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Venture Capital Policies in Canada

Günseli Baygan
VENTURE CAPITAL POLICY REVIEW: CANADA

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VENTURE CAPITAL POLICIES IN CANADA

Günseli Baygan

Abstract

Canada has one of the highest levels of venture capital investment as a share of GDP among OECD countries. Between 1995 and 2001, Canada realised phenomenal growth in venture capital supply and the creation of over 200 new venture capital funds. However, the largest share of Canadian venture capital goes to follow-on funding of smaller firms -- rather than to new deals involving start-ups -- and to traditional manufacturing sectors. In the late 1990s, the Canadian government began attempts to diversify the sources of venture funds through liberalising rules for institutional and foreign investors, modifying tax incentives and introducing government equity funds. Foreign investors, particularly from the United States, are now the major players and are targeting their funding to technology-based start-ups. This paper analyses trends in Canadian venture capital markets and makes policy recommendations which have been developed through an OECD peer review process.

POLITIQUES DE CAPITAL-RISQUE AU CANADA

Günseli Baygan

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ASSESSMENT AND RECOMMENDATIONS

Canada has one of the highest levels of venture capital investment as a share of GDP among OECD countries, and most funds are directed to earlier rather than later stages of the enterprise lifespan. During the 1990s, the number of firms backed by venture capital doubled. Between 1995 and 2001, Canada realised phenomenal growth in venture capital supply and the creation of over 200 new venture capital funds. However, this rapid expansion in capital available for investment was not matched by the requisite management or financial expertise and some adjustment problems ensued. The largest share of Canadian venture capital still goes to expansion or “follow-on” funding of small and medium-sized enterprises (SMEs) rather than to new deals involving start-ups. And the major portion of Canadian venture funding has been absorbed by traditional manufacturing industries. This pattern has begun to change in the past few years, driven by first round investments in new firms in high-technology sectors.

Patterns in venture funding are evolving along with the structure of the Canadian venture capital industry. In the past, 80% of venture capital was invested through the Labour-Sponsored Venture Capital Corporations (LSVCCs), created in 1984 on the basis of preferential tax provisions. These provincially-based funds, sponsored by labour unions and supported by individual investors, generally make smaller investments in manufacturing activities. Corporate and institutional investors, including pension funds, have been largely absent from the Canadian market. While furthering regional development goals, the LSVCCs have had difficulties matching the needs of the growing number of small, technology-based start-ups in information technology and other service sectors.

In the late 1990s, the Canadian government began attempts to diversify the sources of venture funds through modifying LSVCC tax benefits, liberalising rules for institutional and foreign investors, and introducing government equity funds. The Business Development Bank of Canada (BDC) is attempting to leverage private funding through a number of innovative programmes. The Canada Community Investment Plan (CCIP) has worked to augment the supply of “investment-ready” small firms. By 2001, the role of the LSVCCs in venture capital markets shrank to less than 20% of investments. Foreign investors, particularly from the United States, now are the major players and are targeting their funding to ICT-based start-ups. Canadian investors are starting to follow this lead. A summary of progress and recommendations concerning Canadian venture capital policies is given in Table 1.
Table 1. Progress and recommendations on Canadian venture capital policies

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TRENDS IN VENTURE CAPITAL MARKETS

Overview

Canada ranks among the leading OECD countries in terms of venture capital investments as a share of GDP (Figure 1). In the period 1998-2001, early-stage and expansion venture capital investments as a share of GDP ranked second after the United States. From a relatively low level in the early 1990s, the value of investments rose seven-fold from CAD 660 million in 1995 to almost CAD 5 billion in 2001. The number of venture capital-backed firms increased by over 60% from the 1995 level. New capital raised increased from only CAD 908 million in 1995 to CAD 4.6 billion in 2001. Total venture capital under management in Canada increased from CAD 4.8 billion to CAD 20 billion in 2001, an increase of 321%. Investment levels declined in 2002, reflecting a more conservative investor stance following the downturn in technology markets. Still, the outlook for continued growth in venture capital supply in Canada is very favourable (Macdonald and Associates, 2002).

Figure 1. OECD venture capital investment by stage as a percentage of GDP, 1998-2001

Note: The definition of private equity/venture capital tends to vary by country. 
Investment by stage and deal size

Venture capital investments in Canada have been consistently oriented towards the earlier stages of enterprise life (Figure 2), far more so than in countries like the United Kingdom and even the United States. Early-stage and expansion investments have accounted for 80%-90% of total Canadian venture capital investments. However, the majority of these investments have been in the expansion or “follow-on” stage and have not necessarily been new deals. Overall in the 1990s, firms in the expansion stage received a greater share, around 50%, of venture capital investments than early stage deals, which represented on average around 30% of investments. The number of early stage investments increased in the late 1990s, in line with rapid growth in start-ups in high-technology sectors. However, in 2001, expansion investments still represented 68% of the total with over 700 deals (CAD 3.3 billion). Early-stage or new deals numbered around 340 and were valued at CAD 1.6 billion. There is thus not a clear trend towards a focus on earlier stages or start-ups in the Canadian system. Recent research indicates that the majority of Canadian venture capitalists prefer to invest in larger SMEs and find the fixed costs too high to invest in firms that require less than CAD 1 million in risk capital (Industry Canada, 2001).

Figure 2. Canadian venture capital investments by financing stage

Source: CVCA, 2002.

The concentration of Canadian venture capital markets on expansion investments has led to a progressive increase in average deal size. In 2001, deals valued at CAD 5 million and above represented about 80% of the total. The average deal size reached CAD 4.5 million, tripling between 1995-2001. The increase in the average deal size may also be a reflection of changes in the type of venture capital transactions, in particular the rise of syndicated deals around larger investments. In the last few years, there has been a slight shift towards smaller early-stage deals mostly targeted to new firms in the information technology and biotechnology sectors.
Investment by sector

The Canadian venture capital market is undergoing a shift from a focus on traditional industries to support of high-technology sectors. In the early 1990s, the modest pool of venture capital was oriented towards traditional sectors mostly in manufacturing and resource-processing. National disbursements of venture capital were widely diversified by sector, with no one sector capturing more than 20% of total investments. In recent years, the share of traditional industries has shrunk to less than 10% of the total. Venture capital investments are increasingly concentrated on technology-based sectors, which represented over 80% of investments in 2001 (Figure 3). Within the information technology sector which accounted for 71% of investments in 2001, communication and networking attracted 28%, followed by software (17%) and Internet-related companies (13%). The life sciences, primarily biotechnology and pharmaceutical firms, received 17% of total investments in that year. In 2002, there was a continuing shift of investment towards biotechnology and health-related sectors. This technology orientation can in part be attributed to the entry of international investor groups, especially American venture capital funds, with long experience of investing in technology start-ups (D’Argensio, 2002).

Figure 3. Canadian venture capital investments by sector, 2001

Investment by region

As in most OECD countries, there are marked regional disparities in the Canadian venture capital market, which have persisted through the years. The majority of firms that receive venture capital financing are located mainly in the three regions which also account for most of Canadian population and economic activity: Ontario, Quebec and British Columbia (Figure 4). These three regions represented over 70% of total Canadian investments in 2001. Ontario-based companies received 42% of venture
investments in 2001, followed by Quebec (20%) and British Columbia (10%). Regional clustering of venture capital investments is similar to that in other countries and tends to be attracted to areas with high-technology manufacturing and services close to financial centres (e.g., Silicon Valley in the United States, the SouthEast region and London in the United Kingdom). In addition, about 24% of Canadian venture capital goes to foreign firms, primarily in the United States and the United Kingdom.

Figure 4. Canadian investment activity by region, 1999-2001

![Bar chart showing investment activity by region](image)

Source: CVCA, 2002.

Funds raised by source

The relative shares and influence of sources of Canadian venture capital have shifted markedly over time. In the early 1990s, most venture capital was raised by the Labour-Sponsored Venture Capital Corporations (LSVCCs), which are small funds, regionally-based and tending to focus on traditional manufacturing sectors and follow-on investments. At their peak in 1996, LSVCCs raised more than CAD 1.2 billion in venture capital from individuals, about 70% of the total capital committed. However, only a little over one-third of these funds was invested in that year (Figure 5). With rapid growth in venture capital activity in the second half of the 1990s and changes to investor regulations, the role of the LSVCCs has gradually diminished. LSVCCs accounted for about 17% of venture capital investments in 2001 (Figure 6). Other domestic sources of Canadian venture capital in 2001 included private venture funds (13%), corporations (10%), government funds (7%) and institutional investors, including pension funds (7%).

Pension funds, which constitute the second largest pool of capital in Canada after the banking sector, are poised to become backers of venture capital once market conditions are suitable. Thus far, pension fund investments in venture capital in Canada have been limited, due largely to risk-averse attitudes and the lack of appropriate vehicles for investment. Many pension funds reduced their holdings in the early 1990s following poor investment returns in the late 1980s. In addition, there were no sizeable venture capital
funds in which they could invest as the market was dominated by the LSVCCs. Since that time, the assets held by trustee pension funds have increased six-fold reaching about CAD 700 billion in 2001. But with the exception of a few large public sector pension funds (e.g. CDF Sofinov, a subsidiary of *Caisse de Dépôt et Placement du Québec*, which backs new companies in that province), Canadian pension funds and other institutional investors allocate a much smaller proportion of their assets to venture capital than in many other OECD countries. Private equity (which includes venture capital, buyouts and mezzanine financing) accounts for less than 1% of the assets of an average Canadian pension fund, about one-seventh of that in the United States.

The most notable aspect of the Canadian venture capital market is the large role played by foreign investors, particularly from the United States. Foreign inflows have gradually increased over the course of the 1990s. In 2001, almost 30% of Canadian venture capital investments were from foreign sources compared to less than 5% in 1996. There has recently been an increase in Canadian/United States “co-investments”, a potentially efficient mechanism for spreading financial risks in increasingly integrated venture capital markets. Overall, the Canadian venture capital market has overcome constraints posed by very rapid growth and lack of management experience to build on diversified sources of funding.
VENTURE CAPITAL POLICIES AND PROGRAMMES

Overview

The role of small growth-oriented firms in the Canadian economy has increased progressively since the 1980s, partly due to government-backed financial instruments in both debt and equity markets. However, access to financing for SMEs was largely through loans and the LSVCCs, neither of which were particularly suited to technology-based start-ups. The high share of LSVCCs relative to private venture capital funds tended to reduce the quality of deals and equity supplies to other than traditional industries and existing firms. In spite of their large asset holdings, institutional investors, in particular pension funds, have not been active in Canadian venture capital markets. Recent changes to regulations for institutional investors, reforms to the main stock exchanges, and government equity programmes are expected to help redirect venture capital funding from both domestic and international investors.

Investment regulations

Recent changes to investment regulations should continue to redirect the structure of the Canadian venture capital market, partly by reducing the influence of the LSVCCs and providing for larger venture capital investment instruments. The LSVCCs are unique to Canada and have played an important role in its venture capital history. The first LSVCC was introduced in Quebec in 1984, and currently there are about 21 LSVCCs across Canada. They are relatively small funds sponsored by labour unions and capitalised by a large number of individual shareholders who receive tax incentives in exchange for committing their capital for a long period of time (usually eight years) to SMEs whose shares are not publicly-traded. LSVCCs are overseen by a board of directors at least half of whom are appointed by the sponsor with hands-on management by venture industry professionals. Their aim is to enhance regional investment and diversify employment opportunities. In the mid-1990s, they had over CAD 4 billion in assets, more than half of the industry total, and they now account for about one-third of the venture capital under management in Canada although for a lesser share of actual investments.

Despite their valuable contributions, the LSVCCs have had some perverse effects on the Canadian venture capital industry. In some provinces the proliferation of LSVCCs tended to crowd out private investment and limit the growth of private funds. Unlike private venture capital groups that invest for profit, LSVCCs mixed profit maximization goals with social development objectives. The organisational structure of these funds and restrictions on their investment patterns tended to negatively affect their screening processes and ability to adjust to rapidly changing market conditions. The federal government altered the investment incentives in the 1996 budget, by increasing the holding period for LSVCC shares and reducing the maximum amount eligible for investment (as well as reducing related tax credits). As a result, the share of LSVCCs in Canadian venture capital markets has gradually diminished.

In general, the high share of LSVCCs relative to private venture capital funds led to over-concentration on traditional sectors and reduced investment quality. Institutional investors, particularly pension funds, had no outlets for their investments due to the underdevelopment of alternative pooling vehicles such “funds of funds” and were reluctant to develop in-house expertise or to invest smaller amounts. In the 2001
budget, the federal government introduced a number of measures to stimulate the formation of private venture capital funds as well as to encourage institutional investment. Canadian “funds of funds” are expected to become an important part of the infrastructure of Canadian private equity markets with the first three established in 2002: the TD Capital Fund of Funds, the Edgestone Capital Venture Fund of Funds, and the Business Development Bank of Canada (BDC) Fund of Funds.

In addition, the federal government revised rules for establishing Qualified Limited Partnerships (QLP) to facilitate their use by tax-exempt and foreign investors in structuring their venture capital investments. Non-residents investing through partnerships using Canadian investment managers will also not be subject to Canadian tax. These measures are expected to increase venture capital investments through more effective use of QLPs by both Canadian and foreign investors, particularly US pension funds. The government should monitor the effects of these recent reforms on the structure of venture capital investments and, if needed, take further steps to stimulate institutional investment and creation of private funds. The contributions of institutional investors in Canada should grow with greater experience in venture investments through pooling funds.

**Tax incentives**

The most generous venture capital tax incentives in Canada are those associated with the LSVCCs. When created in the mid-1980s, an investor could receive a federal tax credit of 20% on up to CAD 5 000 of investments in LSVCCs. However, in 1996, the federal tax credit was reduced to 15% on up to CAD 3 500 in investments. In addition, investors in Ontario and Quebec, which account for the bulk of LSVCC funds, receive a 15% provincial credit (reduced from 20% previously). Investments in LSVCCs also qualify for tax deductions under the Registered Retirement Savings Plan (RRSP) rules. Thus, for a Canadian investor with a 45% (combined federal and provincial) marginal personal income tax rate, the RRSP deduction combined with a 15% federal tax credit and a matching 15% provincial tax credit implies an overall up-front incentive rate of 75% for LSVCC investments.

Provincial governments in Canada offer wide-ranging tax schemes to improve the financing environment for young businesses in their regions. Since the 1996 Agreement on Internal Trade Implementation Act, venture investments have moved more freely across the country. Tax incentives are given to individuals and corporations that purchase equity shares in registered venture capital funds at provincial level. For example, the British Columbia Equity Capital Program provides tax credits to resident investors who purchase equity shares in registered Venture Capital Corporations (VCCs). The tax credit for both individuals and corporations is equal to 30% of the investment in the VCC subject to investment ceilings and other restrictions on amounts deducted. Also in this province, the Employee Share Ownership Program provides employees with tax credits for investing in their employer, either directly (20% of the amount invested) or through an Employee Venture Capital Corporation (EVCC) (15% of the amount invested). The EVCCs are also eligible for a federal tax credit of 20% up to a maximum of CAD 1 000 per year.

Similarly, the Ontario Community Small Business Investment Fund (CSBIF), which supports venture capital funds investing in qualifying small firms, gives tax credits mostly to individual investors. The first fund of this type, the Niagara Growth Fund, makes equity investment available to SMEs in the Niagara region that have less than CAD 1 million in assets with proven potential for high growth. The Quebec Stock Savings Plan (QSSP) was launched in 1979 to provide venture capital to Quebec-based small firms and to encourage individual investors through tax incentives; the QSSP has been revised several times to channel more funds to smaller-sized firms. In the interest of diversifying the Canadian venture capital portfolio to better match market trends, the effects of the modified tax incentives for the LSVCCs should be assessed. Tax schemes at provincial level should also be evaluated to determine if capital is being
channelled to well-performing investment vehicles and earlier-stage firms as well as flowing freely across the provinces.

**Equity programmes**

The Business Development Bank of Canada (BDC) (formerly the Federal Business Development Bank) is the federal government's main venture capital funding institution. BDC was relaunched in 1995 to enhance its activities and better target the rapidly changing financing needs of small firms (Box 1). From being a *lender of last resort*, it is now focused on being a *complementary* lender in order to leverage private sector funding. Various equity and non-equity programmes have been developed to alleviate perceived gaps in financial markets relating to firm size, investment risk and management know-how. During the recent peak of the venture capital investment cycle in 1999-2000, the CAD 63 million invested by the BDC leveraged an additional CAD 301 million from private sources. Still, the BDC’s venture capital commitments represent only a small fraction, around 2%, of the total capital under management in Canada.

**Box 1. Government venture capital funds in Canada**

The **Business Development Bank of Canada** (BDC) complements financial services provided by the private sector and operates on a commercial basis:

- **The BDC Venture Capital Fund** makes investments at any stage of a company’s development from seed to growth and firm acquisition or expansion to turnaround, including both private and publicly listed companies. The size of investment ranges from CAD 500 thousand to CAD 5 million, in exchange for equity participation of between 15% and 49% or unsecured convertible debt financing, either as a sole investor or a syndicate partner. The average transaction is between CAD 1.5 million and CAD 2 million. BDC participates on the Board of Directors of the firm and provides management support. The BDC also aims to start a CAD 300 million fund-of-funds, targeted at small- and medium-sized pension funds.

- **Seed capital funds** are established with private partners to finance the pre-start-up phase for young companies developing new technologies across Canada. The funds are independently managed. Up to 2001, the BDC and its partners have invested a total of CAD 112.5 million in four seed capital funds, e.g. the Western Technology Seed Investment Fund capitalised by the BDC, Ventures West and the British Columbia Pension Fund; the Eastern Technology Seed Investment Fund capitalised by the BDC and the Bank of Montreal; and the Technology Transfer and Commercialisation Capital Fund in Quebec capitalised by the BDC, Sofinov, Innovatech and MDS.

- **Subordinated financing** (i.e. venture loans) is a hybrid financing instrument incorporating elements of both debt financing and venture capital. Firms that have little or no collateral backing, and that do not want to dilute their ownership structure, usually seek this type of financing. The size of investments range between CAD 100 thousand and CAD 1 million. Loan repayment is based on a combination of interest payments and royalties to a company’s cash flow. There are also other quasi-equity (patient capital loans) programmes to promote innovation which are available in amounts up to CAD 250 000.

- **Management programmes** -- The BDC offers a range of business counselling and mentoring services in key areas, e.g. growth potential assessment, strategic planning, technology strategy, quality control, export market assessment, and e-business solutions. To increase local visibility and accessibility to its services, the BDC has recently expanded its branch network by opening 4 new offices, bringing the total to 85. There are also non-equity assistance programmes for *start-ups*, like the young entrepreneur financing programme and the micro-business loan programme, which combine a package of term loans and management support.
There are also a few regional venture capital funds backed by provincial governments. For example, the Quebec Innovatech Venture Capital Funds were established by the Province of Quebec, covering the Montreal region, Quebec City and Eastern Quebec, and Southern Quebec. These funds provide venture capital to start-up companies, particularly in the technology sector, with first round investments ranging from CAD 250 thousand to CAD 2.5 million. Up to CAD 5 million per company can be invested in subsequent rounds. The main objectives are to enhance technology development, increase firm competitiveness, and contribute to job creation and economic growth. The funds also provide advice and monitoring to their investee companies, as well as important leverage advantages with banks and other lending institutions. The leveraging effects of both federal and provincial funds should continue to be evaluated, and the government role should be reduced as private funding expands.

Business angel networks

Individual investments by “business angels” directly into small firms are difficult to quantify but are believed to be relatively smaller than similar angel investments in the United States. Existing estimates of angel investments vary widely between CAD 5 billion to CAD 20 billion annually. According to a recent study, 18% of Canadian business owners reported to have invested privately in other companies (Statistics Canada, 2000).

The Canadian government has attempted to increase the number of “investment-ready” small firms and to link them with potential angel investors. The lack of management skills and teams in investment candidate firms has been a barrier to realising the potential of the growing supply of venture capital. In 1995, the Canadian Community Investment Plan (CCIP) was launched by Industry Canada as a seven-year programme. The CCIP has two components for building investment development expertise in communities. The first is an Internet-based programme providing entrepreneurs with improved skills to structure and present their investment opportunities and to attempt to match qualified firms with local, regional or national sources of capital. The second established 22 community-based projects to explore how to improve access to capital for local growth firms. Community initiatives are selected after a national competition in which they identify potential growth sectors, deficiencies in local financial services, and relevant strategies. The projects receive up to CAD 600 000 over a five-year period and act as intermediaries between local businesses and various sources of risk capital.

This locally-oriented approach to networking led to a set of best practices and showed that projects designed according to a community’s size and industrial structure could outperform more national efforts. The existence of a critical mass of growth-oriented entrepreneurs and private investors, as well as other complementary local financial services, played a role in the success of the projects. Based on the CCIP experience, on-line training programmes have been developed for making small firms “investor ready”. Canada should continue its decentralised approach to linking firms and business angels, which can provide an example for other countries. However, it should ensure that these are tied into more extensive angel networks at the national level.

Second-tier stock markets

Steps have recently been taken to enhance second-tier stock markets in Canada as attractive exit vehicles for venture capitalists, but the exchanges remain small-scale. The distribution of exits for the Canadian venture capital industry in the 1990s showed that only 8.8% of exits were through initial public offerings (IPOs) on the stock markets as compared to 46% of exits through company buy-backs. This was despite high returns accrued by venture capitalists from their IPO exits relative to traditional exit mechanisms. In addition, a significant number of Canadian firms are listing or cross-listing on exchanges
in the United States which tend to be larger and more liquid. Securities regulation in Canada had tended to limit the formation of a vibrant secondary market for early-stage firms through onerous disclosure and listing requirements.

In 2000, the Canadian government took steps to enhance the overall competitiveness of Canadian exchanges and reduce fragmentation. The four main stock exchanges in Canada -- the Montreal Exchange (ME), the Toronto Stock Exchange (TSE), the Alberta Stock Exchange (ASE) and the Vancouver Stock Exchange (VSE) -- were restructured. The trading of senior securities was consolidated on the TSE, derivatives trading was transferred to the ME, and the ASE and the CSE, after merging to become the Canadian Venture Exchange (CDNX), specialise in the trading of junior securities. The restructuring aimed to eliminate duplication, simplify trading rules and regulations, and lower the costs for smaller participants.

The CDNX received regulatory approval in 2001 to merge and become a wholly-owned subsidiary of the TSE, thus connecting the primary and secondary markets. To better target the financial needs of early-stage companies, the CDNX also created a unique listing program -- the Capital Pool Company Program -- which brings together an experienced management team with small firms in need of capital and expertise. In 2001, companies listed on CDNX raised financing of CAD 1 billion and 26 companies graduated to the TSE, representing 28% of all new TSE listings. These figures were down from CAD 2.4 billion raised and 45 firms in 2000. An agreement to establish a new exchange, NASDAQ Canada, has also been made between NASDAQ Stock Market Inc. and the province of Quebec. The new exchange became functional in November 2000 and will be linked to other NASDAQ exchanges, i.e. NASDAQ Japan, NASDAQ Europe and NASDAQ US, to form a global exchange in 2003. However, this will tend to increase both national and international competition for stock exchange listings and further limit economies of scale for small firm exchanges in Canada.
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