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Parliament of Canada
House of Commons Standing Committee on Finance
finapbc-cpb@parl.gc.ca

Executive Summary: Equity Crowdfunding Tax Credit (ECTC) Proposal for Federal Budget 2017

ECTC Proposal

This Pre-Submission for the Federal Budget 2017 has been authored to propose the development of an Equity Crowdfunding Tax Credit (ECTC) as a new fiscal incentive to support access to equity capital for Canadian micro-cap issuers. The ECTC, a 10% tax credit, would be available to all Canadian investors who invest in new equity issues for eligible Canadian companies. Funds for these investments would be sourced from RRSPs, Pensions, TSFAs and general capital.

The parameters for the 10% ECTC will be further explored in a future Technical Submission and a request to make a presentation to the Standing Committee in future budget consultations. The ECTC will leverage financial technology innovations of Canadian based equity crowdfunding platforms and incorporate the template of new provincial equity crowdfunding regulations including MI 45-108. The goal of the ECTC will be to support the broadest range of Canadians to engage directly as investors with Canadian companies, entrepreneurs and innovators to develop businesses in all sectors of the economy and all parts of the country. The Canadian "crowd" will become informed stakeholders with a vested interest in the success of local enterprises.

ECTC Eligibility

The ECTC eligibility should be based on parameters such as: i) capitalization; ii) stage of development; iii) perceived risk to investors; iv) governance standards; and v) disclosure standards.

It is useful to examine what portion of the Canadian public markets are defined as small cap issues based on general global investment definitions. Applying US standards, public small cap companies have less than a $2 Billion capitalization. Based on Dec. 31, 2015 stock data from the TMX Group, 80% of the listed companies on the TSX are small cap issues, and on the TSXV, 100% are small cap issues.

Applying smaller benchmarks of micro caps with valuations less the $50 Million, the TSX is 26% micro cap or less, with the TSXV 95% micro cap or less.

The large number of micro-cap companies on the TSX and TSXV reflects Canadian expertise using public capital markets to fund earlier stage companies. It is estimated that 70% to 80% of the companies on the TSXV are pre-revenue companies.

Micro-cap public Canadian companies are appropriate candidates for an ECTC. Governance, disclosure and liquidity standards have been established through stock exchange listing standards. These public micro-cap companies are typically too small or early stage for significant support from institutional investors. These public micro-cap companies support employment for a sophisticated eco-system of professionals, innovators and entrepreneurs from every part of Canada across all sectors. There are many success stories of these public micro-cap companies growing to become some of the largest Canadian companies.

The ECTC would be an evolution of the Labour Sponsored Tax Credit (LSTC). The ECTC is viewed to be more transparent, efficient, effective and accessible to a wider range of Canadians and Canadian companies. The ECTC can be combined with the latest equity crowdfunding platform technologies and provincial crowdfunding regulations (MI 45-108) on investor protection and company disclosure standards.

What is the cost of the 10% ECTC?

Micro-cap companies listed on the TSXV are a useful proxy for eligible ECTC companies.

In Table 1, annual funding for new equity issues on the TSXV dropped from $5.2 Billion (2014) to $3.3 Billion (2015) a significant decline of 36%. This decline in necessary equity capital raised for micro-cap companies has had a substantial negative effect on the ability of Canada to foster new jobs and innovative companies.

If all TSXV new equity financings were eligible for a 10% ECTC, annual tax expenditures might be $400 to $800 million per year. When compared to other industry tax incentives these amounts are viewed as reasonable, effective and efficient. The equity raised would be based on efficient market allocation and valuation models. The benefit of this type of efficient transparent process is that Canadians could become engaged investors and own a broad array of earlier stage companies with public disclosure and liquidity standards. The ECTC provides a reduction in investor risk. It would be an effective incentive to enable all Canadians to spend the time to research which Canadian entrepreneurs and companies they wish to support.

Table 1. TSX and TSXV Equity Capital Raised (December 31, 2015)[1]

	TSXV		TSX	
Year	**2015**	**2014**	**2015**	**2014**
Number of Issuers	**1791**	**1971**	**1487**	**1515**
Quoted Market Value $B	**23.2**	**26.6**	**2299.8**	**2511.2**
Equity Capital Raised $M	**3345.3**	**5231.9**	**54379.6**	**52547.6**
Number of Financings	**1279**	**1572**	**577**	**664**

[1] TMX Group Public Data

Are We Raising Enough Equity Capital for Micro-Cap Canadian Companies?

Global central banks policy has taken interest rates to record lows. This has been a massive monetary and fiscal benefit for companies that can obtain debt financing. The real estate sector is an example of major beneficiary of these government policies. Unfortunately, most micro-cap companies cannot obtain significant debt financing. In many cases, it is not prudent to overleverage balance sheets if there is limited free cash flow. Many micro-cap companies, due to size or stage of development cannot obtain institutional equity investment. Equity investment is the primary alternative to debt financing. Equity investment is fundamental to sound business plans and balance sheets.

Are Canadian New Issue Equity Markets funding at capacity or efficient levels?

Total equity funded on the TSXV and TSX has increased by 41.4 % from $40.8 Billion (2008) to $57.7 Billion (2015). During the same period, equity funded on the TSXV declined by 40% to $3.3 Billion while the TSX increased 53.2% to $54.4 Billion.

A benchmark for efficient equity capital funding levels is the growth in large Canadian institutional portfolios net investments over similar period. The rationale would be that over time these institutional portfolios would be participating on a relative correlated basis in Canadian new equity issues.

Net Investments in the Ontario Teachers Pension Plan (OTPP) rose from $85.1 Billion (2008) to $168.3 Billion (2015) or a 97.8% increase.

If a similar 97.8% increase since 2008 was applied to total TSX and TSXV equity funding, then there would have been $80 Billion in total equity funding on the TSX and TSXV in 2015 rather than $57.7 Billion. This shortfall of $22 Billion suggests that Canadian public capital markets for equity funding are operating at 72% of optimal funding levels.

In 2015, total equity funding on the TSXV at $3.3 Billion, was 5.7% of the total TSX and TSXV equity funding, or about half of the average of 11.4% since 2008. If TSXV equity funding should be at an 10% of the optimal total TSX and TSXV equity funding, then the TSXV would be at $8 Billion of equity funding rather than the actual $3.3 Billion in 2015. This analysis suggests that Canadian public markets for micro-cap equity funding using the TSXV as a proxy is operating at 41% of optimal funding levels.

The ECTC will help to restore Canadian public markets to optimal equity funding levels.

What has been the Effect on Canadian Micro-Cap Equity Funding due to the Elimination the Canadian Content Rule for RRSPS and Pensions? I

The Ontario Teachers Pension Plan (OTPP) provides a useful summary of Canadian institutional investment holdings and strategy since the elimination of the Canadian content rules in 2004 for RRSPs and pensions.

In 2004 at OTPP, Canadian Equities made up 20.6% of Net Investments compared to only 2.1% of Net Investments in 2015. During the same period Non-Canadian Equity Investments increased 220% to $74 Billion while Canadian Equities declined 79% from $16.8 Billion to $3.5 Billion.

OTPP has had significant decrease in Canadian equity holdings, with a likely more significant decline in funding Canadian micro-cap equity issues either directly or indirectly through sub-managers. The data is not publically available, but it is estimated the OTPP does not have any micro-cap public Canadian companies in its equity portfolio. The OTPP is a useful proxy for other large Canadian institutional pension funds which also likely have a very limited exposure to Canadian companies with a market capitalization less than $50 million.

Is it time for large Canadian institutional pension funds to take greater responsibility for equity funding for Canadian Micro-Cap companies?

The tax deductible and tax free income status of Canadian pension funds and RRSPs that have an unrestricted portfolio allocation policy is a significant allocation of possible tax expenditures. It is likely that this policy has contributed to sub-optimal equity funding levels for Canadian micro-cap companies. This government policy should be reviewed as part of the 2017 Federal Budget preparations.

The ECTC would be available to both individuals and funds as a way to offset additional management costs and reduce risk to complete the diligence to help to fund micro-cap companies. Institutional funds can also provide an important lead or angel investor roles to provide additional guidance for the Canadian crowd investors that would be drawn to the ECTC eligible equity investments.

Since the elimination of the Canadian content rule for pensions and RRSPs, there are now fewer small cap Canadian investment funds. ETFs generally do not participate in new equity issues. The ecosystem of small cap Canadian fund managers (and related analysts and dealers) provides an important research expertise and funding source for micro-cap companies. An ECTC will help to stimulate the renewal of the decline in Canadian micro-cap funding capabilities and related infrastructure.

Generally, private equity funds are not focused on micro-cap companies as most of these funds are seeking companies with a minimum of $10 million per year in revenues in established businesses that can be leveraged with additional tax deductible debt.

It has been over a decade since the RRSP and Pension Canadian Content policy change in 2004. It is time for the Federal Government to review the effects of this major policy change on Canadian capital markets and optimal equity funding levels for public micro-cap Canadian companies.

Conclusion

The 10% ECTC will be and efficient, effective and fair equity funding policy that will benefit the broadest cross-section of Canadian investors and Canadian companies. It will create jobs, economic growth and stimulate innovation in every part of Canada.

Author

James S. Hershaw CFA, MBA, BSc (Eng)
Managing Director, WATT Capital
jshershaw@wattcapital.com
416-420-9122

WATT Capital
1421 Yonge Street
PO Box 60077
Toronto ON M4T 3A1

Mr. Hershaw is the founder of WATT Capital, a consulting firm that has completed a large number of projects related to the capital markets, investors and issuers. These strategic studies blend perspectives from buy side, sell side, corporate and consulting experience. Mr. Hershaw has recently been a member of the OSC SME Committee that helped to develop the new prospectus exemptions to facilitate access to capital for SME companies, including the Equity Crowdfunding Exemption (MI 45-108).

Mr. Hershaw has had senior roles with Imperial Oil, Bank of Nova Scotia, Nesbitt Burns and Dundee Bancorp. He has direct management experience with start-ups and associated regulatory requirements includes managing technology and natural resources funds, founding and managing three flow through limited partnerships, creating an EMD, and managing a public TSXV mineral company. Recent consulting assignments have included developing a corporate strategy for a private competency assessment and e-learning software company; a RTO to convert a TSXV mineral company into *"Internet of Things"* beacon technology company; and developing a comprehensive preliminary feasibility study and business plan for a MI 45-108 Restricted Dealer equity crowdfunding platform.

Mr. Hershaw believes the new global crowdfunding regulations will help to spark the next wave of technology innovation and corporate finance productivity that will help to stimulate economic growth in all sectors of the economy. The proposed ECTC will make Canada a leader in this new development in equity finance innovation.