VENTURE CAPITAL IN CANADA:
FOCUS ON SMALL AND MEDIUM TECHNOLOGY ENTERPRISES

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Venture capital investors provide crucial financing which enables the growth and development of small and medium sized enterprises ("SMEs").[1] For early stage or rapidly developing firms, which frequently have insufficient assets or collateral to secure traditional bank financing, venture capital is often the only financing option available. According to a survey of business conditions conducted by Statistics Canada in October of 1994, the largest impediment to expansion for SMEs, aside from the need for more orders, is access to capital. In addition, numerous studies, most notably the Canadian House of Commons Standing Committee on Industry in its report *Taking Care of Small Business*, have pointed out the need for more accessible financing for SMEs.

Venture capital investment is accomplished through a broad range of vehicles, ranging from the injection of seed capital for the development of new products to the acquisition of already-established companies. The characteristic which sets venture capitalists apart from other sources of financing is the willingness to assume greater risks, thus filling a critical gap in the financing available to SMEs. In addition, venture capitalists frequently offer strategic management support for the companies in which they invest. This involvement helps to ensure the realization of the company's potential growth and improves the venture capitalist's opportunity to "exit" profitably from the investment.

This paper will focus on the role played by venture capital investors in the development of SMEs. The paper will canvass the sources of venture capital and distinguish them from traditional forms of financing. The examination will then proceed to an analysis of the typical objectives of venture capitalists, their role in corporate governance as well as the means through which such involvements is accomplished. Finally, the paper will discuss the critical role that venture capital (as it relates to SMEs) plays in the industrial development of Canada.

1. The Continuum of Financing Applicable to Small and Medium Sized Enterprises

(a) Founder Capital or "Love Money"

The success or failure of many SMEs in the early stages of their development depends on the availability of key start-up capital. Although the amount of required capital at the very early stages is typically small, "love money" (also known as founder capital or seed capital) is an extremely significant source of this start-up capital. The term "love money" refers to capital advanced by the entrepreneur of the SME (including personal loans secured by personal property of the entrepreneur such cars and houses), family, friends and neighbours.[(2)] It is estimated that 80-90 percent of early stage financing of $1 million[(3)] or less comes from such sources.[(4)]

Love money is of vital importance to the SME as potential outside investors, whether institutional or individual lenders, are usually unfamiliar with the business and the entrepreneur. Further, such outsiders are usually unprepared to spend the time required on a small (and often risky) potential investment to review the entrepreneur's integrity, work habits, business plan and management team. This lack of information is particularly applicable to the start-up ventures as insiders will typically have better information than outside investors concerning the quality and promise of the venture. In addition, the costs associated with due diligence required to be conducted by a potential institutional investor would be difficult to recover for a small investment. Consequently, venture capitalists, merchant bankers and mezzanine financiers frequently avoid investments at the very early stages. On the other hand, friends, relatives and associates are willing to inject capital as they already have a degree of comfort or trust that would take an outside investor weeks or months to duplicate.[(5)]

(b) Traditional Loan Financing

The SME may be able to access traditional loan financing in a few different ways. First, as discussed in the preceding section, entrepreneurs often provide valuable start-up capital to the enterprise through personal loans secured by the entrepreneur's personal property. Second, the loan may be made directly to the enterprise in the form of a line of credit or operating loan. Third, SMEs may obtain term loans which may be secured against or may be used to purchase fixed assets. Although there are a number of sources of traditional loan financing including banks, trust companies and insurance companies, 80% of loans to small businesses in Canada are made by the six large Canadian chartered banks.[(6)]

The major difficulty facing small firms seeking traditional loan financing in the early stages of their development is the lack of "bankable" assets which may be used as collateral to secure such financing. These firms often lack the necessary tangible or fixed assets as their products have not yet been developed to a point where they can be manufactured and marketed. As banks are traditionally risk-averse, they tend to avoid early stage high risk ventures, regardless of the potential interest rates or returns associated with such investments. Consequently, while still an important financing vehicle, traditional loan financing is not often sufficiently available to meet the needs of entrepreneurs at the early stages of their ventures' development.[7]

(c) The Informal Venture Capital (or "Angel") Market

The second segment of the capital market is the informal venture capital market ("IVC") in which individuals, known as "angel" investors, invest directly in small private businesses. The substantial size of the Canadian angel market, estimated at $500 million to $1 billion per year, makes it a vital factor in obtaining the necessary infusion of capital to proceed to the next stage in the development cycle of an SME.[8]

Angel investors are typically professional investors, retired executives with expertise and money or high net worth individuals simply looking for investment opportunities. They tend to be highly educated, experienced at the managerial level in small business enterprises and have significant wealth and cash flow. The average annual income of an angel investor is approximately $175,000 with a net worth of over $1.3 million.[9] Angel investors typically learn about investment opportunities from personal contacts, networks of business associates, active personal research, accountants and lawyers, friends, magazines and newspapers and, to a minor extent, from investment matching services.[10]

Angel investors reject most projects presented to them. It is estimated that over 72% of all projects are rejected before the investors even meet with the entrepreneur with an additional 16% being rejected after such a meeting. If the potential investment has survived to this point, the angel investor will then conduct thorough due diligence of all aspects of the investment proposal with less than 3% of all investment proposals ultimately leading to a commitment of funds.[11] As a result, the angel investor often holds an obvious balance of bargaining power in the entrepreneur's early quest for investment capital.[12]

On average, angel investments range from $25,000 to $300,000 with an approximate average of $125,000.[13] Although most angel investments include the acquisition of equity, almost three-quarters of the investors also purchased some form of debt such as convertible debentures or debt with warrants attached. The angel investor tends to hold its investments for approximately six years and has high expectations of return commensurate with the relatively high degree of risk assumed, typically seeking pre-tax gross returns ranging from 50% to 75% per annum.[14]

While angel investors usually do not require an active role in the ongoing day-to-day management of the enterprise, they often participate in or exercise some degree of control over the management of the enterprise through board representation, insistence on operating covenants or a shareholders' agreement, providing ongoing consulting services and/or periodic documentary review.[15] A discussion of the angel investor's role and participation in the enterprise is discussed in greater detail in section 2(c) below.

(d) The Formal Venture Capital Market

The next segment of the capital market is the formal venture capital ("FVC") market in which wealthy individuals, institutions and government bodies invest money in SMEs through the intermediation of formal venture capitalists and professional managers of risk capital funds. In 1996, a total of $1.09 billion was invested by members of the Canadian venture capital industry through a total of 881 investments made in 525 separate companies, of which $749 million (or 69%) of the total value of venture capital investments was made in technology-based businesses. At the beginning of 1997, the amount of FVC under management in Canada stood at $7.1 billion, up by 19% from the $5.98 billion at the end of 1995. This growth is not only being influenced by the new flow of capital into the industry but also by the tremendous growth in the asset base of the labour-sponsored funds.(16)

The participants in the FVC market can be categorized in three main groups - the public sector, the private sector and the hybrid groups. The public sector, including the federal government (eg. the Business Development Bank of Canada) and the provincial governments, accounted for only 5% of the total funds invested in 1996, down from 8% in 1991. The private sector, which is comprised primarily of private independent funds (funded by wealthy individuals and institutions such as pension funds and insurance companies) and financial corporations accounted for approximately 53% of the total market in 1996, down from 67% in 1991.(17) The last sector, primarily comprised of labour sponsored venture capital funds and selected immigrant investor funds, is the most rapidly growing sector in the industry. These funds are labelled hybrid because of the fact that they are run privately but receive assistance from the various levels of government through the provision of favourable tax credits and other like incentives to investors of such funds.(18) In 1996, the hybrid funds invested a total of $453 million in the Canadian market, which accounted for approximately 42% of the total market, up from 25% from 1991.(19)

While formal venture capitalists rarely finance companies during their very early start-up phase, approximately 43% of the funds invested by such investors in 1996 were invested in early stage financing, when the company is beginning commercial manufacturing and selling its product and, consequently, needs additional capital to scale-up its output. An additional 45% of the FVC invested in 1996 was invested in the expansion stage or mezzanine financing where the company is in the last stage of financing before an initial public offering or buy-out.(20) This financing is typically provided to companies that are the stage of either breaking even or reaching profitability, and is provided in order to effect further expansion in sales and manufacturing, for working capital or for new product development.

Typically, the investments made in the FVC market tend to be much larger than the investments in the IVC market. Whereas the average IVC investment in 1996 was approximately $125,000, the average investments for the public sector and for both the private and hybrid sectors in the FVC market was $570,000 and $1.3 million, respectively.(21)

Given the high amount of risk attributable to investments in these types of enterprises, most venture capitalists seek to participate in the upside performance of the enterprise and expect an average return of 25% to 40% per year on their investments. Furthermore, 41% of the investments made in the FVC market in 1996 consisted of common shares alone while only 6% consisted of only preferred shares.[(22)] Even when debt is issued, the venture capitalist often obtains some form of residual claim in the enterprise's potential through instruments such as convertible debt, debt with equity warrants or combinations of debt and common shares. This type of hybrid debt accounted for over 20% of the investments made in 1996.[(23)]

FVC investors usually anticipate holding their investments for a period of three to eight years.[(24)] Although the extent of the participation of the formal venture capitalist in the day-to-day affairs of the enterprise varies between investors, formal venture capitalists generally require some degree of active involvement. This involvement may include a seat on the board of directors, an active monitoring role or even day-to-day participation. A discussion of the formal venture capitalist's role and participation in the enterprise is discussed in greater detail in section 2© below.

(e) The Participation of Canadian Chartered Banks in the Venture Capital Market

In the past, Canadian chartered banks have been involved in the venture capital market only to a small extent. The chartered banks are typically highly risk-averse in their investment decisions, preferring to rely on the aggregate sum of small profits from a large volume of transactions. By contrast, venture capital investing entails a relatively high degree of risk. It may also require extensive monitoring, with the attendant costs.[(25)] However, there are indications that this trend may be changing. In order to address the "commercialization gap" or "company creation gap" in growth sectors such as information technologies as well as advanced materials and manufacturing, several banks have established subsidiaries which engage in venture capital investment. These venture capital subsidiaries focus on specialty manufacturing, the export sector and knowledge-based industries (eg. the Bank of Montreal Technology Investment Program). These venture capital subsidiaries possess investment funds of up to $350 million, some of which are managed by independent venture capital firms.[(26)] The amounts invested range from $250,000 to $20,000,000 per company, with relatively long-term investment horizons of three to seven years.[(27)]

(f) Initial Public Offerings

SMEs often reach a stage in their life cycle where a public financing may be appropriate to raise the necessary funds and to access the public equity markets. An initial public offering, in which the enterprise offers its securities to the public for the first time, provides a number of advantages to the enterprise including:

(I) a wider range of potential investors;

(ii) increased liquidity;

(iii) an exit mechanism for early stage investors including venture capitalists;

(iv) greater ease to raise money; and

(v) an enhanced public profile.[(28)]

Although the enterprise may reap the rewards of becoming a public company, there are a number of costs and drawbacks applicable to becoming a public company, particularly to a smaller public entity. Financial costs associated with taking the company public (eg. legal and audit fees, securities regulatory filing costs, underwriter's commissions, printing costs, etc.) and with regulatory continuous disclosure obligations can be somewhat burdensome. In addition, the large amount of regulatory involvement attributable to public companies may result in indirect costs such as slower decision making, as well as a loss of confidentiality and autonomy. Moreover, the diversion of management's time may make the enterprise less responsive and may divert valuable resources away from the crucial task of the ongoing management of the enterprise.[(29)] Finally, many of these direct and indirect costs are borne disproportionately by SMEs, given the high percentage of fixed costs and underwriter commissions per initial public offering, the lack of available managerial resources and expert advisors and the lengthier delays before funds are ultimately received.[(30)]

(g) Exit Mechanisms

As noted above, both informal and formal venture capitalists desire to dispose of their investments in the SME within a certain time period. Depending on the SME's stage of development and its financial and operating position, there are a number of different exit mechanisms available to the venture capitalist.

The most common exit mechanism of Canadian venture capitalists is by way of a buyback of the venture capitalist's shares by the enterprise itself. In fact, approximately 46% of the exit mechanisms in Canada in both 1996 and 1995 occurred by company buy-back although the venture capitalist earned only 1.2 times its original cost on its investment (1.8 times their investment in 1995) by this exit mechanism. By contrast, initial public offerings (discussed above) represented 8.8% of the number of dispositions in 1996 (16.5% in 1995) but returned to the venture capitalists more than 6.5 times the original cost (5.1 times in 1995). Furthermore, approximately 7.7% of all disposition mechanisms in both 1995 and 1996 were achieved by a third-party acquiring the SME. The remaining exit mechanisms consisted of write-offs (9.3%), mergers (3.3%), and secondary sales (25.3%).[(31)]

2. The Link Between Venture Capital Investment Objectives and Control Over the Enterprise

(a) Introduction

As noted above, the venture capitalist will generally have a number of objectives relating to the return on its investment, the protection of its investment and the time horizon until disposition. This section will review the methods by which the venture capitalist can meet its investment objectives by focusing on the various types of financing instruments available.

The venture capitalist will also have varying objectives as to the degree of involvement and participation in the SME. For example, the venture capitalist often seeks to spend more time and effort monitoring the entrepreneur/manager than would a traditional banker. Further, many venture capitalists, when making their investment, desire to monitor the viability and performance of the enterprise and, ultimately, on their investment while, at the same time, avoiding involvement in the ongoing day-to-day management of the enterprise.[(32)] This section will canvass the various types of roles the venture capitalist may play in the SME's development cycle and the corresponding methods of achieving these goals. While this section will treat both the IVC market and the FVC market as one, any differences will be duly noted.

(b) Investment Objectives

The venture capitalist's objective of participating in the upside of the enterprise is met by maintaining an equity position and a claim on the residual value of the company. However, as the entrepreneur will invariably refuse to give up control of the enterprise, an outside investor who acquires only a minority equity position would be in a somewhat vulnerable position relating to the management of the business.

One of the most effective methods of meeting the venture capitalist's goal of participating in the upside of the enterprise while still reducing its risk exposure is to purchase a combination of debt and equity or a form of debt convertible into equity securities. In the case of the combination of debt and equity, the investor, through the particular debt instrument, may be able to maintain discipline in the enterprise through covenants which must be met by the enterprise on an ongoing basis. Further, the injection of capital through debt affords the venture capitalist the ability to register a security interest against the assets of the enterprise and thus elevating its status in the enterprise above unsecured creditors and shareholders (although likely subordinate to any applicable bank financing). On the other hand, the investor can still participate in the enterprise's growth potential through its equity participation.[(33)]

A method which is similar to the combination of debt and equity is a debt instrument, such as a convertible debenture, which is convertible into equity of the enterprise at the option of the holder or upon the occurrence of particular events. As noted above, the debt holder will be able to secure its investment against the assets of the enterprise while maintaining the added protection that debt provides. Further, depending upon the terms of the convertible debt, its holder may be able to convert the debt into equity securities, thus taking advantage of the potential earnings and increase in value of the enterprise.[(34)]

(c) Management of the Enterprise

The marriage of the skills and experience which are brought by the venture capitalist and the entrepreneur is a classic example of creating synergies in an economic environment where their respective abilities and talents complement one another. The relationship between the two is not stagnant but, rather, evolves over time as the venture capitalist sees that the entrepreneur matures in his management experience, style and philosophy. Similarly, the controls which the venture capitalist may require or impose at the outset may, explicitly or implicitly, be lessened over time as the enterprise flourishes and the venture capitalist senses that the controls may no longer be necessary or appropriate, or in circumstances where the entrepreneur has independently been able to negotiate the removal or relaxing of the constraints.

If purchasing equity, whether alone or in conjunction with a debt instrument, one of the key protection vehicles available to the venture capitalist is through the creation of a shareholders agreement which governs the business and affairs of the enterprise. In particular, the shareholders agreement will typically (a) provide the investor with a degree of control in the enterprise (providing, for example, that certain types of decisions may not be made or implemented without special corporate approvals having been obtained, which approvals may include a veto right in favour of the venture capitalist); (b) dictate the rules relating to the issuance and disposition of equity securities; and (c) dictate the rules relating to the injection of future financing.(35)

It is important to note that the ability of the venture capitalist to obtain one or more of the following mechanisms will invariably depend upon the relevant strengths of the venture capitalist in relation to the entrepreneur's bargaining position as well as the availability of competing equity sources.

Early in the relationship between the entrepreneur and the venture capitalist, each develops a respect for the abilities of the other, and takes seriously (and frequently defers to) the expertise of the other. The venture capitalist respects the motivation and drive of the entrepreneur who has developed a concept, established a business within a predetermined niche, and has shown (by virtue of historical results) a predisposition towards the success of that business. The entrepreneur, on the other hand, respects the experience and knowledge of the capital markets which the venture capitalist brings to the relationship, and the experience which has been applied in other situations in expanding business operations from one plateau to a higher level. At the outset, each brings to the relationship knowledge, experience and perspective which is crucial to the successful development and advancement of the enterprise's operations. The ambitious enthusiasm of the entrepreneur is tempered with the pragmatism and experience of the venture capitalist, but the constant interaction between the two applied towards the common goal of the enterprise's success are critical in achieving that mission. Over time, as the business grows and the entrepreneur's abilities have been proven, and as the venture capitalist grows more comfortable with placing its destiny in the entrepreneur's decision-making, controls and vetoes are resorted to far less frequently and may in fact be taken out of the formal relationship between the parties.

(i) Role in Corporate Governance

Since venture capitalists often have previous managerial and entrepreneurial experience, many see their role in the enterprise as more than simply providers of equity. Rather, they see themselves as providers of value and expertise. Furthermore, while most venture capitalists wish to avoid participating in the ongoing management of the enterprise on a day-to-day basis (other than in instances of crisis management), many seek to monitor the management by insisting on one or more seats on the board of directors of the enterprise. Through such an appointment, the investors seek to be apprised of important issues facing the enterprise and thus be able to track their investments more closely as well as to provide input to management on ultimate decisions. Consequently, many venture capitalists insist that the debt instrument or shareholders agreement provide for representation on the board of directors by the venture capitalist or its nominees.[(36)]

Although the venture capitalist will rarely have a majority equity position in the enterprise, and will therefore not be able to control the decisions made by the board of directors, debt instruments or shareholders agreements often provide that no decisions may be made without the venture capitalist or its nominee being present at the board meeting at which such decisions are made. Further, debt instruments or shareholders agreements often provide that certain types of transactions will not be approved without the prior consent of the venture capitalist or its board nominee, including:

- amendments to the enterprise's governing documents (i.e. articles of incorporation, by-laws);
- any type of corporate reorganization such as amalgamations, mergers or liquidations
- appointment and election of officers and directors and the compensation paid to such officers and directors
- the entering into of agreements with and the making of any payments to any shareholder of the enterprise
- issuances, redemptions or other dealings with the securities of the enterprise (including the granting of stock options)
- incurring new debt and the mortgaging, pledging or otherwise granting of security interests in the property or assets of the enterprise
- declaration of dividends, the return of capital or the retirement of any indebtedness of the enterprise
- the sale, lease, exchange or disposition of all or substantially all of the property or assets of the enterprise
- any other decisions out of the ordinary course of the enterprise's business[(37)]

(ii) Buy-Sell Provisions

Shareholders agreements often contain provisions known as "buy-sell provisions" which dictate a number of different mechanisms to deal with the purchase and sale of securities of a corporation, whether pursuant to a mandatory obligation or an option to buy or sell the securities. These types of provisions typically fall into two categories - those which contemplate some involvement of a third party and those which involve only the shareholders of the corporation. The first type, where third party involvement is contemplated, includes provisions such as"right of first refusal", "piggyback rights" and "drag along rights". The second type, which involves only existing shareholders, includes "shotguns", "puts" and "calls".[38]

For the venture capitalist, the buy-sell provisions are a key component of any shareholders agreement. First, provisions such as the right of first refusal provide the venture capitalist with the ability to exert control over the process of new investors purchasing outstanding securities in the corporation, thus avoiding undesirable or incompatible new shareholders. If the venture capitalist is opposed to the proposed purchaser, it can simply exercise its right of first refusal and purchase the securities itself.

Next, buy-sell provisions such as "drag-along rights" and "puts" enhance liquidity in the private enterprise's shares and may act as a valid exit mechanism for the venture capitalist to dispose of its investment when it reaches an optimal disposition time. For instance, the marketability of the venture capitalist's investment clearly increases if it has the ability to force other shareholders to sell their shares to a potential third party purchaser. Similarly, the "put" allows the venture capitalist to require existing shareholders and/or the enterprise itself (assuming they have the requisite funds) to purchase its shares at an optimal time on the venture capitalist's investment horizon.

(iii) Additional Financings

Given the fact that most venture capital funds are provided in the earlier stages of an enterprise's development, the enterprise will often require additional financing at a later date to meet increased capital demands associated with a developing and expanding business. Consequently, in order to protect its investment in relation to any new financings, shareholders agreements often provide the venture capitalist with certain rights relating to future financings such as (a) an approval or veto right; (b) a pre-emptive right to participate in the subsequent financing on a pro rata basis in order not to have its interests diluted; or (c) a requirement that all shareholders participate in the subsequent financing. This last provisions may be enforceable either by permitting the non-defaulting's shareholders to advance the defaulter's share on its behalf and thus creating an enforceable debt obligation in favour of the non-defaulting shareholders or by permitting the dilution or forfeiture of the investment of the defaulting shareholder.[39]

3. The Critical Role of SMEs in Industrial Development in Canada

SMEs constitute the majority of enterprises in Canada. They are vital to the maintenance of high employment as well as current and future economic prosperity.

Prior to the 1980s, the Canadian economy relied heavily on resource-based activities, branch plant manufacturing operations and the services required to support these core activities. Most Canadian companies could focus on the North American market without concerning themselves with major competition from other world markets. However, following the recession in the early 1980s, many resource-based companies declined due to depressed commodity prices. Further, at the same time, globalization and technology advancements dramatically altered the comparative advantage of advanced industrial nations. Developing countries began to produce labour-intensive goods at low prices and market them to the industrialized world. Economies moved away from mass-produced, standardized products toward highly differentiated, specialized products. The Canadian dependence on a commodity and resource based economy diminished as production of knowledge intensive goods and services increased. Consequently, Canadian companies began to realize the necessity for international competitiveness through the advent of technology.

The creation of wealth by high-growth firms is key to meeting the new challenges of global competition. Rather than being a handicap, the size of the SMEs represents a clear advantage, as it makes it easier to sustain innovation and an entrepreneurial spirit. At their best, the SMEs continuously improve their production methods, employ organizational flexibility and problem-solving at all levels, as well as engage in pro-active, long-term planning. This argument is supported by economic developments throughout the world. As noted by the House of Commons Standing Committee on Industry, several of the most prosperous and competitive economies in the world today are based on small firms. By contrast, the countries whose economies have declined have generally adhered inflexibly to large-scale mass production, standardized production methods, rigid approaches to management, reactive and short-term planning, as well as innovation reserved for a select group of experts.[(40)]

The success of companies involved in the development, marketing, manufacturing and delivery of technologically advanced products or services is largely dependent on innovation resulting from their own research or research acquired from similar entities. However, these types of companies can achieve their goals only if a suitable financial and managerial infrastructure is available. Venture capitalists, as the early-stage financiers of emerging growth firms, are a key element in that infrastructure.

There are numerous concrete indications of the crucial importance of the SME to the Canadian economy. Businesses with fewer than 100 employees accounted for approximately 49.5% of Canada's employment in 1993, reflecting an increase from 44.5% in 1983. Large companies with more than 500 employees experienced the most sizable decrease in the share of the Canadian labour market between 1983 and 1993.[(41)] By contrast, between the second quarter of 1995 and the second quarter of 1997, SMEs produced 76% of the 980,000 new jobs created in Canada.[(42)]

In addition, because research and development is one of the most significant determinants of the success of the SME, such firms tend to spend significant amounts of capital on innovation. For example, firms with less than $1 million in sales spend proportionately two to three times more on research and development than their larger counterparts. Although the top 100 companies in Canada accounted for 67% of the research and development in 1993, this number represents a decrease from 77% in 1973. Also, the number of firms spending funds on research and development between 1984 and 1993 increased from 1,800 to 4,000. It is reported that SMEs accounted for the majority of this new participation.[(43)]

Finally, the SMEs are increasingly essential to the maintenance of Canada's trade surplus. Although SMEs accounted for only 8.5% of the value of Canadian exports in 1995 ($21 billion), the number of SMEs exporting has grown rapidly - from 33,000 in 1986 to 73,000 in 1992. Moreover, the SMEs are the driving force behind the industries in which Canada is beginning to capture new markets, particularly the rapidly growing technology and service fields.[(44)]

4. Conclusion

The diverse forms of venture capital available to SMEs fill a critical financing void, which might otherwise prevent many businesses from coming into being or flourishing. Both the informal and formal venture capital investors are willing to assume a relatively high degree of risk by injecting capital into emergent companies which often have little or no tangible collateral. The venture capitalists expect to gain a significant degree of control over the business strategy, in order to ensure that the enterprise develops favourably, provides an attractive rate of return on the investment and allows them an opportunity to exit profitably. Statistics indicate that SMEs have been playing an increasingly important role in economic development including a major role in job creation in Canada. In addition, participation by the SMEs in the export market and in the area of research and development has increased. Consequently, the economic growth of the SMEs carries with it a corresponding increase in the significance of the investors who enable the them to develop.

ENDNOTES

1.According to the October 1994 Report of the Standing Committee on Industry of the House of Commons, small businesses are traditionally defined as having fewer than 50 employees in the service sector or fewer than 100 employees in the manufacturing sector, and revenues not exceeding $2-5 million. Medium-sized firms are defined as having fewer than 500 employees [at 72].

2.Canada, House of Commons, *Report of the Standing Committee on Industry* (Ottawa: Parliamentary Publications Directorate, October 1994) at 44.

3. All statistics referred to herein are based upon statistics in Canada, and all dollar amounts are in Canadian dollars.

4. MacIntosh, Jeffrey G., *Legal and Institutional Barriers to Financing Innovative Enterprise in Canada* (Kingston: Government and Competitiveness Project, 1994) at 9.

5. Ontario Securities Commission, Task Force on Small Business Financing (October 1996) at 29-30.

6. MacIntosh, *supra* note 4 at 11.

7. Thompson, Wendy J., *Raising Private Equity and Risk Capital for Small and Medium Sized Enterprises - A Legal Perspective* (Strategy Institute, Hotel Inter-Continental, Toronto, November 16, 1995) at 8.

8. Ontario Securities Commission, *supra* note 3 at 30, and MacIntosh, *supra* note 4 at 17.

9. MacIntosh, *supra* note 4 at 18.

10. Canada, House of Commons, *supra* note 2 at 44.

11. Ontario Securities Commission, *supra* note 5 at 30.

12. MacIntosh, *supra* note 4 at 21.

13. *Ibid.* at 22.

14. Gleeson, Frank, *A V.C.'s Perspective* (InConference - Release #3, 1997, Insight Information Inc., January 29, 1997) at 6.

15. *Ibid.* at 23-25 and 34-35.

16. Macdonald & Associates Limited, *1996 Annual Statistical Review*, Table 11 (Canadian Venture Capital Association, http://www.cvca.ca/statistical_review/).

17. Macdonald & Associates Limited, *supra* note 16 Table 9.

18. MacIntosh, *supra* note 4 at 28-29.

19. Macdonald & Associates Limited, *supra* note 16, Table 9.

20. *Ibid.* Table 11.

21. *Ibid.* Table 9.

22. MacIntosh, *supra* note 4 at 34.

23. *Ibid*., Table 8.

24. MacIntosh, *supra* note 4 at 35.

25. Canada, House of Commons, *supra* note 2 at 9-11.

26. "Knowledge Based Start-Ups to Get Boost from Royal Bank - New Subsidiary to Help Turn Ideas into Businesses" (Canada NewsWire: http://www.newswire.ca, June 3, 1997)

and "Bank of Montreal Unveils $30 Million Venture Capital Fund for early Stage Companies" (Canada NewsWire: http://www.newswire.ca, November 20, 1997).

27. "Venture capital financing through Royal Bank Capital Corporation (RBCC)", (Royal Bank Capital Corporation: http://www.royalbank.com/english/kbi/rbcc.html).

28. MacIntosh, *supra* note 4 at 41-43.

29. MacIntosh, *supra* note 4 at 43-52.

30. Ontario Securities Commission, *supra* note 5 at 33.

31. Macdonald & Associates Limited, *supra* note 16, Table 10, and MacIntosh, *supra* note 2 at 85.

32. Thomson, *supra* note 7 at 10-12, and MacIntosh, *supra* note 2 at 34-35.

33. Thomson, *supra* note 7 at 8.

34. MacIntosh, *supra* note 4 at 85-88.

35. Thomson, *supra* note 7 at 10, and MacIntosh, *supra* note 2 at 84-85.

36. MacIntosh, *supra* note 4 at 183-184.

37. Thomson, *supra* note 7 at 11.

38. *Ibid.* at 12-14.

39. *Ibid.* at 14-15.

40. Canada, House of Commons, *supra* note 2 at 2-3.

41. Industry Canada, *Small Business in Canada: A Statistical Overview* (Strategis: http://strategis.ic.gc.ca, March 1, 1996) at 2.

42. Industry Canada, *Small Business Quarterly* (Strategis: http://stategis.ic.gc.ca, December 4, 1997) at 2.

43. Industry Canada, *Small Business in Canada: A Statistical Overview, supra* at 13.

44. Industry Canada, *Small Business Quarterly, supra* at 9, and Industry Canada, *Small Business in Canada: A Statistical Overview, supra* at 11.

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