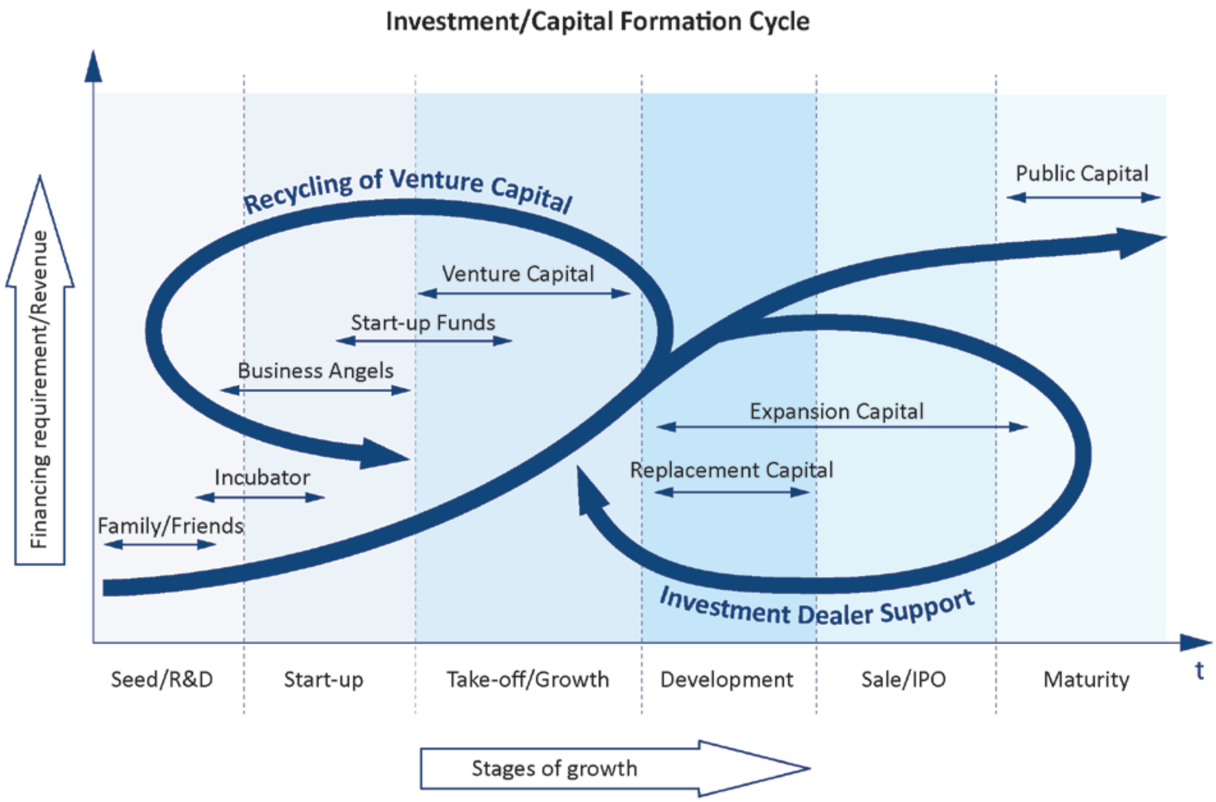
- We commend the federal government's continued prudent financial management, and recommend that these efforts continue.
- We strongly urge the government to maintain the current corporate tax rate level – among the lowest and most competitive of all G20 countries. The lower rates have not resulted in a decline in corporate tax revenues – in fact, more corporate taxes were raised last year than in previous years.
- On the household debt side, we support the government's decision to tighten mortgage-lending rules.

While good fiscal management, competitive taxes, and balanced borrowing are key components in the cycle of investment in Canada, we still need to see increased individual and corporate investment, which requires an examination of the entire investing process.

Just as the circulatory system is vital to the healthy functioning of every human being, the circulation of savings into capital investment and back into savings in Canada's financial system is critical for the economic health of Canada. This diagram is a stylized view of the economic circulatory system, showing the money saved by millions of Canadians becoming productive investments generating jobs paying and contributing to a better standard of living for Canadians who save.



The diagram below shows, within the "investment/capital formation" component of the cycle above, the role of seed money, angel investors, venture capitalists, institutional investors, and investment dealers regulated by the Investment Industry Regulatory Organization of Canada (IIROC).[i] IIROC investment dealers help channel savings of many individual investors into private equity through public investment instruments, such as stocks and bonds.



Source: Money Magnet, Jacoline Loewen 2008; Crédit Agricole Private Equity; IIAC

Blockages at any point in an integrated system can have serious consequences and, given the vital role Canada's investment industry participants play in the country's economic system, it is of the utmost importance that any blockages be cleared. At the IIAC, we believe there are blockages at various stages of the system in Canada – some that can be fixed; some – not easily:

- A number are due to the composition of our economy: nearly 60% of the TSX index is energy and financial sector companies; this concentration is not easy to deal with quickly, but there are steps we can take to promote a more diversified economy long term.

- Some blockages are environmental – the uncertainty of the U.S. and Eurozone situations: here the best we can do is monitor and re-act while keeping our own economy as healthy as possible

- However, other blockages arise when prescriptions taken to address one problem have the unintended effect of harming health elsewhere.

Neither our larger national, nor our smaller regional, members can do what they do best at their stage of the economic system without a steady flow of smaller companies growing to the size where the services our members offer come into play. And they cannot do as well as they might even at *that* stage due to increasing costs from a variety of sources.

As in the case of our personal health, we need a combination of preventative and restorative measures for optimal results in the financial system. We are proposing antidotes that we believe the Committee can usefully recommend and are also relying on the Committee's power to draw attention to areas we raise that are outside its purview.

SYMPTOM: Not enough capital for key stages in the investment cycle, particularly a shortage of capital for investment in:

(i) more capital-intensive innovative businesses with significant research or technology risks that venture capitalists traditionally do not address and

(ii) companies with more traditional market and other risks that private sector venture funds could finance successfully.

DIAGNOSIS: While clearly there are a range of reasons, a diagnosis of some of the problems arises from aspects of financing programs, and imbalances in regulatory and tax systems.

Investors, particularly individuals, must have confidence in the markets and in their institutions, be they financial or even government. To this end, many governments in Canada and elsewhere have determined that for investors and taxpayers to feel protected, regulation is the answer – even to the detriment of the capital markets and the investment process generally.

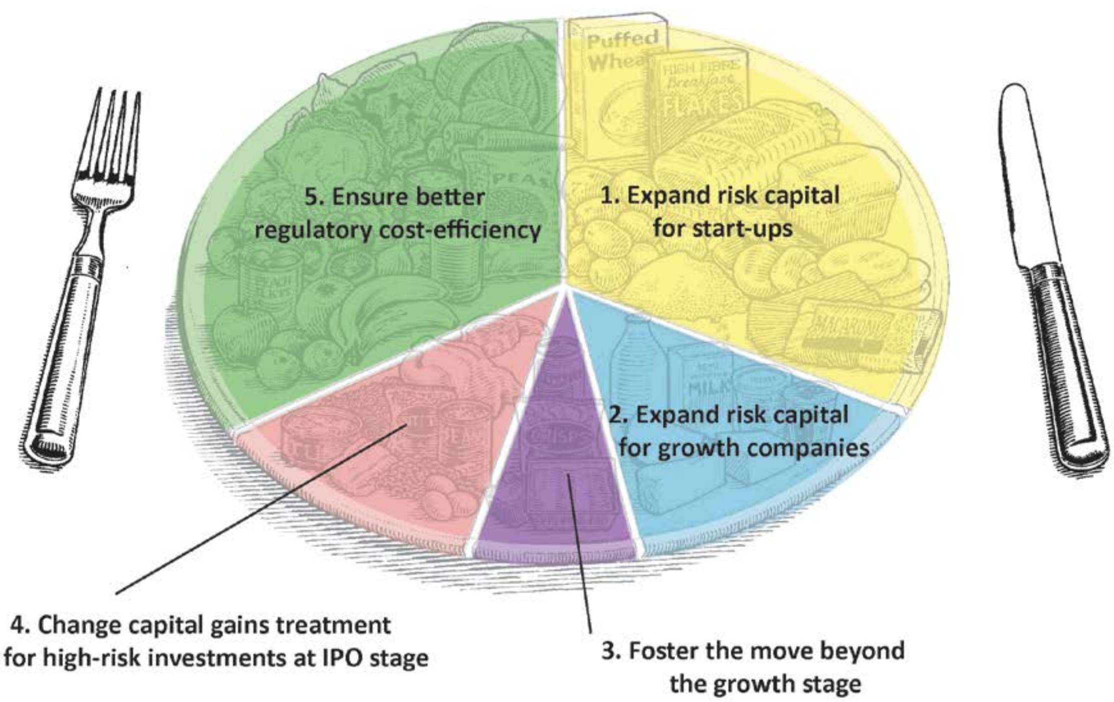
- First, Canada's securities commissions have mandates both to protect investors and to promote fair and efficient capital markets, which is quite a balancing act. There are examples we can provide where we think the balance can be adjusted.[ii]

- Second, the Canada Revenue Agency has a responsibility to ensure taxes are paid, however, the combination of rules and administration that make up our tax system also has an impact on parts of the savings-to-productive-investment system. Again, there are a range of examples we can provide.[iii]

REMEDY: We are sensitive to the fact that for the following prescription for economic health to work, Canada's fiscal management efforts must continue to provide certainty and flexibility. While we believe that our recommendations below are essentially costless or will generate benefits beyond their cost, any upfront spending could be achieved through re-allocation of some small portion the 2012 Budget's $400 million earmarked for private-sector funds to other capital-formation-promoting activities.[iv]

We prescribe below five additions to a balanced capital markets diet for the different stages in the life of a business enterprise in the Canadian economy. We are sensitive to the fact that one part of our prescription for economic health is managing down our deficit and therefore our recommendations – while we believe that they will generate benefits beyond their cost – could be achieved by some re-allocation of the 2012 Budget's $400 million earmarked for private-sector funds.

A Healthy Diet for a Healthy Economy



Source: IIAC

1. Risk capital for start-ups

Building out angel networks: Non-venture-fund financing of emerging businesses is provided for the most part through established angel networks operating across the country, often part of a university-commercial nexus. As studies demonstrate that these networks are underdeveloped in Canada compared with other developed countries, government should consider ways to provide support to accelerate the build-out of these angel networks.

Establishing net return to Canada: Industrial Assistance Research Program (IRAP) and Sustainable Development Technology Canada (SDTC) play a key role in financing research-based start-ups as the government can afford to look at return on capital more broadly and over a longer time horizon. However, Canadian government-funded research and business growth firms frequently get bought by foreign interests, losing both jobs – or at least the best jobs – and chances for building a more broadly-based competitive economy. We believe that steps to ensure some return to Canada in these cases should be identified.

2. Risk capital for growth companies

Expanding the venture capital market in Canada: We believe that some part of the $400 million in venture capital funding announced in the 2012 budget should be permitted to go to foreign venture capital funds as an incentive for foreign funds to build and expand operations in the Canadian market. This would add to available capital in Canada and may promote knowledge transfer.

Using flow-through shares: While lower capital gains tax rates on shares of start-up companies and Scientific Research & Experimental Development (SR&ED) tax credits help some firms, they do not help most of those with long product development lead-times and periods of no earnings. For these, a flow-through share concept works best.

Flow-through shares have been used for years to finance capital-intensive energy and resource projects, where early revenues are small or non-existent, and financiers bear huge risks while exploration and development is pursued. To attract capital for such risky ventures, qualifying expenditures are transferred through flow-through shares to taxpayers who can use the deductions. This model could be extended to other sectors with similar long-development profiles, such as high-tech and bio-tech – potentially high-value-add, productivity-enhancing businesses that even may restore manufacturing jobs.[v]

Restoring broker warrant treatment: Small registered dealers in the Canadian securities industry can complement angel networks in funding small and mid-sized business. We recommend restoration of the former tax treatment of a little-known financial instrument, typically called "broker warrants", inadvertently caught by a 2008 tax change aimed at the earlier taxation of traditional warrants. Broker warrants provide emerging companies with an alternative to paying some underwriting fees as brokers also receive compensation in the form of warrants, giving them the opportunity to purchase stock in the growth company at a future date and pre-determined price.

3. Fostering the move beyond the growth stage

Partnership: We believe that a public-private partnership could work on the particular challenges that seem to impede the $30 million in revenue businesses from reaching the $100 million threshold that is more likely to see ownership remain in Canada with the additional benefits that headquarters bring. This warrants further discussion.

Education: One of the issues to which the inability to move past the growth stage into mature businesses has been attributed is the low-risk appetite of small and medium-size enterprise owner-operators to have their companies grow into competitive organizations that will survive past their personal involvement. Experts in the area believe that the majority of owners do not have venture capitalists' or private equity providers' appetite for risk given the investment of their own money. However, this can be addressed through better knowledge of the growth potential of private equity partnerships and the availability of those who can act for the entrepreneur in coming to a workable arrangement with such entities.

4. Initial public offerings (IPOs) – going public

Capital gains treatment changes: The 2006 Conservative Party election platform included exempting investment gains from personal taxation as long as the proceeds were reinvested within six months. This measure may have been deferred for cost reasons, however, could be targeted only to shares of higher-risk enterprises. Alternatively, the Committee could recommend reducing the inclusion rate for tax purposes of capital gains earned on the sale of high-risk small business investments from the allowable 50% to, say, 25%.

5. Regulatory cost-efficiency

Balanced rules: Cost-benefit analyses must take into account the overall impact of new regulation on the capital markets. Governments and regulators must also assess existing rules' impact and rationalize regulation wherever possible to protect both investors AND the markets that provide the necessary capital to build businesses in Canada. This also means finding a way to ensure that issues crossing jurisdictional lines are addressed, just as health teams made up of different specialists today treat the whole patient.

The federal and most other levels of governments have announced red tape reduction efforts. In the case of financial institutions, likely due to what may be more the perception of the need to protect investors and taxpayers rather than the reality in many cases, cost-efficiency of regulations on those regulated has not been seen as a priority (although regulators do consider cost-efficiency of their own operations). The is no doubt in part because no single part of governments or their agencies sees the total cost of regulation and how much it has grown in the past five years of the financial crisis alone.

Financial literacy: Education, providing the ability to make informed choices at every stage of life, is the first and strongest protection that can be given to investors and the Chair of this Committee has demonstrated leadership in this area. The government announced less than a month ago "Your Financial Toolkit" as a needed resource to help Canadian financial consumers improve their financial well-being. Entrepreneurs could also benefit from tailored education.

Annual check-ups: We hope regulators and those regulated can report back that the patient has improved. What does not get measured does not get done.

Conclusion

I know that our presentation has been full of detail and that time is short. I would be pleased to answer questions and to follow up on specific points in writing as you wish.

Endnotes

i Bank financing is excluded as it is low-risk capital usually backed or collateralized by physical or financial assets.

ii For example, securities regulators may raise the accredited investor exemption in securities rules. This exemption enables Canadians, who have a higher level of investing knowledge and more assets and income to absorb potential losses, to invest without the same degree of disclosures needed for less financially-informed, less well-off Canadians. Even if existing investors whose income and assets do not meet the new thresholds are grandfathered, raising accredited investor limits:

- Will reduce the number of people who could provide financing in the early stages of investment and
- Ignores other factors protecting investors, such as a continual flow of new investor-protection regulations.

iii The government rightly closed loopholes being misused by some tax-free savings account (TFSA) holders in 2009; the 2011 budget closed opportunities for evasion in registered retirement savings accounts and income funds (RRSPs and RRIFs respectively). We fully support the intent of these rules, however, believe that some have gone too far and will have a negative impact on private equity. As well, the cost of tax system administration on financial institutions – for example, the mailing of millions of tax slips, is a growing and forgotten cost that acts as an additional tax on our members and ultimately their clients.

While we are working with the Department of Finance to carve out aspects of new legislation that do not have any aim of tax evasion, and with the CRA to reduce red tape, there is another potential growing chill on private equity. In the start-up and growth phases, companies may have no income and few assets, and they therefore are hard to value. As there is no market for the shares, to transfer or even report them under existing tax rules requires a value that is "fair" according to the facts and circumstances of the situation. This is leading some of our members, worried by the potential after-the-fact judgement of CRA tax auditors with the attendant cost, interest and penalties, to refuse to accept them into RRSPs or to require that investors obtain outside valuations costing $10-20,000 each.

iv IIAC, with other organizations, participated in the government's public consultations on this subject held this summer.

v A PriceWaterhouseCoopers study estimated extending flow-through shares to Canada's biotech sector would be a more-than-self-sustaining tax cost financing structure.