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Comment and Insight

Comment: Boosting venture markets

A key factor in the growth of small business is public markets. But they need support to expand and grow

By Ian Russell | June 1, 2017

There is almost universal consensus about the key to Canada's economic future: the expansion of emerging and small businesses. The frustration? How to achieve it.

Unfortunately, Ottawa-based policy-makers have proven determined to ignore the importance of public equities markets as an engine in growing small businesses, preferring bureaucratic programs that direct public funds to perceived winners. This is so despite the TSX Venture Exchange's (TSXV's) proven track record of success. Over the past 30 to 40 years, the TSXV has developed a cost-effective and flexible investing framework, yielding actively traded markets and financing mechanisms for small listed companies.

Unlike private markets, full and ongoing disclosure of listed companies' operations and earnings performance provides investors with detailed information on current and anticipated future success. Investors, in turn, weigh the evidence carefully as they put their own capital on the line.

But the public exchange's greatest advantage is its role as an engine to expand the capital available for small enterprises. As share prices and price/earnings multiples rise for successful companies, the liquid public market allows investors to cash out investments, with the monies often recycled to other publicly listed companies or back into small private companies. Indeed, in the buoyant pre-2008 resources markets, the TSXV was a veritable engine of diverse capital formation.

Vibrant public equities markets also help private equities markets thrive. Angel investors, venture capitalists and even business owners intent on selling their private businesses rely on the initial public offerings launched in public markets.

Weak public equities markets also have a larger negative impact on Canadian venture capitalists than on U.S.-based venture capitalists listed in Canada. (The latter account for almost half of the venture financing in our markets.) Typically, U.S.-backed firms are more likely to have the size to keep funding a growing business and to delay cashing out. As these companies expand, they inevitably shift their base of operations to the U.S. and obtain a listing on a U.S. stock exchange. And that means lost economic activity and jobs here in Canada.

The strain on Canadian small-capitalization public markets - including excessive regulation (particularly, costs from "protected market" rules) - is beginning to show. Roughly 25% of small institutional and retail investment dealers have disappeared from the markets in the past five years, taking with them the research, investor and issuer advice, structured financing and distribution of equity shares in which these firms had proven expertise.

At the same time, the demographic trend of aging investors, who are more focused on large-cap equities and passively managed funds than on speculative equities, has reduced investor participation in the venture market.

The revival of public venture markets in the face of these challenges will depend on several factors. Securities regulators, for one, need to relieve the regulatory burden. For example, small firms that specialize in speculative securities and advise on a minimal portion of clients' assets should be governed by a streamlined rule book.

And the playing field should be levelled. Exempt-market dealers that compete with Investment Industry Regulatory Organization of Canada registrants, yet make no contribution to public markets through research and public financing, should be subject to full oversight.

The TSXV announced a strategic plan about a year ago to address long-standing structural problems, including the need to build a larger pool of active investors and diversify the listings base. This plan includes broadening the offshore reach of the TSXV, as well as reducing cross-border tax and regulatory issues.

The federal government also needs to act. That could include introducing incentives to encourage small issuers to launch public and private offerings. Such a program should provide incentives for investors to purchase the listed shares of these issuers, as the U.K. does through its Enterprise Investment Scheme.

Small-cap public markets often are given short shrift in the policy debate when it comes to encouraging the growth of small business. But these markets have the potential to finance a vibrant small-business sector in Canada. To take advantage of it, we need to reorient our thinking.

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