Unlocking Sovereign Capital: Reforming Canada's ITB Venture Capital Fund Mechanism

Mobilizing $15.3 Billion in Outstanding ITB Obligations to Strengthen Canada's Defence Innovation Ecosystem

Executive Summary

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The Industrial and Technological Benefits (ITB) policy is a cornerstone of Canada's defence procurement strategy. It ensures that major contracts deliver economic value within Canada. Under this policy, winning contractors, referred to as obligators, must invest in Canadian industry an amount equal to the value of their contract. These investments are directed toward job creation, innovation, and economic growth across the country.

The policy offers several transaction types that obligators can use to meet their commitments. One of these is the **Venture Capital Fund (VCF) transaction**.[1] The VCF mechanism allows prime contractors to fulfill obligations by making venture investments that support Canadian small and medium-sized businesses (SMBs) in advanced technology sectors. These investments qualify for a credit multiplier of five times the amount invested. Although the VCF mechanism is an innovative addition to the ITB policy, **it has never been used.** This is largely because of the complexity of the transaction and the relatively low return on the 5x multiplier.

The purpose of this white paper is threefold. First, it will provide an overview of the VCF transaction policy within the ITB framework. Second, it will outline the critical need to unlock venture capital that is dedicated to Canadian defence innovation. Third, it will present recommendations for policy adjustments that would enable the VCF mechanism to unlock billions of dollars in outstanding ITB obligations to be directed into Canada's venture capital markets.

Key Definitions and Their Importance to Canada

Venture Capital

Definition: Private investment capital that finances high-risk, high-potential technology startups and scaling companies.

Importance for Canada: Technology is a strategic asset, and developing it requires risk-tolerant capital. Without sufficient venture capital, Canada risks falling behind in critical sectors that underpin both economic competitiveness and national security.

Seed Capital

[1] See section 7.10 https://ised-isde.canada.ca/site/industrial-technological-benefits/en/key-references/model-terms-and-conditions

Definition: The earliest stage of venture capital, used to fund new companies at the "tip of the spear" in technology development.

Importance for Canada: Seed capital is effectively sovereign capital. Without Canadian-led seed funding, our most promising defence and dual-use companies will turn to foreign investors, risking loss of intellectual property, talent, and strategic control to other nations.

Industrial and Technological Benefits (ITB) Policy

Definition: Canada's procurement offset framework that requires prime contractors on major defence projects to generate economic activity in Canada equal to the contract value.

Importance for Canada: Today, at least **$15.3 billion in ITB obligations remain unallocated.** This represents a massive pool of locked-up capital that, if directed through mechanisms like venture capital, could unlock and scale Canada's defence innovation ecosystem.

Canada's Capital Gap: Seed Stage and Defence

Canada faces a critical **twofold capital gap** that directly affects its ability to scale sovereign defence technologies:

1. **A widening seed-stage capital gap**
   Despite growth in Canada's overall venture capital market, seed financing has not kept pace. According to the Canadian Venture Capital Association's (CVCA) 2024 report, **seed-stage funding in Canada fell from CAD 958 million in 2023 to CAD 510 million in 2024**, which represents a sharp **47% year-over-year drop**.[2] This means Canadian founders face greater difficulty securing the earliest, riskiest dollars required to launch and validate new technologies. Without seed capital, promising defence and dual-use companies never reach the scale required to attract later-stage investors. Canada's seed capital is sovereign capital.

2. **No dedicated pool of defence & national security seed capital**
   Unlike Canada, many of our G7 allies have recognized the strategic importance of early-stage capital for strategic technologies and have acted to close this gap. For example, the **United Kingdom's National Security Strategic Investment Fund (NSSIF)** was specifically established to invest in seed and early-stage companies

[2] See https://reports.cvca.ca/books/myfw/#p=1

critical to national security.[3] Similar mechanisms exist in the United States and France. Canada, however, has yet to create a dedicated pool of sovereign capital focused on defence innovation at the seed stage.

Strategic Implication: Without sovereign Canadian seed capital, our most promising defence startups risk being underfunded or forced to turn abroad for financing. This erodes Canadian control over intellectual property and leaves us reliant on foreign-developed technologies in areas that are vital to our national security and economic resilience.

Understanding Venture Capital Fund Transactions in the ITB Framework

There is a critical need to develop and incentivize Canada's capital markets to deploy both seed-stage venture capital and dedicated defence and innovation capital. We are now in a technology arms race not just with our nation's adversaries, but also with our allies. Capital is a strategic asset. The urgency requires swift tool development. Fortunately, Canada already has the mechanism in place via the ITB Venture Capital Fund transaction policy. With some minor policy adjustments, this transaction type would unlock a portion of the $15.3 billion in outstanding ITB obligations, channeling funds into early-stage Canadian defence and dual-use innovation.

VCF transactions allow prime contractors to meet their ITB obligations by investing into a Canadian venture capital fund, which in turn invests in multiple eligible Canadian SMBs. Instead of supporting a single company directly, contractors back a portfolio of startups and early-stage firms, leveraging professional fund managers to identify high-potential technologies aligned with Canada's priorities.

Current Structure and Mechanism

- Contractors (or eligible donors on their behalf) commit funds into an approved Canadian VC fund.
- The fund invests these dollars into qualifying Canadian SMBs (privately held, under 50 employees for services or 100 for manufacturing).
- Initial investments per SMB are capped at $1 million to encourage diversification.

[3] See https://www.british-business-bank.co.uk/finance-options/equity-finance/national-security-strategic-investment-fund

- If a recipient company goes public or ceases to qualify as a Canadian SMB, future investments in that company no longer count.

The Multiplier Incentive

- Every dollar invested through a VCF yields 5 dollars of ITB credit.
- Example: A $5 million VCF commitment generates $25 million in ITB credit.
- Credits are awarded in two stages: 50% upfront upon commitment, and the balance pro-rated as the fund deploys capital into eligible SMBs.
- Current policy caps VCF credits at 5% of a contractor's total obligation.

Summary
VCF transactions provide contractors with a leveraged, portfolio-based tool to meet obligations while injecting scarce seed capital into Canadian defence innovation. Although designed to spur high-impact investment, the policy has never been used. Activating it now would align Canada's ITB framework with its strategic need for sovereign early-stage capital.

ITB Policy Adjustments and Recommendations

For VCF transactions to become a viable and attractive option for obligators, targeted adjustments are required. While the policy framework was amended to allow VCF transactions, the prohibitive restrictions and weak incentives have prevented any uptake. Without reform, Canada risks leaving billions in locked-up capital idle rather than deploying it to strengthen our defence innovation base. The following targeted policy amendments for the VCF transaction would provide a significant capital injection into Canada's innovation economy.

1. Lift the $1 Million Investment Cap

- **Current Issue:** The cap on ITB-eligible investments of $1M per company is misaligned with the capital intensity of defence and dual-use ventures and further exacerbates Canada's challenge of retaining sovereign ownership in Canadian companies.

- **Recommendation:** Remove the cap or raise it substantially (e.g., $20M+). Many Canadian companies in aerospace, cyber, advanced materials, and AI require larger cheques to scale. Keeping investments artificially small undermines the effectiveness of the policy.

2. Expand the Definition of Eligible SMBs

- **Current Issue:** Eligibility is restricted to companies under 50 employees (services) or 100 employees (manufacturing). This excludes many scaling Canadian defence and dual-use firms at precisely the stage when capital is most critical.

- **Recommendation:** Redefine SMBs for VCF purposes as companies with up to 250 employees, consistent with international norms. This ensures growing Canadian companies remain eligible for support and are not forced offshore to secure capital.

3. Increase the Multiplier Incentive

- **Current Issue:** At a fixed 5× multiplier, VCF transactions are too complex and administratively heavy to justify for obligators, especially compared with simpler direct investment routes that can offer higher multipliers (up to 9×).

- **Recommendation:** Increase the VCF multiplier to 9×, matching the top end of other ITB transaction multipliers. This would properly reward obligators for using a more sophisticated transaction type that channels capital directly into Canada's innovation ecosystem.

Strategic Rationale

These adjustments would remove artificial barriers and create a compelling incentive structure. Raising the caps and multiplier would:

- Unlock significantly larger pools of Canadian capital for dual-use and defence technologies.
- Support companies at the scale-up stage, where foreign capital often pulls them out of Canada.
- Make VCF transactions competitive with other ITB options, ensuring they are finally utilized.

In short, these reforms would transform VCF transactions from a theoretical tool into a practical, impactful mechanism to mobilize billions of dollars in ITB obligations into Canada's sovereign innovation ecosystem.

Conclusion

Canada stands at a crossroads. While more than $15 billion in ITB obligations remain locked and unused, our allies are moving quickly to strengthen their sovereign technology bases through dedicated pools of early-stage defence capital. Without immediate action, Canada risks falling behind, losing promising companies to foreign ownership, and eroding our ability to control the technologies that underpin both our economic competitiveness and our national security. By reforming the Venture Capital Fund transaction mechanism, we can finally direct this capital to where it is most urgently needed. Unlocking these funds will keep Canadian companies Canadian, protect intellectual property, and ensure that the next generation of dual-use and defence technologies are built in Canada, for Canada. The time for incremental change has passed. Canada must act now to turn policy potential into strategic advantage.

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