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Discussion

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Discussion After the Speeches of Robert D. Pavey and Robert Hamilton

QUESTION, *Professor King*: I have a two-part question for Robert Pavey. First, what is the psyche of the person who puts the money in the venture capital firm. Secondly, a general question, do you have the sense that we are losing a lot of innovation by virtue of financial gaps.

ANSWER, *Mr. Pavey*: We raise our capital from institutional investors. The vast majority of that two to four billion dollars that is raised by institutional venture capital firms is raised from pension funds, corporate pension funds, university endowment funds, and public employee retirement systems of one sort or another. The fundamental thing that changed in the 1970s was a modification of the then prevailing interpretation of the prudent man rule. It changed from requiring every investment to be prudent, and, when viewed in hindsight, you are bound to have some that look imprudent, to requiring that the portfolio investment program had to be prudent. That has been interpreted over the last decade as meaning that institutional investors should carve out a small portion of their resources and put them into higher risk investments for the prospect of higher return. There has also been a lot of theory concerning portfolio maximization, concluding that if institutional investors have a spectrum of risks in their portfolio they will get higher overall returns. That has led to a significant flow of money into our industry.

Two decades ago most of the money came from individuals and wealthy families. Today it is largely from institutional investors. So, our economic role is to take money from large institutional investors and re-apply a small percentage, a couple percent, into the high-risk high growth part of the high-return spectrum.

In terms of the kind of people who invest, I suppose we are as varied as the kind of things in which we invest. People say you are venture capitalists, you like to take risks. No, I do not like to take risks. Risk is the price that I accept for high return prospects. Mostly, I think people who invest in these kind of companies view themselves as company builders. We enjoy the process of working with young companies. I was speaking with somebody yesterday over lunch. He was surprised to learn that a venture capitalist like myself really only makes one or two new investments a year. We sit on the boards of directors of a lot of our portfolio companies. We work with those companies during the management transitions that are typical and influence other things that are so critical to the growth of the company. We are not smart enough to have these great ideas to build our own companies, so we see our-

selves as assisters and participants in the company-building process.

I really think that is true even of the angel investor. Someone said they put their money in and sit back. The way I see it working in Silicon Valley, is that a number of semiconductor industry executives who have made some money, sometimes millions, through their success, will put \$50,000 or \$100,000 into other companies, and will sit on the board and work to help the companies grow. I think that is a very important resource to a young company. They do this not only to make money, but also because they, like me, enjoy the company building process. That kind of deals with the psyche.

Now, are we as a society losing out because we do not have more of this kind of capital? I think the simple answer is yes. I will admit they are all kinds of war stories about fifty Winchester disc companies being financed and venture capitalists are just like everybody else, we swim in schools sometimes and we do too much of the same thing. But this is normal and we need more of it. Almost 100 years ago we had 100 automobile companies, and you cannot blame the venture capital industry for that. In my judgment this is an area where more is better and I do not mean necessarily just more for venture capitalists. I think the network which allows 500,000 companies each year to be financed by individual investors is an enormous asset. It is a farm system for firms like mine, for example, but it is also an enormous asset for our country. We have to assume that large numbers of those will get started and fail. That is the way the process works. It is a turnover process all the time. Through survival of the fittest, however, major new companies develop.

We need more of that and anything we can do to encourage that would help us in the long run.

QUESTION, *Ms. Wince-Smith*: I had a question for Mr. Pavey. What is your view as a venture capitalist who understands some of the environmental issues of the need to change accounting standards in the United States in order to reflect some of these new technologies and their implications? For instance, in twenty-first century manufacturing the last thing you want in just-in-time delivery is an inventory. Yet our accounting standards still treat an inventory as an asset.

Do you see any real movement in the near term of bringing our accounting systems and standards to reflect the reality of technology development and all of that?

ANSWER, *Mr. Pavey*: There are some aspects of that issue that I have thought a lot about and some I thought very little about, which may indicate that it is not in the forefront of what I think are the critical problems. The fact that inventory is treated as an asset may, to some degree, mistake the real value of that inventory. Any good executive today is trying to get optimum return on assets and return on equity, so I think there is a powerful incentive to keep inventory down

even though it is on the balance sheet as an asset.

Now, the fact that we do not put research on the balance sheet as an asset at all, on the other hand, can be a problem. We encourage all of our companies, however, even though the accounting world now wants us to capitalize software development, not to do it. Capitalize as little as you can because it just looks flaky on the balance sheet, and, while some people say balance sheets do not count, I believe the market pays a premium for a high quality balance sheet. I do not think that is as big an accounting concern as an issue a previous speaker mentioned. This is the stock option issue where you have now got FASB all upset because we are not hitting the income statement with some sort of expense when we grant stock options in this country, and I just think that is ridiculous. Stock options do affect the earnings per share and stock is a capital transaction, it need not be a P&L transaction. We have accounting to reflect stock options in fully diluted earnings per share. We do not need more. The excitement over this is generated by a few big company executives who have reported large amounts of income reflecting stock options, but big companies do not make significant use of stock options compared to small companies. Stock options are used throughout young-growth companies as an equity tool, and to turn around and hit those companies who are trying to get over the hump of getting profitable with an enormous additional experience is absolutely foolish policy in my judgment.

QUESTION, *Professor King*: I wanted to ask Bob Hamilton a question. It seems as though in Canada the way you outlined it in terms of these incentives there is an ability for the people in the tax department and the people who are concerned with the R&D to work together. Are you able to keep the political element out of this exercise?

ANSWER, *Mr. Hamilton*: I guess in this case since the political elements and the policy considerations worked out well, it was a happy marriage. I think, yes, that we can in this area because, again, the changes that we are talking about here are adjustments, and not fundamental. There was never any dispute that Canada has a generous and attractive tax regime for R&D. Some would argue maybe we should provide more assistance, but I think that issue was not of debate. What was at issue was really just how to make the thing work a little bit better. Could we take out some of the impediments? Could we make some technical fixes that would make the program more accessible? Because what some firms were finding, and frankly, even smaller firms with these very generous incentives, was the difficulty accessing them and knowing whether they were eligible. There was some uncertainty, to the point where some just did not even bother trying to access the program. That is why I say you can have a well-designed system in all aspects but it can really break down if it is not accessible. So, I think

we focused on those technical aspects and minimized the political dimension to it. Although R&D is also a popular agenda item right now.

As I say, we have been quite happy that people have come back to our minister and said that the changes were good and really reflected their concerns, and that the process was a nice way to do business. We were able to have a productive exchange with industry where we understood each other's concerns. What we told industry during the consultation is let us not design something here that is going to fall apart — that is in nobody's interest. In other words, if the industry pushes us to change the rules in a way that they can abuse and lots of money starts to go out the door, the government's reaction, especially after some previous experiences, would probably be to just withdraw extensively from that area.

So I think the community built up some knowledge about how we operate, the constraints we face, and how it was in everybody's interest to try to move this forward in a way that addressed their concerns but recognized our constraints. Indeed, from a process perspective, we have just done the same kind of thing again in the December economic statement that we put out that announced the R&D changes. We said we are going to be looking at other areas where we try to take some tax impediments out of the system to help Canadian firms access technology. We are following the same process. We said here are three areas we want to look at. Here is an amount of money, 400 million over five years. One difference is that the consultations involve a much broader community, not just R&D. And, again, it seems to be working reasonably well because we have had a good set of discussions with businesses in setting out the parameters early on. This process is a refreshing change because so often one gets just wish list after wish list of things that the government is never going to do, especially in this kind of a fiscal environment.

In setting out the debate that way and putting those parameters around it I think it has worked really well. Time will tell if we continue to use this process.

QUESTION, *Mr. Howard*: When I was in government the government took great pride in the amount it was paying out in R&D and there was very little follow up to see how well the money was, in fact, invested in R&D. Has that improved or do we just throw this money out and hope like hell it is going to engender some satisfactory results?

ANSWER, *Mr. Hamilton*: Well, there probably would not be as much follow up as some would like in terms of knowing exactly how effective these incentives are — what kind of incremental R&D activity do they give rise to. I think we are quite comfortable, certainly for the smaller firms, that these incentives are quite effective in helping them perform the R&D, particularly at early stages because the tax credits are refundable for small firms. And larger firms as well have

indicated to us how important the incentives are in attracting projects to Canada.

Anecdotal and maybe further than anecdotal evidence suggests that, yes, they have been somewhat effective, but I have to contrast that again with the chart that I showed you that says Canada has a fairly low level of R&D spending relative to other countries. There are good reasons for that. The smaller country that we are and the structure of our industries are important factors. We are concerned about the effectiveness of these incentives. Again, I do not know what the benchmark is. That is, if we did not have these incentives how much R&D would we be doing? I suspect it would be a lot less.

The short answer to this question is there probably is not as much rigorous follow-up on that research.

REPLY, *Mr. Pavey*: I would ask how can there be? Companies do not know how to measure the results of R&D effectively. Do we think the government is better at measuring the results of R&D? It is a tough measurement. It is like advertisement. You just know you have to do something, but you are rarely clear on the return.

QUESTION, *Mr. Fay*: Do you have an oversight committee that watches over your shoulder?

ANSWER, *Mr. Hamilton*: No, we do not per se have an oversight committee. What we do have in Canada is a tax evaluation function within our department and it looks at tax expenditures like the R&D tax incentives. The auditor general and the public accounts committees ask us to review tax expenditures and see how effective they are. We have not done one of those yet for the R&D tax incentives. In fact, I am not sure when we will do one, but I suspect over the near term we will have to submit a significant tax expenditure as I outlined. So there is that function, but there is not a formal committee that is overlooking us and overlooking that activity. We do have to provide evaluations for tax measures on a regular basis. I would suspect that the R&D tax incentives will be reviewed over the near term, and at that point we will evaluate the effectiveness of the program.

