CVCA
CANADA'S VENTURE CAPITAL & PRIVATE EQUITY ASSOCIATION
ASSOCIATION CANADIENNE DU CAPITAL DE RISQUE ET D'INVESTISSEMENT

March 16, 2009

Premier Dalton McGuinty
Government of Ontario
Legislative Building, Queen's Park
Toronto, Ontario
M7A 1A1

On behalf of Canada's Venture Capital and Private Equity Association (CVCA), I would like to draw your attention to the critical situation facing Ontario's venture capital industry. The current severe economic downturn is further exacerbating an already difficult fund raising and investing environment and risks compromising our collective ability to fund the industries of tomorrow.

Venture capital (VC) firms generally focus on entrepreneurial and fast growing small businesses in the technology arena, including information and communications technology, life sciences and biotechnology, alternative energy and clean tech. Perhaps the best known Canadian VC success story is Research in Motion, which has fundamentally changed the way we work and communicate while at once creating tens of thousands of jobs and serving as an engine for Canada's economy.

The CVCA has recently released a study on the economic impacts of venture capital. This study has been led by the CVCA with the financial support of Ontario, several other provincial governments and the federal government. This study clearly shows that venture capital in Canada has resulted in the creation of close to 150,000 jobs and an additional 1% to Canada's GDP. In addition, according to the Information Technology Association of Canada (ITAC), 700,000 Canadians work in the broader information technology and communications technology sectors.

This record reflects the specialized business-building skills that Canada's venture capital firms bring to their portfolio companies. It is also a measure of our long-term focus, astute risk management and strong sense of corporate responsibility and accountability to stakeholders.

While the venture capital industry has been a key driver of Ontario's prosperity, our members are currently facing significant challenges that we believe require government action. At a time when our economy urgently needs new success stories like RIM, ATI, Open Text, Cognos and Corel, we believe that it is vital for the government to address the:

- Current lack of funding available to bridge the gap between research and development and the commercialization of promising technologies;
- Existing obstacles to foreign investment

MaRS Centre, Heritage Building, 101 College Street, Suite 120-J, Toronto, Ontario M5G 1L7
Telephone: 416-487-0519 ▪ Fax: 416-487-5899 ▪ Website: www.cvca.ca

Each of these challenges is presented below along with a proposed approach to form the basis for a more detailed discussion.

Access to Funding

Given the current economic environment, fundraising in our sector reached new lows in 2008. The ability of funds to raise new capital impacts their capacity as financial intermediaries to make investments into promising companies. Because of the increasing difficulties in fundraising, between 2003 and 2008, venture capital investment in Ontario dropped to $99 million in Q 4, 2008, down precipitously from $177 million in Q 3, 2008 and from $217 million in Q 4, 2007.

The lack of capital available to venture capital investors reflects the broader market volatility and the new market realities. Institutional investors such as pension funds have incurred considerable losses in their public equity portfolios, which in turn has resulted in a corresponding lower allocation to venture capital and private equity. Additionally, individual investors are increasingly reticent to invest in publicly-traded vehicles such as Labour-Sponsored Venture Capital Corporations, for a variety of reasons, including the gradual withdrawal of tax incentives for investing in the asset class.

Simply, the lack of capital is putting Ontario's innovation at risk. Without funding, there is an increasing and very real risk that Ontario will not be able to fully capitalize on and benefit from its multi-billion dollar investment in research and development.

We note that the federal government has already taken significant steps towards improving SMEs' access to credit. However, the fastest-growing, most export intensive Canadian SMEs are disproportionately backed by equity infusions from venture capital funds. The current economic environment is depriving venture capital funds of their ability to raise capital, thereby robbing our most promising SMEs of the opportunity to grow.

A practical commercialization support program will ensure that more of Ontario's enterprising companies are able to realize their full potential, which will help to strengthen Ontario's competitiveness in the global, knowledge-based economy of the 21st century. The CVCA recommends the following initiatives:

- Setting up a federal $300-million, third-party managed fund of funds similar to the fund recently-established by Ontario to help fuel the growth of vibrant, leading-edge companies;
- Doubling the size of the Ontario venture fund through a direct injection of $200 million in government funding;
- Improving the federal Scientific Research and Experimental Development program (SR&ED) so that for every $1 of approved claims,$1.50 is returned to the company, thereby stimulating its growth and development; Ontario's support on this score would be welcome;
- Enabling greater use of government procurement/offsets to encourage domestic as well as foreign multinational investment in domestic venture capital funds; and

- Creating an incentive for large Ontario corporations to invest in domestic VC funds, where an investment in a VC fund would receive the same tax treatment that is currently available for in-house research and development.

These measures would benefit Ontario's technology firms as well as its venture capital funds in both the short and medium term and would improve our collective ability to achieve the longer-term innovation and productivity goals that are necessary to maintain the province's competitiveness in the global economy.

Removing Remaining Obstacles to Foreign Investment

Foreign venture capital investment has historically been an important contributor to the success of emerging Canadian companies. However, at the end of the fourth quarter of 2008, foreign venture capital investment in Canada fell 56% in 2008 relative to 2007, the lowest level in five years. Moreover, this trend appears to be accelerating.

We encourage the government to examine ways to improve Ontario's and Canada's investment appeal. The CVCA shares the analysis of the situation put forth by the recently-released federal Advisory Panel on Canada's System of International Taxation, namely that the current Section 116 process "may negatively affect Canada's ability to access foreign capital, particularly by private companies." (p.91). The Advisory Panel's Recommendation 7.4 that deals with this matter is, regrettably, insufficient to deal with the problems encountered by our members and by the foreign investors with whom they deal.

Canada currently defines taxable Canadian property to include shares of a private corporation resident in Canada. At the same time, Canada's tax treaties cede taxing jurisdiction to the country where the non-resident vendor is resident, provided the shares do not derive their value principally from real property. Based on the large number of tax treaties Canada has concluded, it appears that Canada is prepared to exempt from taxation all gains realized by non-residents, other than the gains from the disposition of real property.

In light of this treaty policy, we believe that Canada should adopt a broader exemption in its domestic law to exempt gains realized by non-residents other than those arising from the disposition of real property.

We see little benefit in providing the exemption only on a bilateral basis. The benefit of a broader exemption is that it would make Canada a more attractive destination for equity investments by non-residents and, in particular, venture capital and private equity funds. A broader exemption would also reduce a significant compliance burden that acts as an impediment to foreign direct investment in Canada. Unfortunately, recently enacted changes regarding the Section 116 clearance certificate process did not address the issue and are unlikely to reduce the number of situations involving arm's length transactions in which clearance certificates are obtained. We recommend amending the definition of taxable Canadian property so as not to include the shares of a private corporation resident in Canada other than when such shares derive their value principally from real property in Canada.

This proposed solution would put an end to the onerous Section 116 compliance requirements (except for real property), should not result in any significant tax revenue loss and would mirror the practices of most leading international jurisdictions.

We would strongly urge Ontario to continue to press the federal government to remove the Section 116 obstacles to foreign investment.

Encouraging Angel Investing

Although it is not within the CVCA's mandate, we recognize the important role that Angel Investors play in our ecosystem. Although the CVCA has not taken a formal position on the topic, I will note that one half of U.S. State governments have adopted some sort of "Angel Tax Credit" to stimulate the creation of start-ups.

In closing, the strength of our venture capital industry has a direct impact on Canada's economic health as well as the financial well-being of millions of Ontarians. At the CVCA, we take this responsibility very seriously.

We would welcome the opportunity to meet with you to further discuss the opportunities and challenges that are outlined in this letter. I can be reached at 416-607-5150 while the CVCA's Executive Director, Richard Rémillard, can be contacted at 613-744-8969.

Yours sincerely,

Gregory Smith
President
CVCA

(www.cvca.ca)

cc. Dwight Duncan
Minister of Finance

John Wilkinson
Minister of Research and Innovation