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

December 12, 2008

Mr. Michael Ignatieff
Interim Leader of the Liberal Party of Canada
81 Metcalfe Street
Suite 400
Ottawa, Ontario
K1P OG9

Dear Mr. Ignatieff:

On behalf of Canada's Venture Capital and Private Equity Association (CVCA), I would like to extend congratulations to you on your appointment as Interim Leader of the Liberal Party.

Canada's economy and financial markets have been significantly challenged by the global liquidity crisis and will undoubtedly continue to be tested in the months ahead. As you consider the appropriate fiscal and monetary stimuli that might be employed to deal with this crisis, I would like to highlight how Canada's private equity and venture capital industry can help to reinvigorate and strengthen the Canadian economy.

As President of the CVCA, I am writing to you on behalf of 139 member funds with more than $75 billion in capital under management. Our members are an integral part of Canada's financial sector and play an increasingly vital role in meeting the capital requirements of a broad range of companies across all sectors.

Private equity (PE) funds typically invest in small and medium-sized enterprises (SME) in a range of industries, including the manufacturing and service sectors. One high-profile PE success story is Porter Airlines, which has injected new competition into our national airline industry and provided benefits to the economy as a whole.

Venture capital (VC) firms generally focus on entrepreneurial and fast growing small businesses in the technology space, including information and communications technology, life sciences and biotechnology, 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.

Porter Airlines and RIM are but two of thousands of examples. Clearly, private capital, and the innovation and discipline it brings, builds strong Canadian companies. A study conducted on behalf of the CVCA in the spring showed that between 2002 and 2006, private equity firms added an estimated $25 - $30 billion to Canada's GDP and created 114,000 jobs. The CVCA will shortly be releasing a companion study on the economic impacts of venture capital. This study has been led by

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

the CVCA with the financial support of Industry Canada and several provincial government departments. Preliminary results indicate 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, over the past five years investments in private equity returned more than $10 billion to Canada's pension funds, including the Ontario Teachers' Pension Plan, Caisse de Dépôt and the Canada Pension Plan, among others, and their millions of beneficiaries. That is 30% more than if that money had been invested in the TSX 300.

This record reflects the specialized business-building skills that Canada's private equity and 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 private equity and venture capital industry has been a key driver of Canada's prosperity, our members are currently facing three specific and significant challenges that we believe require government action. At a time when our economy urgently needs new success stories like Porter and RIM, 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; and
- The need to maintain an appropriate regulatory climate that does not impede private equity and venture capital investment.

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, we expect fundraising in our sector to reach a new low in 2008. This reality is particularly acute for venture capital firms. 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 2002 and 2007, venture capital investment in early-stage Canadian companies dropped 42%, a trend that is continuing in 2008.

The lack of capital available to private equity and 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, preferring the safety of risk-free assets such as government-guaranteed GICs.

Simply, the lack of capital is putting Canada's innovation at risk. Without funding, there is an increasing and very real risk that Canada will not be able to fully capitalize on and benefit from its multi-billion dollar national investment in research and development. As the Finance department's December 11 pre-Budget consultation paper noted, "Canada's long-term economic plan is to improve productivity through education and skill development, investment in new capital and technologies, and innovation."

We note that the federal government has already taken 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 Canada's enterprising companies are able to realize their full potential, which will help to strengthen Canada's competitiveness in the global, knowledge-based economy of the 21st century. The CVCA recommends the following modest initiatives:

- Improving the Scientific Research and Experimental Development program (SR&ED) tax credit program so that for every $1 of approved claims, $1.50 is returned to the company, thereby stimulating its growth and development;
- Setting up a $300-million, third-party managed fund of funds similar to those funds recently established in Alberta, British Columbia and Ontario to help fuel the growth of vibrant, leading-edge companies;
- Enabling greater use of government procurement/offsets to encourage domestic as well as foreign multinational investment in Canadian venture capital funds; and
- Creating an incentive for large Canadian corporations to invest in Canadian 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 Canadian technology firms as well as Canadian 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 Canada'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 third quarter of 2008, foreign venture capital investment in Canada had fallen 36% from the same period in 2007. Moreover, this trend appears to be accelerating.

We encourage public officials to examine ways to improve Canada's investment appeal. The CVCA shares the analysis of the situation put forth by the recently-released 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.

Ensuring an Appropriate Regulatory Climate

We strongly support regulatory initiatives that will help to spur the growth of Canadian enterprises and increase Canada's attractiveness as a destination for foreign investment dollars. This includes the creation of a national securities regulator, which would significantly reduce regulatory overlap and duplication.

However, any regulatory measures that attempt to constrain or dictate how the industry uses leverage could prevent private equity transactions and investments from occurring at all, which would have a significant and detrimental impact on the Canadian economy. It is important to note that the use of leverage by Canadian private equity funds has traditionally been less than that of our international counterparts, which reflects the relatively conservative nature of the Canadian private equity industry. In addition, our member funds use leverage to complete transactions, rather then using the leverage within the funds themselves.

We encourage a balanced regulatory approach that recognizes the unique role of private equity and venture capital in Canada's capital ecosystem.

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

We would welcome the opportunity to meet with you prior to the upcoming Budget 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)