DESIGNING AN EFFICIENT SECURITIES MARKET FOR SMALL AND MEDIUM-SIZED ENTERPRISES (SMEs): PERSPECTIVES FOR REFORM

by

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A thesis submitted in conformity with the requirements for the degree of Doctor of Juridical Science (S.J.D.)
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0-612-41087-0
ABSTRACT

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by Stéphane Rousseau

Doctor of Juridical Science (S.J.D.), 1999
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Small and medium-sized enterprises (SMEs) play a vital role in the Canadian economy. While the growth and success of these enterprises do not depend solely on financial support, access to financing is critical for their expansion. In this respect, public equity financing performs a crucial function among the various sources of capital in the funding of growing SMEs. Accordingly, it is essential that smaller enterprises for which going public is justified are able to access the public equity market.

The issue of the accessibility of public equity financing implicates directly securities legislation, which regulates capital markets. Thus, the purpose of this dissertation is to examine the role of securities regulation in enhancing capital formation by entrepreneurial firms. The dissertation focuses more particularly on the initial public offering (IPO) market because of the vital function that it performs in allocating capital to enterprises.

The dissertation analyses the institutional setting in which securities are issued and priced for factors that contribute to an efficient market. Drawing on a review of the empirical research literature on the pricing efficiency of the initial public offering market, it underlines the market imperfections that may hinder SMEs’ access to the equity market and that regulation should seek
The dissertation also studies the regulatory framework governing the IPO market and shows that it is not adapted to the particularities of SMEs and imposes thereby unnecessary barriers to the financing of SMEs. Taking as a starting point the work of the Ontario Securities Commission Task Force on Small Business Financing, the dissertation then examines specific proposals to facilitate securities offerings by SMEs. While the dissertation concerns primarily the IPO market, it addresses some aspects of the development of an active and liquid secondary market for small and medium-sized enterprises. In performing the revision of the regulatory framework, this dissertation emphasises the need for the implementation of a cost-effective regulatory regime governing the securities market.
ACKNOWLEDGEMENTS

In preparing this dissertation, I have received valuable assistance and support from several persons to whom I would like to express my sincere gratitude. My thanks go to professor Jeffrey MacIntosh who, despite a busy schedule, accepted to supervise my work. Professor MacIntosh directed me towards this research area and provided me with insightful and pertinent comments throughout the realization of this dissertation. A particular acknowledgement is also due to professor Hudson Janisch who, as Associate-Dean for Graduate Studies, enthusiastically encouraged me in my research project. Finally, special thanks go to Julia Hall, graduate program co-ordinator, who – with her remarkable sense of humour – provided me with valuable assistance that allowed me to successfully steer this project to its completion.

I would also like to sincerely thank two professors from the Faculté de droit de Université Laval who have played a determining role in my decision to pursue graduate studies in law. My thanks go to professor Denis Lemieux, with whom I have had the privilege of working with for many years, who introduced me to legal scholarship by permitting me to work on stimulating research projects early on during my undergraduate studies in law. Likewise, I would like to thank professor Raymonde Crête who generously transmitted me her interest for legal scholarship in the field of corporate and securities law, a subject often neglected in civil law jurisdictions, and encouraged me to pursue doctoral studies in law.

I am further indebted to Dean Claude Fabien and to all of my colleagues at the Faculté de droit of Université de Montréal who encouraged me in the completion of this dissertation. I wish also to thank the Social Science and Humanities Research Council of Canada (SSHRC) and the Fonds pour la formation de chercheurs et l'aide à la recherche (FCAR) for their financial assistance.

Finally, I would like to express my deepest gratitude to Lyne Pedneault for her patience, comprehension and inestimable support throughout this project.
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INTRODUCTION

Small and medium-sized enterprises (SMES) play a pivotal role in the Canadian economy. They constitute the vast majority of firms in the country, are vital to employment, and contribute to a significant portion of economic activity. The dynamism of small and medium-sized enterprises is particularly critical for the country in the context of the “new economy” which is associated with the rise of knowledge-intensive industries and the decline of goods production in the manufacturing sector. The capacity of SMES to innovate, their flexibility in adjusting to changes in technology and their ability to adapt to current needs have given them a competitive advantage over larger rivals in this new economic setting.

The significant role, which small and medium-sized firms play in the economy, depends to a great extent on their ability, once established, to grow. While the growth and success of these enterprises do not depend solely on appropriate financial support, access to appropriate financing is critical for their expansion. In this respect, it is widely recognised that public equity financing performs a crucial function among the various sources of capital in the funding of growing SMES. Accordingly, government policy should seek to ensure that growing entrepreneurial firms have access to public equity financing.

Since the issue of the access to public equity capital implicates directly securities legislation which regulates capital markets, the purpose of this dissertation is to review the role of securities regulation in enhancing capital formation by entrepreneurial firms. In this respect, this dissertation will focus primarily on the initial public offering (IPO) market because of the vital function that this market performs in allocating capital to corporations. However, given the importance of a healthy secondary market for the success and viability of the primary market, the dissertation will address some aspects of the development of an active and liquid secondary market for small and medium-sized enterprises.

Crucial to the accessibility of public equity financing for SMES is the efficiency of the securities market. An efficient market allows savers to lend their capital at lower cost, resulting in a higher rate of return on assets. In turn, borrowers face lower cost of financing in an efficient
market which facilitates access to capital. Thus, the dissertation will analyse the institutional setting in which securities are issued and priced for factors that contribute to an efficient market. It will identify the market failures that may increase the cost of public equity for SMEs and that regulation should seek to correct.

As will be argued in this dissertation, the existence of imperfections in the market impeding efficiency should however not be taken as necessarily mandating government intervention. Indeed, regulation does not always play a productive and useful role. As we will see, regulation imposes compliance and opportunity costs on issuers that tend to have a high fixed-cost component and affect, thereby, more severely SMEs. Accordingly, a central objective of the dissertation is to review securities regulation in the perspective of implementing a cost-effective regulatory regime. Any case for policy intervention will thus have to demonstrate not merely that market imperfections have an adverse impact on investments under the current regime, but that their impact can be reduced cost-effectively by the proposed policy measure or reform.

In corollary, the goal of cost-effectiveness requires the elimination of policies that impair the efficiency of the market. The goals of market efficiency and investor protection serve as justifications for a complex set of rules which impose significant costs on issuers. Although all issuers incur these costs, the expenses generated by regulation can be especially burdensome for SMEs because of the high fixed-cost component of such expenses. Thus, the dissertation will review the regulatory regime in order to identify the reform needed to adapt it to the characteristics of SMEs.

The dissertation contains six chapters. The first chapter presents the general problematic of SMEs financing and underlines the role of securities regulation in improving the accessibility of public equity financing. The next chapter reviews the empirical research literature on the pricing efficiency of the initial public offering market to assess the degree to which the market price of IPO securities reflects information about firm value. The third chapter then examines the private information networks of the IPO market to determine the role that securities regulation can play to enhance the informational efficiency of the new issues market.

Relying on the findings of the previous chapters, the fourth and fifth chapters review IPO regulation as it applies to SMEs in the perspective of implementing a cost-effective regulatory
regime. Taking as a starting point the work of the Ontario Securities Commission Task Force on Small Business Financing, the dissertation reviews specific proposals to facilitate securities offerings by SMES. In performing the revision of the regulatory framework, it emphasises the need for the implementation of a cost-effective regulatory regime governing the securities market. In the last chapter, some aspects of the development of a secondary market trading system for SMES are discussed.
CHAPTER I

THE NEED TO IMPROVE THE ACCESS OF SMALL AND MEDIUM-SIZED ENTERPRISES TO PUBLIC EQUITY FINANCING

This chapter purports to outline the general problem of the dissertation. It presents firstly an overview of the critical role played by small and medium-sized enterprises (SMEs) in the economy. Underlining the importance of financing in ensuring that entrepreneurial ideas are transformed into growing businesses, it then emphasises the role of public equity financing for SMEs. It notes however that smaller enterprises have difficulty accessing this source of capital because of market imperfections and regulatory barriers that makes it costly to do an initial public offering. Finally, the chapter discusses the role of securities regulation in improving the accessibility of public equity financing for SMEs.
SECTION A: THE GROWING IMPORTANCE OF SMALL AND MEDIUM-SIZED ENTERPRISES (SMES) IN THE CANADIAN ECONOMY

Small and medium-sized enterprises have always played a vital role in the Canadian economy.¹ In the last two decades, economic and technological changes have however made these firms even more important. This section presents the role of SMES in the Canadian economy and discusses their importance for the competitiveness of the country.

1. SMES and the New Economy

The structure of the world economy has undergone major changes over the past two decades because of the technological revolution, the increasing internationalisation of business and the liberalisation of trade.² These changes have lead to what some have called the "new economy"³ or the "new competitor economy".⁴ Along with the intensification of competition in all sectors of the economy, one of the salient characteristics of this new economic environment is the decline of

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¹ There are many ways of defining what are small and medium-sized enterprises. D'Amboise proposes three qualitative criteria to classify enterprises: the geographical scale of operations, the degree of independence and the type of management. According to this author, SMES usually operate in a rather restricted geographical environment. They are independently owned and operated, as well as characterised by personal or direct management, as opposed to professional management. While these criteria are useful in the identification of SMES, they need to be supplemented by quantitative criteria that are really measurement of size. The quantitative criteria generally used relate to the number of jobs the firm supports and to wealth creation. Thus, small firms are considered to be enterprises with fewer than 100 employees in the manufacturing sector and fewer than 50 employees in the service sector, or enterprises that have annual sales below $5 million. Medium-sized firms have up to 500 employees or have sales less than $50 million. Canada, Small Business Working Committee, Breaking Through Barriers - Forging Our Future. (Ottawa: Supply and Services, 1994) at 5 [hereinafter Breaking Through Barriers]; Canada, House of Commons, Standing Committee on Industry, Taking Care of Small Business (Ottawa: Supply and Services, 1994) at 71, 72 [hereinafter Taking Care of Small Business]; G. d'Amboise, The Canadian Small and Medium-Sized Enterprises - Situation and Challenges (Halifax: The Institute for Research on Public Policy, 1991) at 9-20. See also J.G. MacIntosh, Legal and Institutional Barriers to Financing Innovative Enterprise in Canada (Kingston: Discussion Paper 94-10, School of Policy Studies, Queen's University, 1994) at 2, 3 [hereinafter Financing Innovative Enterprise].


resource-intensive industries in the manufacturing sector and the surge of knowledge-intensive industries in the service sector.¹

Much of the growing importance of the knowledge-based economy rests on the increasing use of information and communication technologies. In the knowledge-based economy, knowledge, as embodied in human capital and in technology, is now the determining driver of productivity and economic growth. Thus, 50 per cent of the Gross Domestic Product (GDP) in the major OECD economies is now produced by knowledge-based industries and the fastest rate of growth in output and employment are being recorded by high-technology firms.²

In the new economy, size does not give the same economic advantage to firms as in the past.³ The increase in competition brought by the reduction of trade barriers and the emergence of new countries require additional flexibility and responsiveness from firms that must compete with more efficient producers in other countries.⁴ Large firms may have difficulty adapting to this increasing pressure for change and improvements to products because of the legacy of uncompetitive products, investments and employees. SMEs, however, appear to have the ability to respond more quickly than larger firms to changes in market conditions. In fact, "flexibility enables SMEs to affect major firms' advantages based on their economies of scale and their


⁸ Ibid.


technical and financial resources." Smaller firms react quickly to requests from their environment. They can move away from standardised production more rapidly than larger firms can. Their flexibility also allows them to follow trends identified in a market and give them a competitive advantage in a market where consumer tastes and market conditions change swiftly.

In addition, since smaller enterprises can produce in small quantities, they are not always forced to submit to the demands of mass production. Small orders can still be profitable for them. Thus, these enterprises can produce customised services and products that are increasingly demanded as general income grows.

Moreover, the reduction of trade barriers facilitates the sale of the small firms' products all over the world. The enlargement of the market makes it economic for these firms to develop special products that could not be developed economically for an isolated national market. At the same time, the liberalisation of trade allows small firms to obtain components from suppliers at lower costs, thereby reducing their production costs and permitting them to be more competitive. Furthermore, the rapid diffusion of technological process accompanying the reduction of trade barriers increases the scope for developing new products, as well as the advantages of flexibility and responsiveness. New technology also diminishes the economies of scale enjoyed by large firms by lowering the production costs of smaller firms. The fact that more work can be done with fewer workers has made it possible for small companies to effectively compete with larger ones.

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11. Technology and Competitiveness, ibid. at 23.


13. Ibid.


15. Ibid.; C. Pratten, The Competitiveness of Small Firms (Cambridge: Cambridge University Press, 1991) at 27-34, 115-123 (A survey of small UK firms about the sources of competitiveness of small firms leads the author to argue that the single most important factor for the resurgence of small firms is the faster technical progress and the nature of that technical progress which has thrown up many opportunities for developing new products).
In sum, the technological and economic changes, which have occurred in the last two decades, can explain to some extent the drive shown by SMEs. These changes suggest that SMEs are likely to play a central role in the economy for the future.

2. **The Role of SMEs in the Canadian Economy**

The Canadian economy is dependent on the strength of SMEs. Historically, Canada’s economy has always been essentially based on small and medium-sized enterprises. Data for 1992 show that there were about 2 million SMEs in Canada representing more than 90 per cent of all registered businesses in the country and contributing to close to 60 per cent of the private sector GDP. Over the last decade, the number of SMEs has grown dramatically as these firms accounted for about 99 per cent of the new businesses created between 1982 and 1992. One of the reasons of the spectacular growth of small firms over the last decade may well be the acceleration of the movement of women into the labour force. Women are becoming increasingly entrepreneurial, accounting for more than a third of total business owners in 1996, from less than a quarter in 1979. During the same period, the number of women business owners in the Canadian economy increased by about 150 per cent, while the number of male business owners increased by about 50 per cent.

SMEs not only represent a very significant proportion of Canadian businesses, but are also vital to employment. SMEs have increased their share of employment in the last decade and now

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18 *Statistical Overview*. ibid. at 2.

account for almost two-thirds of private-sector employment. Large businesses with more than 500 employees have conversely experienced a substantial decrease in employment share during that period. Although small business employment varies considerably from one industry to the other, SMEs' activities and employment are more concentrated in sectors that are not capital-intensive, such as services, than in capital-intensive sectors such as manufacturing. Given the shift in most of the world's industrial economies away from manufacturing industries toward the service sector, it is not surprising that these firms have had such a good employment rate growth.

Large enterprises remain nevertheless important for the economy. When jobs associated with newly-created firms are set aside, employment growth in large enterprises is the same as in smaller enterprises. Furthermore, large enterprises appear to be less vulnerable than smaller enterprises to financing constraints, marketing difficulties, and difficulties to hiring qualified employees.

Moreover, larger enterprises dominate the export sector. Indeed, the performance of smaller firms in the export sector is disappointing. Even though the number of SMEs is growing rapidly, they accounted for only nine per cent of the value of Canadian exports in 1992. However, it must

20 Statistical Overview, supra note 17, at 2; Progress Report, supra note 17, at 1. However, a recent study on small firms (those with less than 20 employees) job creation in Canada indicates that only a small number of companies accounted for the growth in employment in the last years. G. Picot & R. Dupuy, "The Concentration of Job Creation in Companies", Canadian Economic Observer, August 1996, at 3.1. Further, SMEs provide new jobs at lower wages. B. Little, "Small Firms Linked to Lower Pay", The Globe and Mail, October 4, 1996, at B1 (Citing a Statistics Canada study).

21 Statistical Overview, supra note 17, at 4-6.

22 However, the disproportionate role of small firms is more evident in the goods-producing and distributive services sector than in the faster growing consumer and business services sectors, where employment growth between small and large firms is less. G. Picot et al., "Small Firms and Job Creation - A Reassessment", Canadian Economic Observer, January 1995, at 3.1; G. Picot & R. Dupuy, Job Creation by Company Size Class: Concentration and Persistence of Jobs Gains and Losses in Canadian Companies (Ottawa: Statistics Canada, Research Paper No. 93, 1996).

22 1 G. Picot & R. Dupuy. Ibid.


23 Statistical Overview, supra note 17, at 14, 15; Taking Care of Small Business, supra note 1, at 23-25. The reliance of SMEs on the domestic market appears to constrain their profitability according to a recent Statistics Canada survey. B. Little, "Biggest Firms Make Biggest Returns", The Globe and Mail, October 31, 1996, at B4.
be emphasised that the value of their exports may be underestimated since some of these firms export indirectly through the sale of goods and services to larger Canadian firms.\(^2^4\) In addition, SMES are the driving force behind a significant proportion of the new export activity, especially in the fast-growing service industry.\(^2^5\) While not every small business will or should export, SMES' export activities remain crucial for the country. Especially, if Canada is to markedly improve its merchandise trade surplus, the biggest potential for growth lies in small and medium-sized firms.\(^2^6\)

The most important role of SMES may however well be to help improve Canada's competitiveness which has been the subject of some preoccupation in the last few years.\(^2^7\) There exist several definitions of competitiveness. A country is competitive at the macro level if it maintains a growth rate of real income equal to that of its trading partners in an environment of free balanced trade.\(^2^8\) Competitiveness can also be defined as "the degree to which a nation can, under free and fair market conditions, produce goods and services that meet the test of international markets while at the same time maintaining or expanding the real income of its citizens".\(^2^9\) More specifically, competitiveness relates to productivity, trade performance and real income.

National competitiveness is better defined by reference to broader indicators that show the extent to which a country's involvement in global markets through trade, investment, and technology flows leads to growth in real incomes. The crucial link between these economic activities and national economic well being is provided by productivity. Growth in productivity is by far the single most important factor determining growth in real wages.

\(^2^4\) Growing to Meet Tomorrow, supra note 17, at 7. Few Canadian firms engage directly in exporting. For instance, in 1992, only 25 per cent of manufacturers made direct export sales; five firms accounted for 24 per cent of all our exports, and 50 firms accounted for over 50 per cent. Industry Canada, Building a More Innovative Economy (Ottawa: Supply and Services, 1994) [hereinafter Building a More Innovative Economy].

\(^2^5\) Statistical Overview, supra note 17, at 14.

\(^2^6\) Building a More Innovative Economy, supra note 24. Industry Canada notes that a great trading culture must be developed among SMES. Accordingly, additional support will be given to these firms to help them to export.

\(^2^7\) See for example M.E. Porter, Canada at the Crossroads - The Reality of a New Competitive Environment (Ottawa: Supply and Services, 1991).


Productivity growth generates the added production of goods and services that underpins increase in wages.\textsuperscript{30}

A number of studies indicate that there has been a decline in the growth rate of real income per capita in Canada in the last two decades stemming essentially from a slowdown in the growth of productivity.\textsuperscript{31} This decline of productivity growth is particularly troubling given that productivity in other industrialised countries increased at a faster rate than in Canada during that period. This suggests that Canada's competitiveness has been declining vis-à-vis that of its new rivals in the global economy which can produce goods and services at a lower opportunity cost.

It is not the purpose of this dissertation to address the factors that have caused the slowdown in productivity in Canada.\textsuperscript{32} Nevertheless, it appears necessary to stress the importance of technological change for the improvement of productivity and real income.\textsuperscript{33} Technological change involves "the advance of society's pool of knowledge of the industrial and agricultural arts taking the form of entirely new products, new designs of existing products, new or improved processes, as well as new techniques of marketing and management."\textsuperscript{34} It is a complex phenomenon resulting from firms' research and development (R&D) activities that is composed of three inter-related stages: (1) inventions which involve the generation of new ideas; (2) innovations which consist of the development of these ideas into products or processes; (3) diffusions whereby the new

\textsuperscript{30} Pulling Together, supra note 2, at 6.


\textsuperscript{32} The four factors most likely to have caused the slowdown in productivity are: weak demand conditions, leading to lower capacity utilisation rate; sharp increases in real energy prices; adverse interindustry shift; and a slower rate of capital accumulation. See The Bottom Line, \textit{ibid.} at 20-26; M.E. Porter, \textit{ibid.} at 53-84.

\textsuperscript{33} The Bottom Line, \textit{ibid.} at 25; Pulling Together, supra note 2 at 34; P. Mohnen, \textit{The Relationship between R&D and Productivity Growth in Canada and Other Major Industrialized Countries} (Ottawa: Supply and Services, 1992) at 1-3; Ontario. Premier's Council, \textit{Competing in the New Economy}, vol. 1 (Toronto: Queen's Printer, 1988) at 28 [hereinafter \textit{Competing in the New Economy}].

\textsuperscript{34} L.N. Switzer, "Adaptation to Technological Change", in L. Sarna, \textit{Corporate Structure, Finance and Operations}, vol. 5 (Toronto: Carswell, 1988) 1 at 6.
technology is spread in the economy.\textsuperscript{35} Stoneman summarises the importance of technological advance for economies:

Technological advance enables economies to produce more or better outputs from given inputs; it opens up new sources of or new types of raw materials; and it can generate success on foreign markets. In fact technological advance is often viewed as the main force in an economy leading to increased output per head.\textsuperscript{36}

Despite the importance of technological change for economic growth,\textsuperscript{37} which is magnified by the current shift to a knowledge-based economy, Canada has a relatively poor technological innovation record.\textsuperscript{38} One indicator of the level of innovative activity of a country is the national commitment to R\&D.\textsuperscript{39} The level of spending by firms on R\&D in 1991 was of 0.8 per cent of the GDP, last among comparable industrialised countries.\textsuperscript{40} The country lags also behind other industrialised countries in the adoption and diffusion of advanced manufacturing technology, a feature of innovative firms.\textsuperscript{41} This poor innovative record can be attributed, namely, to the country's industrial structure characterised by the presence of foreign subsidiaries and natural resources companies, as well as to the small size of the Canadian economy.\textsuperscript{42}

\begin{itemize}
  \item \textsuperscript{36} P. Stoneman, \textit{ibid}, at 16.
  \item \textsuperscript{37} For empirical evidence supporting this view, see P. Stoneman, \textit{ibid}, at 26-34; E. Mansfield, "Microeconomics of Technological Innovation", in R. Landau & N. Rosenberg, \textit{supra} note 29, at 307.
  \item \textsuperscript{39} Research and development encompasses fundamental and applied research, specification and design, and the development of prototypes and plans. See \textit{Pulling Together, ibid}, at 34.
  \item \textsuperscript{41} \textit{Pulling Together, supra} note 2, at 38-40; G.P. Steed, \textit{Not a Long Shot: Canadian Industrial Science and Technology Policy} (Ottawa: Science Council of Canada, 1989) at 40-41.
  \item \textsuperscript{42} \textit{Building a More Innovative Economy, supra} note 24 at; G.P. Steed, \textit{ibid}, at 40.
\end{itemize}
SMEs are likely to be instrumental in improving Canada's poor innovative performance. A recent survey of the Economic Council of Canada indicates that SMEs experience higher level of real R&D growth than larger firms. Further, the tendency of smaller firms to increase their R&D expenditures at a faster pace than larger firms is expected to hold for the period 1994-1999. It is now generally recognised that more than 50% of small businesses are engaged in product or process innovation, which is a level close to that of large enterprises. For this reason, public policy should be directed at nurturing growing firms to increase innovation and the overall competitiveness of the Canadian economy.

SECTION B: THE ROLE OF PUBLIC EQUITY IN FINANCING SMALL AND MEDIUM-SIZED FIRMS

The significant role played by small and medium-sized firms in the economy depends to a great extent on their ability, once established, to grow. Growth is a multidimensional concept that can be defined generally as an increase in the present value of an organisation's resources. It refers more precisely to an increase in the size of the business as measured by number of employees, net assets, sales volume and physical capacity, or to an increase in the domain of the firm as measured by market share, size of the served market, or number of customers. It is vital that the more

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44 R.J. Squires, supra note 40. at 4.

45 Ibid. 4-5.


47 J. Barber et al., "Barriers to Growth: The ACARD Study", in J. Barber et al. (Eds.), Barriers to Growth in Small Firms (London: Routledge, 1989) at 1.

successful business experience growth so that they can account for an increasing fraction of their markets and industries. Indeed, it is difficult for an economy to develop successfully if it relies solely on a high rate of new business activity formation, with each activity remaining small.\textsuperscript{49}

Several factors influence the growth of firms and their evolution to subsequent stages of development.\textsuperscript{50} Graphically stated, to establish themselves successfully on a path of sustained growth, firms must expand their sales, have access to additional resource inputs, and expand their management team and their technological and market knowledge base.\textsuperscript{51} While the growth and success of SMEs do not depend solely on appropriate financial support, access to finance is critical for the expansion of these enterprises.\textsuperscript{52} Indeed, according to a 1994 Statistics Canada survey on small business financing, the biggest impediment to expansion for SMEs, after a need for more orders, is access to capital.\textsuperscript{53} Similarly, the National Advisory Board on Technology noted that access to capital whether for start-up or expansion was the primary financing issue for new or emerging technology firms.\textsuperscript{54}

\textsuperscript{49} Ibid. at 5-7.


\textsuperscript{50} J. Barber et al., supra note 47, at 9-16; The Enterprise Challenge, supra note 48, at 9-12.


\textsuperscript{53} National Advisory Board on Technology, Committee on Financing Industrial Innovation (Ottawa: Supply and Services, 1991) at 14.
A wide variety of financial sources are potentially available to provide debt or equity capital to SMEs during the various stages of their growth and development. At the start-up stage, financing is provided by the entrepreneurs themselves and from friends, relatives and business associates. This seed capital, referred to as "love money," is a significant source of start-up capital for SMEs and arguably vital for high tech ventures. Once established, firms may obtain financing from banks, informal venture capitalists (or business angels), venture capitalists and government programs. Firms that reach a certain level of sustained growth may then contemplate or realise an initial public offering (IPO).

This dissertation does not intend to discuss the issues pertaining to each of those various sources of financing. It focuses rather on one source of financing: public equity capital obtained through IPOs. The focus on public equity financing can be justified on a number of grounds.


56 Financing Innovative Enterprise, supra note 1, at 10. Recently, a survey undertaken for the Canadian Chamber of Commerce found that personal savings and loans by family members and friends were the top three sources of start-up capital for enterprises with less than $1 million in revenues: Taking Care of Small Business, supra note 1, at 44.

57 Banks are the most common sources of business financing and the dominant lenders to small and medium-sized businesses. In their submission to the Berger Committee, banks claimed that at the end of 1993, they had about $30 billion in loans to SMEs, representing about 90% of lending to the small business sector. About 30% of the commercial lending of the Canadian banks goes to small business (loans of less than $1 million). Taking Care of Small Business, ibid. at 9. However, more recent data for 1996 marshaled by the Conference Board of Canada indicate that Canadian banks accounted for about 60% of outstanding SME commercial loans (which totaled $85.6 billion in 1996). See C. Moser & P. Vanasse, What's New in Debt Financing for Small and Medium-Sized Enterprises? (Ottawa: The Conference Board of Canada, Members' Briefing 208-97, 1997) at 2-3. For a critical assessment of the role of bank finance, see L. Wynant et al., Chartered Bank Financing of Small Business in Canada (London: School of Business Administration, 1982).

58 R.T. Harrison & C.M. Mason, "The Role of Informal Venture Capital in Financing the Growing Firm", in Finance for Growing Enterprises, supra note 52, at 77. The informal venture capital (IVC) market represents one of the largest pools of risk capital in the country. According to Riding et al., investments in the IVC market total approximately $500 million to $1 billion annually. Business angels invest about $100,000 annually through a mix of equity and debt, and are particularly active in deals of less than $100,000 from which institutional providers of venture capital shun. A. Riding et al., Informal Investors in Canada: The Identification of Salient Characteristics (Ottawa: Report Submitted to the Federal Department of Industry, Science, and Technology and to the Ministry of Economic Development and Trade of the Province of Ontario, 1993).

59 Infra Chapter III notes 89-138 and related text.

60 For instance, the Small Business Loans Act, R.S.C., c. S-11, assists small businesses in obtaining financing for fixed assets investments. Under the SBLA, the federal government guarantees 90% of loans of up to $250,000 made to authorise small businesses.
At a general level, equity capital appears to be more adapted to SMEs, especially those that operate in knowledge-based industries. SMEs tend to have limited or erratic cash flows which make the fixed payment schedule of debt financing inappropriate or unmanageable. Moreover, debt financing is often difficult to obtain because of the intangible nature of the investments considered by the firms and their lack of bankable assets. Indeed, the level of collateral support required by banks has often the effect of precluding many SMEs operating in the service sector and/or in the knowledge-based industries from raising capital through debt financing because of their lack of hard assets. Debt financing may also be unavailable because firms have reached a level of equity gearing that precludes them from getting more debt capital before they have new equity.

More specifically, two additional factors justify the importance of the public equity market. The first factor emphasises the motivational aspect of going public for entrepreneurs. Jog explains:

[...] entrepreneurs are provided with an additional impetus to start a business and nurture if they have a reasonable expectation that, if and when necessary, capital markets will provide them with monetary rewards by purchasing their equity in the firm at an attractive price.

The second factor refers to the influence of the IPO market as an exit mechanism on the investment strategies on venture capitalists. Exit plays a critical function in the operation of an

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61 B. Eichenlaub, Publicly Traded Canadian Software Product Firms (Ottawa: Industry Canada, 1996) (Equity financing is used extensively by software product firms since it provides the investor with a high return potential and does not create a fixed cash flow requirement on the firm as does debt financing); Financing Innovative Enterprise, supra note 1, at 44-89.


65 The level of gearing refers to the ratio of borrowings to equity or risk capital.


67 V. Jog, supra note 63, at 358. See also E.W. Davis, "The Stock Exchange and the Unlisted Securities Market", in Finance for Growing Enterprises, supra note 63, at 127; Competing in the New Economy, supra note 33, at 178.
efficient venture capital market.\textsuperscript{68} Although there exists a variety of methods venture capitalists can use to exit their investments, IPOs are on average the most profitable exit option.\textsuperscript{69} Thus, a vibrant IPO market provides venture capitalists the incentives to engage in small firm financing.\textsuperscript{70} Furthermore, the high returns generated by successful investee firms that go public that enable venture capital firms to undertake new investments.

Finally, it is worth highlighting the more practical advantages for firms and entrepreneurs of going public:\textsuperscript{71}

1. An initial public offering allows firms to raise new capital to meet the capital requirements underlying their operating and growth objectives.\textsuperscript{72} This injection of new capital may be used to facilitate extension of business, to undertake mergers or acquisitions, or to perform research and development.

2. Publicly traded securities are more liquid than privately held securities and command therefore a higher price. This increased liquidity allows early stage financiers such as venture capitalists and angels investors to sell their investments without having to suffer a penalty due to the illiquidity of their shares. By being able to offer investors a security with liquidity and an ascertainable market value, managers of going public firms have increased financing alternative following the IPO.\textsuperscript{73}

3. Going public improves firms' ability to attract and retain qualified personnel through the use of attractive compensation plans including share incentives, such as stock options and purchase plans that may be taxable at lower rates.\textsuperscript{74} The enhancement of employee

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\textsuperscript{69} J.G. MacIntosh, "Venture Capital Exits in Canada and the United States", in P.J.N. Halpern, supra note 63, at 279.

\textsuperscript{70} J. Lerner, "Venture Capitalists and the Decision to Go Public", (1994) 35 J. Fin. Econ. 293. The growing involvement of venture capital firms in high technology has been associated with the flurry of IPOs of many high-tech companies. See M. Evans, "Take my cash please", Fin. Post, March 16, 1996, at 6.

\textsuperscript{71} A study by Jog and Desroches indicates that the principal reasons given by Canadian firms for going public are: to make acquisitions, to increase working capital, to carry out an operational plan, to improve equipment, and to pay debt. See J.J.Y. Desroches & V.M. Jog, Entrepreneurs and Initial Public Offerings (Halifax: The Institute for Research on Public Policy, 1991) at 58.


\textsuperscript{74} The IPO Process, supra note 72, at 1; Financing Innovative Enterprise, supra note 1, at 42, 43. See M.C. Jensen & K.J. Murphy, "Performance Pay and Top Management Incentives", (1990) 98 J. Pol. Econ. 225 (Executive compensation should be linked to performance).
participation through stock option plans also ties the long-term interest of the employees to the firm and may improve their productivity and their commitment to its success.

4. Public companies gain prestige and heightened public profile. The increased public visibility may attract and facilitate dealings with customers, suppliers and other stakeholders, as well as assist the company in attracting and retaining employees. In addition, the scrutiny under which public firms become may also facilitate future financing. It is easier to sell securities once the company is known from investors.

5. Further, the extension of the firm's equity base resulting from going public improves its debt/equity ratio and permits additional debt to be issued. It also increases the firm's borrowing power since lenders are more likely to be tolerant of higher levels or longer periods of borrowing when the borrower is able to fund these liabilities by a new issue of equity.

Going public has however a number of drawbacks:78

1. A substantial amount of information with respect to matters such as sales and profits, company strategies, mode of operation, material contracts, and the compensation of executives must be disclosed by publicly traded firms which may compromise the firm's competitive position.

2. Going public also reduces the flexibility of the firm's management because of the regulatory restrictions imposed on the management of the operations of the company. For example, the need to obtain approval from the board of directors or the shareholders is often cited as creating a different decision-making process within the organisation that reduces the autonomy of owner-managers.

3. Once a company becomes publicly traded, the focus is put on the market price of the stock. This will force management to "consider the impact on the market price of its stock when making various decisions." Since, investors judge a company's performance by the sales and profits published quarterly, this will put pressure on management to balance the short-term and long-range impact of decisions and strategies. Although this concern for the impact of decisions on stock market price is entirely legitimate, too intense a focus on the day to day stock price fluctuations can limit the practical alternatives of a public company in an unwholesome way.


76 Financing Innovative Enterprise, supra note 1, at 41, 42.

77 G.R.D. Goulet, supra note 72, at 9; M.A. Weisdorf, Going Public and the Public Equity Market (Toronto: CIBC-Wood Gundy, 1996) at 2. It is also easier to obtain loans based on the collateral value of the shares.

78 See generally, The IPO Process, supra note 72, at 3, 4; G.R.D Goulet, ibid., at 10-12.


80 C.W. Scheider et al., ibid. at 4.
4. Going public means a reduction in the control of the company. While there might not be a complete loss of control of the company with the IPO, subsequent public offerings, may progressively dilute the original owners' holding and put control in the marketplace or in the hand of an outsider.\textsuperscript{81}

These drawbacks are generally seen to be outweighed by the benefit of accessing a vast source of equity and by the other advantages outlined above. Accordingly, it is essential that firms for which going public is justified be able to acquire such financing. This requires that the IPO market be efficient and that the regulatory regime governing the access to the market be cost effective.

\textbf{SECTION C: THE EFFICIENCY OF THE SECURITIES MARKET}

The primary function of a securities market is to channel capital from providers of funds to enterprises competing to raise funding. Given the critical role played by \textit{SMEs} in the Canadian economy and the underlined importance of public equity finance for growing \textit{SMEs}, this dissertation is concerned with how well the IPO market is functioning for these firms. In economics terms, this means assessing the efficiency of the market in allocating funds between users and providers and capital.

Market efficiency has important implications for the economy in that it translates into lower financing costs.\textsuperscript{82} In a nutshell, an efficient market allows firstly savers to lend their capital at lower cost, resulting in a higher rate of return on assets. Secondly, borrowers face lower cost of financing in an efficient market which leads to a lower cost of capital that can stimulate investments.

The notion of market efficiency encompasses three different — but nonetheless related — concepts: allocational efficiency, operational (or internal) efficiency, and informational (or external) efficiency.

\textsuperscript{81} \textit{Ibid.} at 5.

efficiency. To understand the role of regulation in promoting efficiency, it is important to define these concepts.

1. Allocational Efficiency

Allocational efficiency is the most important type of capital market efficiency. A capital market that is "allocational efficient" channels funds to users with the most promising investment opportunities. This ensures that "those who can the best use capital are taken care of first and those who make the poorest use of capital are the last to receive it".

The efficient allocation of capital by the market depends on the accuracy of securities prices. In a perfectly efficient market, securities prices reflect the intrinsic value of the firms based on information about the fundamentals. Accordingly, the securities of firms having the opportunities to make the most productive investments will have the most attractive terms for

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85 J.P. Williamson, supra note 83, at 25.


investors and will be able to bid investment dollars away from securities offering less attractive terms.\textsuperscript{88} When the prices of securities are the best indicator of their value, investors can rationally compare firms and invest their funds in "those companies and projects that seem more likely to succeed".\textsuperscript{89} Accurate stock prices thus favours the efficient allocation of capital by directing capital to the most promising investments that offer the greatest returns.

The accuracy of stock prices also induces an efficient allocation of real resources by providing appropriate guidelines for the flow of capital.\textsuperscript{90} Securities prices determine the cost of capital which serves as the primary criterion of firms' investment decisions.\textsuperscript{91} Investments in real resources are undertaken so long as they create value for the firms' owners.\textsuperscript{92} For this to happen, these investments must offer benefits, in the form of returns, above the cost of financing.\textsuperscript{93} If the cost of equity capital is too high for firms this "amounts to raising the hurdle rate investment projects must meet in order to be accepted as profitable".\textsuperscript{94}

When securities prices reflect the intrinsic value of firms, capital is less expensive to promising firms with good investments and more expensive to failing firms.\textsuperscript{95} The attractiveness of the promising firms' securities leads investors to bid up their price thereby permitting these firms to

\begin{thebibliography}{99}
\item J.F. Barry, ibid. at 1317.
\item See generally P. Halpern et al., Canadian Managerial Finance, 3rd Ed. (Toronto: Holt, Rinehar and Winston of Canada, 1989) c. 16.
\item D.R. Harrington, "Capital Budgeting", in D.E. Logue, Handbook of Corporate Finance (Boston: Gorham, Warren & Lamont, loose leafs) at ¶D1.02.
\item J.P. Williamson, supra note 83, at 29-30.
\item L.D. Johnson & B. Pazderka, The Economic & Social Benefits of Stock Markets (Vancouver: The Fraser Institute, 1995) at 90.
\item J.F. Barry, supra note 86, at 1317; H. Wu, supra note 84, at 264.
\end{thebibliography}
sell their shares at a proportionately higher price than less promising firms. This allows firms with the most productive real investments to receive funds first at a lower cost and improves efficient resource allocation by directing scarce resources to those who can best use them.

2. Operational Efficiency

Operational efficiency refers to the cost of performing transactions on the securities market. The expenses that comprise transaction costs are those of using the market to allocate financial resources. Thus, they cover the issuing costs encountered by firms financing their investments with new equity (or flotation costs) and the related costs of having their securities traded on an active secondary market. Transaction costs also embrace those faced by investors to transfer their funds from one firm to another, or from one type of investment to another. In addition, they include information costs that consist of expenses related to the production, acquisition, processing and verification of information. Finally, they encompass the compliance costs generated by the regulatory regime enacted to protect investors from unsuitable ventures. In an operationally efficient market, these costs will be kept at their minimal.

Operational efficiency is necessary to allocational efficiency. As noted by Williamson, "a generally high level of transaction costs makes investment generally less profitable and hence discourages all investment." For instance, high transaction costs in the new issue market will raise the cost of capital for firms and discourage them from using this source of funds to finance their

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97 J.F. Barry, supra note 86, at 1318-1319; W.J. Baumol, supra note 86, at 6-7.
100 J.P. Williamson, supra note 83, at 27.
101 Ibid.
investments. In addition, transaction costs influence allocational efficiency through its effect on informational efficiency as information costs determine the amount of information that is acquired, processed and verified by the market.\textsuperscript{102}

3. \textbf{Informational Efficiency}

An informational efficient capital market is defined as a market in which prices at any time fully reflect all available information.\textsuperscript{103} This definition embraces two different assertions. Firstly, all relevant information with respect to the risk and return of securities is available to the market and is used to assess their underlying values, and therefore to establish their prices.\textsuperscript{104} Secondly, prices adjust rapidly, if not immediately, to any new information about the securities as it becomes available.\textsuperscript{105}

When the securities market is informationally efficient, investors cannot use available information to identify mispriced securities and earn above average returns.\textsuperscript{106} The rapidity with which prices impound new information also precludes investors from making profits from trading on new information that has not been incorporated into securities prices.\textsuperscript{107} Indeed, the prices of securities reflect at all times their underlying value. Further, this implies that securities prices change only when new and unavailable information becomes available. Since such information is by nature unforeseen and unpredictable, prices move randomly and investors cannot predict successfully what prices will do in the future. Thus, an important implication of informational

\begin{footnotesize}
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\item \textsuperscript{102} See in general R.J. Gilson & R.H. Kraakman, \textit{supra} note 99; M. Gillen, \textit{supra} note 87, at 363-365.
\item \textsuperscript{105} \textit{Ibid.}
\item \textsuperscript{106} R. Brealey \textit{et al.}, \textit{supra} note 87, at 322-323; \textit{Note, supra} note 104, at 1039.
\item \textsuperscript{107} J.F. Barry, \textit{supra} note 86, at 1332; R. Brealey \textit{et al.}, \textit{ibid.} at 322-323; J.N. Gordon & L.A. Kornhauser, \textit{supra} note 86, at 770; \textit{Note, supra} note 104, at 1038-1039.
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efficiency is that no investor can earn above average returns through arbitrage because under- or overvalued securities cannot be identified, except by chance. In other words, no one can beat the market.

In a perfectly informational efficient securities market, prices are such that the securities, which have the same degree of risk, should have the same expected returns, i.e. the same cost of capital. This will foster the flow of capital to the most profitable investments by allowing investors to compare alternative investments. The immediacy with which prices respond to new information plays also a critical role in the efficient allocation of capital, as underlines Gillen:

If the prices did not respond immediately it could cause a misallocation of savings to investments in productive assets. Where securities are overvalued for some period of time there could be an allocation of savings to investment in the production of goods and services financed by the sale of those securities which is excessive in relation to the demand for those goods and services. Similarly, where securities are undervalued for a period of time, there could be an allocation of savings to investment in the production of goods and services financed by the sale of such undervalued securities which is inadequate in the relation to the demand for those goods and services.

For a market to be informationally efficient, certain conditions must be met. There should be no transaction costs in trading securities; there should be a large number of buyers and sellers so that prices cannot be controlled by any one buyer or seller; investors should have relatively costless access to all available information; and investors should be equally rational as they agree on the implications of information on securities prices. Under these conditions, prices should reflect all available information.

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109 In fact, this is because there are no under- or overvalued securities in a perfect market. R. Brealy et al., *supra* note 87, at 329-330; D.R. Fischel, *supra* note 83, at 4-5; Note, *ibid.* at 1039.

110 W.J. Baumol, *supra* note 86, at 6-7; Note, *ibid.* at 1067.

111 M. Gillen, *supra* note 87, at 349.

To qualify the degree to which securities markets are efficient, financial economists have developed three forms of market efficiency corresponding to the types of information examined. The market is "weakly" efficient when all information contained in prior price movement is incorporated into security prices. When the market is efficient in the weak form, information about past prices and trends does not "enable an investor consistently to outperform a buy-and-hold strategy in managing a portfolio." The market is "semi-strong" efficient if prices reflect all publicly available information. In a semi-strong efficient market, the market responds instantaneously to any new publicly announced information. Finally, "strong form" efficient capital market prices, reflect not only publicly available information in a but also non-public information. In such a market, it is therefore impossible for insiders to trade profitably on the basis of their unique access to information, because this advantage does not exist.

Empirical studies of market efficiency have found that Canadian and American securities markets are efficient in the weak form. While markets are not efficient in the strong form in either Canada or the United States, empirical evidence does support the semi-strong form of market efficiency in both countries. However, in Canada, professors Daniels and MacIntosh caution that "the relatively less comprehensive empirical record confounds confident and sweeping generalisation as to the efficiency of Canadian capital markets in relation to information that is publicly available." According to these authors, this means "that certain aspects of the Canadian

113 See "Efficient Capital Markets I". supra note 103.
114 J.F. Barry, supra note 86, at 1331; M. Gillen, supra note 87, at 351; Note, supra note 104, at 1041.
115 B.G. Malkiel, supra note 87, at 137.
116 J.F. Barry, supra note 86, at 1331; M. Gillen, supra note 87, at 352; Note, supra note 104, at 1044.
117 R. Brealey et al., supra note 87, at 319; Note, supra note 104, at 1050.
119 R.J. Daniels & J.G. MacIntosh, ibid. at 873-874.
markets conform to the semi-strong efficiency while others do not."\textsuperscript{120} In particular, Daniels and MacIntosh emphasise that concerns can be raised with respect to the informational efficiency of the securities markets with respect to small and medium-sized enterprises.\textsuperscript{121} Indeed, the requisite conditions for a market to be informational efficient may not exist in the segment of the securities markets composed of SMES.\textsuperscript{122} Furthermore, according to one author, these conditions may be especially lacking in the IPO market with respect to these firms.\textsuperscript{123}

\section*{SECTION D: THE ACCESSIBILITY OF PUBLIC EQUITY FINANCING FOR SMES}

In a perfectly efficient capital market, the Modigliani-Miller Theorem states that a firm's value is independent of its capital structure.\textsuperscript{124} The choice among various financial instruments is inconsequential to the value of the firm. Different methods of financing simply determine how a firm's value is divided between its various claimants, not the value itself.\textsuperscript{125} In this model, how an investment is financed is irrelevant to the value it will eventually generate. A firm enhances its value only if it makes good investments, e.g. the kind that enhances the present value of its income stream, which are determined by the technological and product markets.\textsuperscript{126}

\begin{footnotesize}
\textsuperscript{120} Ibid. at 874.

\textsuperscript{121} Daniels and MacIntosh discuss generally this concern. ibid. at 877-883.

\textsuperscript{122} Ibid. See also T.L. Hazen, "The Short-Term/Long-Term Dichotomy and Investment Theory: Implications for Securities Regulation and for Corporate Law". (1991) 70 N.C. L. Rev. 137 at 155, 156 n. 80.

\textsuperscript{123} See in general on the efficiency of the IPO market L.A. Stout, supra note 87, at 656-664.


\textsuperscript{125} R. Brealey et al., supra note 87, at c. 17.

\end{footnotesize}
The Modigliani-Miller Theorem considers financial factors only through the cost of capital. However, the cost of capital is deemed to be independent of the way firms finance themselves because capital markets are assumed to be perfect. Firms are able to secure external finance for a project as long as its expected marginal return exceeds its cost of capital. Since there is no shortage of funds for firms with value-increasing projects and the marginal costs of debt, equity and internal funds are equal. Hence, firms’ investment decisions are independent of its financial condition because external funds provide a perfect substitute for internal capital.\footnote{Small Enterprise Financial Management, ibid. at 72.}

The assumptions underlying the Modigliani-Miller Theorem undoubtedly fail to represent the reality of the financial world in which investors and enterprises evolve. The presence of market imperfections can cause financial factors to affect the cost and availability of capital and thereby influence the firm’s capital and investment decisions. In this context, funds are not perfect substitutes for each other and the cost of funds influences strongly firms’ finance choices. Further, firms may become financially constrained when they have exhausted all their low-cost funds and the high cost of other sources of capital makes them inaccessible.

This section will present a typology of market imperfections which are likely to influence the cost of public equity for firms. It will then review the financial behaviour of SMEs focusing more particularly on the use of public equity financing by these firms to determine whether there are any constraints limiting the use of this source of funding. As we will see, the evidence suggests that the cost of public equity may be too high for SMEs, preventing them from relying on this source of capital to finance their investments.

1. **Market Failures and the Cost of Public Equity**

In a perfect capital market, firms choose indifferently between the various sources of capital available. Market imperfections affect the costs of the different sources of funds and create a financing hierarchy which may cause firms to face financial constraints. In this section we will survey the market imperfections influencing the cost of public equity financing by SMEs.
a) Transaction Costs

The transaction costs of issuing equity establish an advantage for internal finance over this source of financing. Generally speaking, transaction costs arise from the arrangement of an exchange between two parties. Ronald Coase gives a crisp illustration of the factors captured by the expression "transaction costs":

In order to carry out a market transaction it is necessary to discover who it is that one wishes to deal with, to inform people that one wishes to deal and on what terms, to conduct negotiations leading up to a bargain, to draw up the contract, to undertake the inspection needed to make sure that the terms of the contract are being observed, and so on.

The first category of transaction costs incurred by firms issuing equity is the flotation costs. There are two principal components to the flotation costs: expenses and underwriter compensation. Expenses refer to the professional fees of accountants, lawyers, and underwriters, to structure and conduct the transaction. Underwriter compensation includes a direct fee based on a fixed percentage of the issue and warrants issued to the underwriter can be exercised at the issue's price. These costs will be examined more closely in subsequent chapters. Suffice it to mention, at this point, that flotation costs have a large fixed-cost element and represent, therefore, a higher percentage of proceeds for small issues than for large issues. Further, note that an important

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portion of these costs results from securities regulation requirements, an issue that I will explore in
detail in subsequent chapters.\textsuperscript{132} 1

In addition to flotation costs, firms going public face the cost of maintaining a reasonably
liquid secondary market in which investors can trade their shares. The existence of a liquid
secondary market is crucial for the success of new issues since investors value the ease at which a
security can be converted into cash, \textit{i.e.} its liquidity.\textsuperscript{133} If a security is not liquid, investors will add a
liquidity premium when they establish the equilibrium interest rate on the security.\textsuperscript{134} Increasing the
liquidity for securities in the markets decreases the liquidity premium demanded by investors and
reduces overall cost of financing for issuers. As we will see below, the cost of maintaining a
secondary market is however quite substantial for SMES and must be balanced with the benefits
accruing from increase in liquidity.\textsuperscript{135}

b) Imperfect Information and Agency Problems

The asymmetric distribution of information between outside investors, who provide capital, and
managers, who control its use, creates two important problems which can raise the cost of public
equity. The first problem concerns \textit{ex ante} information regarding the quality of firm seeking
financing. When information interesting the quality of investments is asymmetrically distributed
between potential investors and owner-managers, an adverse selection problem may arise leading to
a breakdown or a severe limitation of the market. The second problem involves the uneven
distribution of \textit{ex post} information between investors and owner-managers concerning the
behaviour of the latter. Given the agency relationship that exists between equityholders and firm

\textsuperscript{132} 1 For an overview, see \textit{Financing Innovative Enterprise, ibid.} at 43-49.


\textsuperscript{134} P. Halpern \textit{et al.}, \textit{supra} note 91, at 53.

managers, *ex post* asymmetric information increases the risk of moral hazard by making it easier for firm managers to pursue their own interests at the expense of firms' equityholders.

i) **Adverse Selection**

Substantial information differences exist between managers of firms seeking public equity finance and potential equityholders. Indeed, managers typically possess valuable information about the value of the firms' existing assets, the return from new investment projects, as well as their own industriousness and moral rectitude, which is not available to potential investors. This information asymmetry can firstly be caused by an inadequate supply of information by these firms. As closed corporations, SMES do not have to comply with stringent financial information reporting requirements and this information remains generally private and unavailable to potential investors. In addition, because of their young age, smaller enterprises tend to have relatively unsophisticated information and accounting systems and usually lack a good track record of their past performance. This information problem is exacerbated by the reluctance of managers to disclose information to outsiders to promote their self-interest or for fear of compromising the firm's competitive edge.

Information asymmetry can also exist because of defectiveness in the demand for information. The relatively poor quality of information available on SMES makes it difficult and

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138 *Financing Innovative Enterprise*, supra note 1, at 68; *Small Firm Management*, ibid. at c. 3.

expensive for potential investors to gather information in order to assess the value of the firms seeking financing. In this respect, prospective investors will suffer from the relative disinterest of financial intermediaries, such as analysts or rating agencies, towards smaller closely held firms that can provide independent information on these firms. Indeed, few financial intermediaries collect and analyse information on these firms because of the small size of the market for financial information for closed corporations.

Moreover, the evaluation of the information collected can be hampered by some difficulties. Investors may not be sophisticated enough to assess correctly the available information and make the appropriate inquiries. Appraising the value of innovation-based projects of firms operating in the high technology industry and evaluating ex ante the qualities of firm managers as well as their risk preference may also prove to be complicated for investors, without the assistance of financial intermediaries. Besides, even if investors have access to reliable information on enterprises, it is more likely that managers will know better what this information means for the firm. Indeed, managers possess organisational knowledge of their firm acquired through work which can hardly be matched by any investors.

The ex ante superior information possessed by managers creates an adverse selection problem which can raise the cost of equity for SMEs. Since in the presence of information asymmetry it is difficult for potential equityholders to evaluate the value and prospects of firms,


142 Small Firm Management, supra note 137, at 59.

143 C.P. Himmelberg & B.C. Petersen, supra note 139, at 39; Financing Innovative Enterprise, supra note 1, at 69. The evaluation of high tech firms can be complicated by the intense marketing efforts made by these firms with respect to their new products. See R.A. Prentice & J.H. Langmore, "Beware of the Vaporware: Product Hype and the Securities Fraud Liability of High-Tech Companies", (1994) 8 Harv. J. Law & Tech. 1.

144 S.C. Myers & N.S. Majluf, supra note 136, at 196; R.T. Harrison & C.M. Mason, supra note 58, at 84.

firm managers will generally tend to exaggerate their capacities and the value of their projects in order to get the highest price for the security offered, and will leave to potential investors the task of distinguishing between good and bad investments. In such a case, rational investors can choose to invest in information gathering in order distinguish the quality of the projects. However, this solution involves a substantial investment that may only be justified for a large equity investor, unless the costs of this activity can be supported by a large number of investors interested in the venture.

When information transfer is incomplete, either because it is impossible or too costly, investors will prefer paying a price for the firm's equity that reflects the average of the population of firms seeking financing. Investors will demand a premium to buy the equity of firms with good projects to offset the losses which arise from funding firms with bad projects. When imposed on relatively high quality firms, this premium will raise the cost of public equity finance to a level such as projects which merit financing (positive net-present-value projects) will not be undertaken to avoid the excessive cost of this source of capital. As a corollary, since firms with good projects will prefer not to use public equity to finance their projects, investors will interpret the decision to issue new shares as a signal that investment opportunities are not expected to be very promising. The cost of the equity will be low enough to allow some bad risk projects that should not proceed to go ahead and lower quality firms will not be reluctant to raise public equity. Ultimately, as a result

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147 H.E. Leland & D.H. Pyle, supra note 136, at 371; H.R. Stoll, ibid. While different mechanisms exist to spread the cost of information gathering and processing among investors, it is possible to believe that the information asymmetry is never completely resolved between managers and potential shareholders. These mechanisms will be examined further below. At this point, I want to emphasise the consequence of adverse selection created by information asymmetry.


149 S.C. Myers & N.S. Majluf, ibid.; H.E. Leland & D.H. Pyle, supra note 136, at 371. This assumes that managers act in the interest of existing shareholders and will therefore avoid actions that will reduce the value of their investments.

of adverse selection, too few high quality projects will go ahead and too many low quality projects will be implemented, leading to the failure of the market as investors refuse to participate\textsuperscript{151}.

The impact of adverse selection on the level of firm investment has received considerable support in the empirical literature. Several studies have shown that information asymmetry drives a wedge between the cost of internal and external funds.\textsuperscript{152} These studies indicate that firms likely to suffer from information asymmetry depend more on internal funds than external funds to finance their investments. However, asymmetric information not only gives rise to an adverse selection problem, it also influences the level of agency costs resulting from the sale of securities to outside investors which can raise the cost of external funds.

\textit{ii) Moral Hazard}

The sale of securities to outside investors entails a separation between ownership and management which creates an agency relationship between the managers and shareholders of the firm.\textsuperscript{153} In this relationship, shareholders, who act as principals, delegate to managers, their agents, the authority over corporate affairs. The delegation of decision-making from shareholders to management is essential for publicly held corporations given the high transaction costs and diseconomies of scale associated with shareholder management.\textsuperscript{154} While the separation of ownership and management is efficient and arguably enhances the productivity of shareholders' capital, it also leads to agency

\textsuperscript{151} H.E. Leland & D.H. Pyle, \textit{ibid.}, at 371.


problems arising from the conflict of interests between the agent and the principals. Indeed, if unconstrained, management will tend to maximise their own welfare rather than the shareholders'. In the words of Jensen and Meckling, "[i]f both parties to the relationship are utility maximisers there is good reason to believe that the agent will not always act in the best interests of the principal."

When ownership and management are united, there is no scope for agency conflicts since owner-managers bear the costs of any opportunistic behaviour. However, once owner-managers sell a portion of the firm's securities to outsiders, the owner-managers enjoys the full benefits of non pecuniary benefits consumption, while bearing only his proportional ownership fraction of the reduction in the value of the firm's shares. Accordingly, as the owner-managers' ownership fraction of the equity falls, their incentives to engage in perquisite consumption increases.

Agency conflicts arising from the separation of ownership and management take different forms. For instance, managers may redistribute wealth to themselves in an unseen manner, to the detriment of investors, through excessive consumption of non-pecuniary benefits or perquisite such as excessive remuneration, lavish offices, expensive company cars, and the like. Managers of high technology firms enjoy relative freedom to strip assets out of the firms because of the intangible non fixed nature of the assets of these firms, which makes it harder to shareholders to detect this form of opportunistic behaviour.

Managers may also be tempted to shirk their responsibilities as their equity interests falls by devoting less efforts managing the firm or searching out new profitable ventures. Detecting

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156 M.C. Jensen & W.H. Meckling, supra note 74, at 306.
158 R.J. Gilson, supra note at 154, at 837.
159 *Financing Innovative Enterprise*, supra note 1, at 81.
160 M.C. Jensen & W.H. Meckling, supra note 74; R.J. Gilson, supra note 154, at 837.
shirking might be difficult in the case of high technology firms given the complexity of the projects in which these firms are involved. The outcomes of the projects may not be easily measured, thus complicating outside investors monitoring. However, according to MacIntosh, owner-managers of high technology firms are less likely to engage in shirking "given that entrepreneurs are self-selecting individuals of high motivation with a drive to succeed".

In addition, managers may be unduly-risk averse and pass up profitable investment opportunities that the firm's shareholders would prefer to invest in. Owner-managers will have a tendency to be risk-averse since they have a substantial portion of their personal wealth invested in their firms. Any loss incurred by the firms will have potentially important direct consequences on their jobs and investments. This will be especially true for SMEs where owner-managers have relatively undiversified portfolios and generally lack the protection of limited liability. Accordingly, they will prefer projects that are safe but offer a lower expected return than riskier net present value ventures which would maximise firm value, whereas outside shareholders who hold diversified portfolios will tend to have the opposite preference. Thus, it is possible that SMEs owner-managers engage in risk shifting by inappropriately reducing the risk of their firms at the detriment of shareholders. While, the high level of uncertainty surrounding the estimation of the risk of SMEs might make it more likely that their owner-managers will engage in risk shifting, this probability should not be overstated since one of the fundamental characteristics of entrepreneurs is that they are risk takers.

Aware of the risk of agency conflicts, rational investors can make estimates of the costs associated with this moral hazard and pass these costs back to the owner-managers by increasing

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161 K.M. Eisenhardt, supra note 146, at 60.
162 Financing Innovative Enterprise, supra note 1, at 81.
164 Small Firm Management, supra note 137, at 9; Small Enterprise Financial Management, supra note 126, at 75. See also Financing Innovative Enterprise, supra note 1, at 82.
the reward expected in return for their participation in the firm. In addition, through resource expenditures, it is possible for shareholders to reduce the opportunity the managers have to capture non-pecuniary benefits. Shareholders can choose to monitor the behaviour of managers and get access to the hidden information that will reveal whether managers are acting in a manner contrary to their interests and thereby prevent such behaviours.

In order to avoid a reduction in the price of their firms' share value, managers will also expend resources, called "bonding costs" by Jensen and Meckling, to guarantee to outside investors that they will limit their opportunistic behaviours. For instance, management can incur third-party monitoring costs designed to make it more difficult to engage in adverse behaviour. Contracts can also be devised where managers formally bind themselves to agreed types of behaviour and provide sanctions should the behaviour deviates from that stipulated in the contract. Another way to align the goals of principal and agents is through incentive compensation schemes which "create specific positive inducements for a manager to exert optimal effort and to make efficient decisions."

Agency conflicts are not costless for firms since it is generally impossible to align at zero cost the interests of agents and principals. In the words of Jensen and Meckling:

In most agency relationships the principal and the agent will incur positive monitoring and bonding costs (non-pecuniary as well as pecuniary), and in addition there will be some divergence between the agents' decision and those decisions which would maximize the welfare of the principal.

The sum of the costs of the prevention of moral hazard along with the loss in firm value resulting from the impossibility to entirely align the interests of management and shareholders are

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165 A. Barnea et al., "Market Imperfections, Agency Problems, and Capital Structure: A Review", (1981) Fin. Mgmt. 7 at 11; Small Enterprise Financial Management, ibid. at 81. However, shareholders must have sufficient information to discount adequately the shares of the firm.

166 Monitoring can be undertaken in different ways. A.G. Anderson, supra note 154, at 778-780; K.M. Eisenhardt, supra note 146 at 61; M.C. Jensen & W.H. Meckling, supra note 74.

167 M.C. Jensen & W.C. Meckling, ibid.; K.M. Eisenhardt, ibid. at 60.


169 M.C. Jensen & W.H. Meckling, supra note 74.
called the agency costs of equity. These costs increase with the presence of information asymmetry which makes it difficult for outside shareholders to evaluate managers' risk preferences and to engage in effective monitoring to distinguish between opportunistic and non-opportunistic behaviour. The cost of maintaining the agency relationship will therefore likely raise the cost of public equity.

Resolving the agency problem does not require a total elimination of the conflict of interests between managers and shareholders given the costs of monitoring and preventing opportunistic management behaviour. Rather, the solution is to minimise the sum of adverse management behaviour and the costs of its prevention. Stated differently, "the solution should minimize the sum of the existing inefficiencies and the costs of the solution."

2. The Financial Behaviour of SMEs

The theoretical arguments presented in the previous section suggest that market imperfections affect the cost of public equity capital for SMEs. Recent empirical research confirms the theoretical arguments and indicates that market imperfections in capital markets weigh more heavily on small and medium-sized enterprises. In particular, the impact of market imperfections is reflected both on the financing and investment decisions of SMEs.

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171 Small Firm Management, supra note 137, at 40; Financing Innovative Enterprise, supra note 1, at 68.

172 S.D. Oliner & G.D. Rudebush, supra note 128, at 653. These authors find no evidence of a relationship between the ownership structure of corporations, used as a proxy for agency costs, and the preference of firms for internal funds over external funds. However, the ownership data concerned only relatively mature firms.


174 Note, supra note 104, at 1160.
Many commentators have remarked that the existence of market imperfections in capital markets cause the cost of capital to differ by source and providers of funds. This variation in the cost of capital creates a "financing hierarchy" or "pecking order" in which internal funds have a cost advantage over new debt or equity finance. In this model, firms prefer using internal funds rather than external funds to finance their investments because of the higher cost associated with external funds and its impact on the profitability of the investments. When all of the low-cost internal funds are exhausted, firms accordingly rely on their cash flow to finance investments, unless the cost disadvantage of external finance is small. In such cases, firms' investments are driven by the fluctuations in their cash flows and not by the existence of profitable investments.

While the investment behaviour of larger enterprises is consistent with the existence of a financing hierarchy, empirical studies indicate that market imperfections affect particularly severely SMEs in that these enterprises are found to rely more on internal funds than larger enterprises to finance their investments. Empirical evidence also shows that the flow of internal capital is the principal determinant of the rate at which small high tech firms acquire technology through research and development. This suggests that small firms with growth opportunities closely tied to

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177 S.M. Fazzari et al., supra note 128, at 183.

178 Ibid.

179 Starting with Fazzari, Hubbard and Petersen, a number of empirical studies have found the existence of a strong correlation between cash flows and investments supporting this theory. S.M. Fazzari et al., ibid. (cash flow and investment are strongly correlated for low-dividend firms); H. Shaller, supra note 128, (young firms pay a higher price for new equity financing than more mature firms and their investment spending is more influenced by liquidity); J.A. Weinberg, supra note 126 (smaller firms rely more on internally generated funds to finance their investments activities). See also M.R. Binks et al., "Information Asymmetries and the Provision of Finance to Small Firms", (1992) 11 Int'l. Small Bus. J. 1. It is worth noting that a correlation between investment and cash flow does not per se establish that investment spending is constrained by the availability of internal funds. To determine whether this correlation really implied the existence of financial constraints, the literature uses different investment models. See S. Bond & C. Meghir, "Financial Constraints and Company Investment", (1994) 15:2 Fiscal Studies 1 at 7-9.

180 C.P. Himmelberg & B.C. Petersen, supra note 139.
research and development have difficulty relying on the external capital markets as the primary source of financing.  

The important role played by liquidity in determining SMES investments is troubling given that cash flows do not provide an adequate source of financing for these firms' investments. Especially in the early stage of their operations, SMES may not generate positive or sufficiently constant level of cash flow in the form of profits to finance investments. In addition, for high tech firms, innovation projects do not generate cash receipts before a long time. Therefore, most of the projects of high tech firms cannot be internally funded and require external financing. Accordingly, the high cost of external funds can act as a significant barrier on the growth and development of SMES. SMES are well aware of this problem as they identify the availability and cost of finance for expansion as one of the most important constraint which they face.

More specific evidence on the financial behaviour of SMES also reveals that these firms are less likely to raise and use public equity financing. In particular, the examination of the capital structure of SMES indicates that market imperfections have a significant impact on the cost of public equity capital. Several Canadian studies show that SMES have a deficient capital structure with insufficient equity and long-term capital and too much reliance on short-term debt. For instance, a study conducted by Jog and Shaller on the balance sheet of small Canadian firms for the years 1980 to 1987 reveals that, on average, some 50.6 per cent of SMES capital consist of debt finance, with

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181 See also S.C. Vogt, supra note 152.

182 D. Brophy & J. Shulman, "Financial Factors Which Stimulate Innovation", (1993) 17 E.T.&P. 61. In addition, we have seen that debt may not be an appropriate financing instrument for SMES.

183 See e.g. Canada Consulting Group, Under-Funding the Future: Canada's Cost of Capital Problem (Ottawa: 1992) c. IV.

184 J. Baldwin, supra note 52, at 13; E. Norton, "Factors Affecting Capital Structure Decisions", (1991) 26 Fin. Rev. 431 at 438 (managers identify capital markets as their primary concern when making financial decisions rather than clients or some market segments).

20.2 per cent coming from short-term trade credit.\textsuperscript{186} About 25.4\% of the financing of the firms are provided by shareholders' equity in the form of retention and paid-in-capital, while the rest of the capital comes from affiliates and other instruments.

Furthermore, it appears that Canadian SMES have a lower rate of initial public offerings in comparison with their American counterparts. In 1982, the Economic Council of Canada noted that the number of small public offerings (less than $2 million) of industrial shares in the United States in the period 1977-1981 was 234 times the Canadian number.\textsuperscript{187} While this study is now dated, more recent data indicate that Canadian firms go public less often than American firms.\textsuperscript{188} Moreover, anecdotal evidence suggests that an increasing number of firms, especially in the technology sector, prefer going public in the United States arguing that they get a better evaluation from more knowledgeable and less risk-adverse investors.\textsuperscript{189}

This low rate of going public is particularly disquieting given the slower growth path of Canadian SMES noted by Sharwood. Sharwood estimates that between 1978 and 1986, only 0.38 percent of small businesses (less than 100 employees) graduated to become medium-sized (100-499), whereas during the same period in the U.S. 15 percent of small business graduated to the medium-sized category.\textsuperscript{190} Further, over this period in Canada, none of the medium-sized

\textsuperscript{186} Trade credit is a form of short-term debt that includes accounts payable, short-term debt due to affiliates and other current liabilities. Unfortunately, Jog and Shailer's study does not provide a breakdown of the composition of the debt instruments used by SMES. V.M. Jog & H. Shailer, supra note 128, at 13-16. See also "National Survey on the Financing of Small Business", \textit{The Daily}, November 15, 1994, at 15 (Statistics Canada - Cat. No. 11-001E) (Small business with fewer than 50 employees generally rely on loans for their financing).

\textsuperscript{187} Economic Council of Canada, \textit{Intervention and Efficiency} (Ottawa: Supply and Services, 1982).

\textsuperscript{188} \textit{Financing Innovative Enterprise}, supra note 1, at 52.


\textsuperscript{190} \textit{Taking Care of Small Business}, supra note 1, at 5. See also Canada, \textit{Report of the Royal Commission on Corporate Concentration} (Ottawa: Supply and Services, 1978) at 257-259 noting that Canada has a lower ratio of medium-sized firms to larger firms in many industries.
enterprises expanded into the category of large corporations. These results are made even more worrisome by the continuing decrease in the number of business start-ups since 1988-89.\(^{191}\)

Although they constrain the capital structure and investment decisions of SMEs, market imperfections are not the only factors which impede the accessibility of public equity financing for small enterprises.\(^{192}\) Regulation can also influence the cost of public equity financing facing small enterprises. Thus, as discusses the next section, public policy should seek to eliminate not only market imperfections but also regulatory requirements that unnecessarily increase the costs of public equity capital for SMEs.

**SECTION E: THE ROLE OF SECURITIES REGULATION IN IMPROVING SMES' ACCESS TO PUBLIC EQUITY FINANCING**

Securities regulation has two broad purposes.\(^{193}\) Firstly, regulation seeks to promote the economic functioning of the market so that funds are allocated efficiently to firms who will use them the most effectively.\(^{194}\) Secondly, it aims at protecting investors by ensuring the fairness and honesty of the market in order "to instil and maintain the confidence of investors in the trustworthiness of the securities market".\(^{195}\) The limited use of public equity financing by SMEs challenges both of these regulatory goals in different ways.

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191 The number of start-ups peaked in 1988-89 at 165 980 and has been falling ever since. *Statistical Overview*, supra note 17, at 9-12.


194 See *Report of the Attorney General's Committee on Securities Legislation in Ontario* (Toronto: Queen’s Printer, 1965) at para. 1.06, 1.08-1.10 [hereinafter *Kimber Report*]

195 G.R.D. Goulet, *supra* note 72, at 68. See also *Kimber Report*, *ibid.*, at para. 1.06, 1.12.
The financial behaviour of SMEs, which suggests that public equity capital is too costly for smaller enterprises, indicates that this segment of the securities market may not be characterised by a high degree of efficiency. This possible inefficiency of the market for SMEs securities is worrisome as it may hamper the growth and competitiveness of smaller enterprises.196 Thus, a central objective of this dissertation is to examine the efficiency of the market for SMEs securities and to determine whether it can be improved by regulation. In performing this analysis, the dissertation will focus primarily on the initial public offering market because of the vital function that it performs in allocating capital to corporations.197 Recall that stock price accuracy affects capital allocation directly only when firms raise capital, i.e. when they issue, or consider issuing, securities.198 When firms issue equity, the price obtained for the securities sold, along with the number of securities sold, determine the amount of capital raised by the firm for investment purposes. However, the price at which a firm's shares are traded on the market does not influence the amount of capital that is allocated to it.199 Accordingly, "to induce an efficient allocation of capital, it is of paramount importance that stocks are accurately priced whenever companies issue stock".200

While the accuracy of stock prices in the secondary market appears less important for the efficient allocation of capital, it must be stressed that the operational and informational efficiency of this market remain nevertheless valued by investors and influence the cost of capital in the new issue market. Indeed, investors will require a premium to buy the securities of firms that are expected to be traded on an inefficient and illiquid secondary market.201 From this it follows that the existence of a healthy secondary market is not unrelated to the success and viability of the primary

196 M. Kahan, supra note 86, at 1039-1041.

197 Even though the primary market plays a critical role in capital allocation, its efficiency has been traditionally neglected by regulators more concerned with secondary markets. See L.A. Stout, supra note 87, at 663-665.

198 M. Kahan, supra note 86, at 1012-1013; L.A. Stout, ibid., at 651.

199 Ibid.

200 M. Kahan, ibid., at 1013.

market and, consequently, to the efficient allocation of capital.\textsuperscript{202} Hence, without attempting to discuss the full range of issues pertaining to the efficiency of the secondary market, this dissertation will address some of the salient aspects of the development of an active and liquid secondary market for small and medium-sized enterprises.

The revision of the regulatory framework governing the initial public offering market will be undertaken keeping in mind that the high cost of public equity is not only the product of market imperfections, but also caused by regulation. As we will see in subsequent chapters, regulation imposes compliance and opportunity costs on issuers that tend to have a high fixed-cost component and affect, thereby, more severely SMEs.\textsuperscript{203} The importance of the burden imposed by those regulatory costs on SMEs is such that it has been remarked that “an unintended by-product of securities laws has been the erection of an artificial barrier to entry for small and new enterprises seeking to issue securities in order to raise development capital.”\textsuperscript{204}

From this perspective, this dissertation will review securities regulation as it applies to SMEs in the perspective of implementing a cost-effective regulatory regime.\textsuperscript{205} Any case for policy intervention will thus have to demonstrate not merely that market imperfections have an adverse impact on investments under the current regime, but that their impact would be reduced cost-effectively by the proposed policy measure or reform. Stated differently, when contemplating the desirability of an intervention, we will not compare the real with the ideal, but rather the various

\textsuperscript{202} Ibid.; G.R.D. Goulet, \textit{supra} note 72, at 359-361; M. Mendelson & J.W. Peake, "Intermediaries' or Investors': Whose Market is it Anyway?", (1994) 19 \textit{J. Corp. L.} 443 at 444; N.S. Poser, \textit{supra} note 133, at 886.

\textsuperscript{203} \textit{Financing Innovative Enterprise, supra} note 1, at 43-49, 115-130; B.R. Cheffins, \textit{supra} note 129, at 203-211; D.G. Hartle, \textit{Public Policy Decision Making and Regulation} (Halifax: The Institute for Research on Public Policy, 1979) at 166-167.

\textsuperscript{204} R.D. Baysinger, \textit{supra} note 132, at 89.

real alternatives. Ultimately, as Mintz remarks, "it might be that governments cannot achieve anything at all to improve the performance of capital markets."206

In corollary, the revision of the regulatory regime will seek to eliminate policies that impair the efficiency of the market. This will require determining whether the benefits generated by the policies reviewed are greater than the costs they impose on issuers.207 Since the goal of investor protection has traditionally been the central rationale of the regulatory regime,208 it can be expected that the revision of the regulatory regime will lead to a challenge of the justifications offered to support the need to protect investors in securities markets.

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206 J.M. Mintz, supra note 82, at 741-742.

207 Ibid. at 11: Financing Innovative Enterprise, supra note 1, at 92-93.

208 P. Anisman & P.W. Hogg, "Constitutional Aspects of Federal Securities Regulation", in Proposals for a Securities Market Law for Canada, supra note 83, 135 at 138: "Securities legislation, therefore, has generally been intended to increase investor confidence by ensuring the fair operation of the market with the ultimate purpose of enhancing its efficiency."; D.L. Johnston, supra note at 1: "The traditional goal of securities regulation has been the protection of investors." Kimber Report, ibid. at 1.06. See also W.M.H. Grover & J.C. Baillie, "Disclosure Requirements", in Proposals for a Securities Market Law for Canada, supra note 83, at 349; J. Seligman, "The Historical Need for a Mandatory Corporate Disclosure System", (1983) 9 J. Corp. L. 1.
Small and medium-sized enterprises play an important role in the Canadian economy. It is therefore crucial to ensure that appropriate conditions are in place to foster the creation and growth of SMES. A central policy issue in this respect is the access of these enterprises to appropriate financing.

This dissertation focuses on public equity financing which performs a crucial function among the various sources of capital in the funding of growing SMES. Access to public equity financing appears to be problematic for SMES as market imperfections and regulatory barriers raise the cost of this source of capital. Accordingly, there may be a role for public policy to enhance the accessibility of public equity financing for SMES. However, it is argued that public policy should seek the implementation of a cost-effective regulatory regime.
CHAPTER II

THE PRICING EFFICIENCY OF THE INITIAL PUBLIC OFFERING (IPO) MARKET: THEORIES AND EVIDENCE

In the previous chapter, we argued that SMEs may have difficulty accessing public equity financing because of the existence of market imperfections and regulatory barriers which raise the cost of this source of capital. In this chapter, we examine more closely the operation of the initial public offering market (IPO) to determine how market imperfections affect the pricing of newly issued securities. In particular, we review the empirical research literature on the pricing efficiency of the IPO market to assess the degree to which the market price of IPO securities reflects information about firm value. Two specific pricing anomalies are identified. Firstly, empirical studies report evidence of consistent underpricing of newly issued securities resulting in large initial returns accruing to investors. Secondly, the studies show that IPO securities are overpriced in the long run in that they under-perform non-IPO securities. To provide an understanding of these two pricing anomalies, we examine the various theoretical models put forward to explain the underpricing and long-run under-performance of IPOs.
SECTION A: THE UNDERPRICING OF INITIAL PUBLIC OFFERINGS

Initial public offerings play a central role in allocating resources in the economy. Because of the importance of IPOs, financial economists have devoted considerable attention to the pricing of newly issued securities. A first group of noteworthy studies examine the pricing efficiency of the IPO market by comparing the offering price of new issues with the price at which securities trade in the after-market. These empirical studies consistently find that newly issued securities are, on average, underpriced. In this section, we present the empirical evidence on the underpricing of IPO market marshalled by financial economists and discuss the various theoretical models offered to explain this systematic mispricing.

1. Empirical Evidence of Underpricing

The short-term performance of new issues' price appears to be inconsistent with efficient markets and with effective information processing by IPO market participants. Indeed, it is now well recognised by the finance literature that IPOs are, on average, underpriced.\(^1\) Underpricing is essentially a short-term phenomenon and implies that large initial returns accrue to investors of IPOs of common shares because of price changes between the offering price and the market price at the end of the first day or within the first few weeks after the offering.\(^2\)

This well-known anomaly of the IPO market, which exists in every country that has a stock market, has been the subject of abundant academic studies around the world.\(^3\) However, it is in the

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United States that researchers have devoted the most attention to this phenomenon following the pioneer study of Ibbotson. While it is beyond the scope of this study to review the vast American literature on this subject, it is necessary to highlight its most salient findings.

Firstly, the underpricing of initial public offerings is a persistent phenomenon that shows no sign of abating in the United States. Thus, the average initial returns accruing to investors of IPO for the decade of the 1960s were 21.3 per cent, 9 per cent for the 1970s, 15.2 per cent for the 1980s, and 10.9 per cent for the 1990s. For the period 1960-1992, the average underpricing was of 15.3 per cent.

Secondly, the extent of this underpricing is highly cyclical, with some periods in which the average initial returns appear to be systematically larger than in other periods. For example, Ritter, who documented the periods in the post-war era where underpricing has been particularly high, reports that in 1980 and 1981 the average initial return was over 48 per cent for IPOs. These periods where IPOs seem to be flagrantly underpriced, referred to as 'hot issue' markets, arguably coincide with one or a few industries in the natural resources sector experiencing a high run-up in their value.

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5 R.G. Ibbotson et al., supra note 1, at 69.
6 Ibid.
7 Ibid. at 66.
9 Hot issue markets were first documented by R.G. Ibbotson & J.F. Jaffe, "'Hot Issue' Markets", (1975) 30 J. Fin. 1027.
Finally, the American studies suggest that *endogenous* factors to the issuer are potential determinants of the level of underpricing. More specifically, initial returns are found to be usually inversely related to issuer quality as proxied by factors such as the size of the firm, the amount of the proceeds, or the level of sales. Thus, smaller offerings are underpriced, on average, by more than larger offerings.

Early studies in Canada based on data from periods prior to 1970 indicated a degree of IPO underpricing in excess of 40 per cent. However, recent studies suggest that the average degree of underpricing for Canadian IPOs has decreased continuously since these first studies. Jog and Riding, in a 1987 study based on 100 firms that went public on the Toronto Stock Exchange (TSE) in the period 1971-1983, found that Canadian IPOs were underpriced by 9 to 11.5 per cent, on average, with 60 per cent of issues underpriced and 40 per cent overpriced. A more recent study by Jog examining 383 IPOs on the TSE for the period 1971-1994 seems to confirm this tendency towards a lower degree of underpricing. Jog's study shows that the average underpricing for the period 1984-1994 was 7.89 per cent with less than half of the issues underpriced. Furthermore, the results indicate that the annual underpricing for this period has remained below 7 per cent in all but two of the years. In addition, the study reveals that the state of the market influences the degree of underpricing, finding "some evidence that IPOs issued in bull markets are, on average, more underpriced than those issued in bear markets."
These results, supported by another study by Clarkson and Merckley, suggest that the degree of underpricing in Canada is much lower than in the other industrialised countries except France. They lead Jog to conclude that "Canadian capital markets are doing a good job in allocating risk capital to entrepreneurs" and thereby "that policy makers need not be too concerned about IPO underpricing in Canada and its impact on the entrepreneurs' motivation to go public."

Jog's optimism should not be overstated. It is important to stress that all of the recent Canadian studies on underpricing examined the pricing of firms issuing shares on the TSE, which is the largest stock exchange in the country. The bulk of the firms listed on the TSE are large firms that have, in general, positive net income prior to listing. In addition, the TSE has the most stringent listing requirements of the Canadian stock exchanges. The listing requirements of the TSE makes it more difficult for junior issuers to get listed on the latter than on other exchanges such as the Alberta Stock Exchange (ASE) or the Vancouver Stock Exchange (VSE). Thus, in 1992-1993, the average size of offerings on the TSE was $28.3 million (U.S.) whereas it was only of $0.6 million (U.S.) and $0.4 million on the VSE and ASE respectively.

By using a sample of firms composed only of TSE-listed issuers, Jog's research may give a truncated view of the Canadian marketplace as it fails to consider an important portion of small

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18 V.M. Jog, supra note 14, at 361.
19 Ibid. at 392-395.
20 J. Higgins, Canada and U.S. Cost Comparisons of Initial Public Offerings (IPOs) (Ottawa: The Conference Board of Canada, 1994) at 3.
21 Ibid. at 3-4. On the different listing requirements of Canadian stock exchanges see infra Chapter VI text accompanying notes.
22 Ibid. at 12.
firm IPOs. Given the relationship found by American studies between firm quality — as proxied by firm size and the amount of the offering — and the degree of underpricing, it may be possible that the lower number of SMEs in Jog’s sample account in part for the apparent lower degree of underpricing in Canada. In this perspective, it is unfortunate that no data on the characteristics of the firms composing the sample and the related level of underpricing appears in Jog’s study. Moreover, the study documents only those firms that have gone public and tells little “about firms which tried to raise equity capital via an IPO but failed to get the necessary support.” For these reasons, it remains necessary to examine closely the institutional and regulatory setting of the IPO market in order to assess its efficiency for SMEs.

2. Theories of IPO Underpricing

Several theories have been put forward by financial economists to explain the underpricing phenomenon. Most of the modern theories offer explanations that arise from informational asymmetries between the four groups of participants in the IPO market: the issuer, the underwriter, the initial buyers and the investors in the secondary market. In the information-based models, one group of market participants typically possesses superior information on firm value. The theories however differ in their determination of which participants possess superior information.

Besides the widely discussed information-based models, a number of alternative theories have been proposed to explain underpricing. Since the explanatory power of these latter theories remains generally very limited, I will present the model that has received the most attention in the literature and which concentrates on the liability risk faced by underwriters in the IPO market.

23 In fairness, Jog does acknowledge that his study “may reflect the experience of somewhat larger firms.” V. Jog, supra note 14, at 394-395. Elizabeth Maynes also makes this point in her comment of the Jog study. See E. Maynes, “Comment”, in P.J.N. Halpern, supra note 14, at 411.

24 V. Jog, ibid.

25 For a good summary see S.C. Anderson et al., supra note 1.
a) The Signalling Model of Underpricing

Several authors have relied on Leland and Pyle's insight on signalling to explain underpricing. The application of signalling theory to IPO pricing assumes that issuing firms know more about their prospects and the value of their projects than any other market participants. According to the proponent of this theory, high quality issuers use underpricing to differentiate themselves from low quality firms to reduce risk of adverse selection and realise greater proceeds from the sales of their securities.

The most common signalling model involves two sequences of events. A good quality firm first undertakes an IPO where it sells underpriced securities to finance a part of its project. Information about the true value of the firm is then revealed to the market and the firm subsequently proceeds to a seasoned equity offering (SEO) where it gets a price for its securities that reflects more accurately its true quality. The initial underpricing of the new issue conditions investors to interpret more favourably subsequent dividend results. These benefits compensate the firm for the immediate loss created by the underpricing of the IPO.

Since the quality of a low value firm will likely be revealed after the IPO, 'bad' firms that use underpricing to mimic good quality firms will not benefit from this scheme and will not be able to recoup the loss from underpricing in the future. Hence, it is argued that underpricing is a credible signal of firm quality since it is unlikely to be imitated by poor quality firms.

A number of testable implications flow from the signalling model.

Under the signalling models we expect that firms with greater IPO underpricing are: (a) more likely to subsequently issue seasoned equity; (b) likely to issue larger amounts of equity in

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their seasoned offerings; (c) likely to issue seasoned equity more quickly after the IPO; and (d) likely to experience a smaller price drop when the SEO is announced.27

A study by Jegadeesh et al. testing these implications provides some support for the model, finding that issuers with greater level of underpricing are more likely to engage in a seasoned offering, and have, on average larger SEOs.28 However, the authors remark that the evidence is weak from an economic perspective and conclude that "[t]he lack of a strong association between IPO underpricing and subsequent offering calls into question the explanatory power of the signalling hypothesis."29

Subsequent studies cast further doubts on the value of the signalling model. Garfinkel, who examined a sample of 494 IPOs issued in the period 1981-1983 in the U.S., found that the degree of underpricing did not materially influence the likelihood of further SEOs.30 Similarly, a study by Michaely and Shaw, using a sample of 947 IPOs issued in the U.S. between 1984-1988, indicates that issuers that have a higher degree of underpricing raise capital through SEOs less frequently, and for smaller amounts, than issuers experiencing a lower degree of underpricing.31 Further, the authors found "no support for the model's assertion that firms that underprice more will experience less favorable price reactions when they issue seasoned equity."32 Finally, Jain and Kini found that,

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28 Ibid.
29 Ibid. See however I. Welch, "Equity Offerings Following the IPO. Theory and Evidence", (1996) 2 J. of Corp. Fin. 227, where the author presents an IPO signalling model in which some issuers signal their quality not only by underpricing their IPO more, but also by waiting more patiently before they sell the remainder of the firm in a seasoned equity offering.
32 Ibid. at 311.
contrary to the predictions of signalling theory, IPO firms that underprice do not exhibit superior operating performance in comparison to those who do not.\textsuperscript{33}

b) The Winner's Curse Model

The winner's curse model of underpricing, first formally proposed by Kevin Rock, is based on the information asymmetries that exist among potential investors.\textsuperscript{34} In Rock's model, there are two groups of investors in the market that are differentiated by the level of information they possess about firm value: (i) informed investors that have perfect or superior information about firm value; (ii) uninformed investors who lack special knowledge about firm value.

The competition between informed and uninformed investors for good offerings induces an adverse selection mechanism where uninformed investors get securities in poor quality issues with greater probability. Whereas uninformed investors will bid for new issues indiscriminately, informed investors will generally only subscribe to an issue where its expected after-market price exceeds the offering price. Thus, informed investors will subscribe to more shares of the good quality issuers, leaving the uninformed investors with a disproportionate number of the less successful issues that will be overpriced.\textsuperscript{35} Since issues are not allocated on a pro rata basis, the bias against uninformed investors is exacerbated when good quality issues are rationed because of over-subscription and underwriters favour informed investors.

\textsuperscript{33} B.A. Jain & O. Kini, "The Post-Issue Operating Performance of IPO Firms", (1994) 49 J. Fin. 1699. However, see V.M. Jog, supra note 14 at 17 (The stock price of underpriced IPOs performs better than overpriced IPOs over the long run); R.B. Carter \textit{et al.}, "Underwriter Reputation, Initial Returns, and the Long-Run Performance of IPO Stocks", (1998) 53 J. Fin. 285 (IPOs taken to the market by prestigious underwriters experience less short-term underpricing and perform better than average IPOs over the long run).


\textsuperscript{35} Note that since IPOs are underpriced, investors have an incentive to undertake security analysis to identify offerings that are likely to appreciate in price, on average, in the aftermarket. These investors will likely earn sufficient profits from underpriced issues to recoup the costs of their analysis. However, the security analysis accomplished by these investors induces a winner's curse for investors who try to free ride on their efforts.
Rational investors, who realise that they receive a disproportionate amount of overpriced securities, will refuse to participate in the IPO market unless they are compensated for their allocational disadvantage. Therefore, according to the winner's curse model, IPOs are underpriced to keep uninformed investors in the market and ensure that new issues are fully subscribed. The excess returns on underpriced issues compensate uninformed investors for the losses they incur when they bid for overprice issues.

An important extension of the winner's curse model is provided by Beatty and Ritter who show that there is a positive relationship between the degree of uncertainty about the market clearing price of a new issue and the extent of underpricing. These authors argue that the winner's curse intensifies with the *ex ante* uncertainty of the issue, where *ex ante* uncertainty is defined as the uncertainty about the value of the issue once it starts trading. This is because where *ex ante* uncertainty is severe, "the differing probabilities of getting good versus bad shares become more important since bad shares become even worse." Differently stated, uninformed investors stand to lose more as *ex ante* uncertainty increases. For this reason, uninformed investors demand that more money be left on the table, through underpricing, for issues with greater *ex ante* uncertainty through underpricing. The winner's curse problem will thus be more severe for more speculative offerings.

36 K. Rock, *supra* note 34, at 188.

37 C.B. Barry & R.H. Jennings, "The Opening Price Performance of Initial Public Offerings of Common Stock", (1993) 22:1 *Fin. Mgmt.* 54 (Consistent with the view that underpricing rewards uninformed investors participating in the presale market and initial allocation, the study finds that large initial returns are realised at the opening of the market).


Beatty and Ritter further argue that underwriters play a central role in enforcing underpricing and ensuring that investors are compensated for the winner's curse that they face.\(^4\) In a nutshell, underwriters enforce the underpricing equilibrium in order to preserve their reputational capital and avoid adverse consequences to their business.\(^5\) Thus, the presence of underwriters prevents issuers from cheating and setting too high an offering price given their level of ex ante uncertainty.

It is worth mentioning that the extent of the adverse selection problem can be mitigated by the use of a best efforts contract rather than a firm commitment offer.\(^6\) In a best efforts contract, underwriters do not purchase the, but rather only agree to sell as much of the securities offered as they can, earning a commission on the securities sold. When it is not fully subscribed, or when a minimum level of shares is not sold, the offering is withdrawn. By setting a threshold of demand high enough so that demand by uninformed investors is insufficient to fill it alone, issuers can induce uninformed investors to submit orders. Indeed, in doing so, the issuer binds itself to withdraw the offering if demand by informed investors is not forthcoming, thereby assuring uninformed investors that they will not be allocated a disproportionate fraction of the issue if it is overpriced.

From this it follows that issuing firms should not have to severely underprice their shares with a best efforts contract as they would with a firm commitment offer. However, Ritter found that best efforts offerings were more underpriced than firm commitment offers.\(^7\) Nonetheless, this result

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\(^{4}\) Ibid. at 216-217.


\(^{6}\) This is suggested by J.R. Ritter, "The Costs of Going Public", (1987) 19 J. Fin. Econ. 269 at 276-277.

confirms the view that best efforts underwritings mitigate adverse selection problems, since it is firms whose value is highly uncertain that use best efforts contracts. These firms have to use best efforts offers because the required underpricing under firm commitment offers would be too severe.

With respect to the explanatory power of the winner's curse model, Rock notes that "[t]he crucial test of the model involves the degree to which shares are rationed on the offer date." However, it is not possible to test the model directly in Canada or the U.S. because "information on the rationing process adopted by underwriters and issuers is not observable." Hence, empirical studies in the two countries have tested the winner's curse model using indirect evidence on the relationship between proxies for \textit{ex ante} uncertainty and underpricing. For example, in the U.S., a study by Miller and Reilly explored the relationship of underpricing to uncertainty using a sample of 510 IPOs issued during 1982-1983. Relying on the gross proceeds from the offering as a proxy for uncertainty, the authors found a significant correlation between \textit{ex ante} uncertainty and the degree of underpricing. These results confirm the findings of Beatty and Ritter that indicate the existence of a positive relation between underpricing and the gross proceeds of the offering.

In Canada, an early study by Jog and Riding attempted to examine the link between uncertainty and underpricing suggested by the winner's curse model, using various proxies for \textit{ex ante} uncertainty. The results of their study were mixed. While the authors found that underpricing was significantly related to trading volume, the business sector of the firm and the use of proceeds

45 K. Rock, \textit{supra} note 34, at 205.


from the offering, they failed to find a relation between underpricing and aftermarket variance, or the level of ownership retention by the original owners.

Jog and Riding's study was extended by Clarkson and Merkley who analysed the underpricing phenomenon using various proxies for \textit{ex ante} uncertainty identified by the literature.\textsuperscript{50} The results of their study supported the existence of a relation between most of the proxies for \textit{ex ante} uncertainty and the degree of underpricing:

Specifically, we found that underpricing decreased with the level of annual sales, gross proceeds from the offer, auditor quality, and underwriter prestige, and increased with the size of underwriter's fee. We also found that underpricing was greatest for firms in the extractive industry sector and for firms which were classified as high-tech, and smallest for firms in a regulated industry and for firms which used the proceeds from their offer for financing purposes. In addition, we found that underpricing was the smallest for firms which included an earnings forecast in their offering prospectus. Interestingly, we found, in contrast with previous Canadian evidence, but consistent with previous U.S. evidence, that underpricing increased with the level of the market-based risk measures and decreased with the level of ownership retention. Further, in contrast with previous U.S. evidence, we did not find a significant relation between underpricing and either the age of the firm or the number of risk factors listed in the offering prospectus.\textsuperscript{51}

In an attempt to examine more closely the impact of rationing on the degree of underpricing despite the unavailability of data on subscriptions and allocations of IPOs, Seha Tinic, assuming that institutional investors constituted a good proxy for informed investors, used data presented in the \textit{Institutional Investor Report} of the Securities and Exchange Commission that documented institutional purchases of a random sample of 84 IPOs issued during 1968-1969.\textsuperscript{52} Tinic's analysis of these data did not "support the proposition that institutional investors in the aggregate receive disproportionately large amounts of grossly underpriced IPOs."\textsuperscript{53} Hence, he concluded that no bias in rationing good issues to informed investors seemed to exist in the data of the sample, contrary to the winner's curse model.

\textsuperscript{50} P.M. Clarkson & J. Merkley, \textit{supra} note 17.
\textsuperscript{51} \textit{Ibid.} at 66.
\textsuperscript{53} \textit{Ibid.} at 795-796.
The findings of Tinic should not be overstated. His study contrasts sharply with empirical evidence of studies from countries where bias in rationing can be observed. Indeed, evidence of a winner's curse was found in the British, Finnish and Singaporean IPO markets. Even more importantly, a recent U.S. study by Michaely and Shaw focusing on information asymmetry across investor groups, rather than on ex ante uncertainty, showed significant support for the winner's curse model. These authors tested the proposition that underpricing should decrease as information asymmetry across investor groups decrease, using two markets in which the degree of information asymmetry among investors differed markedly: (i) a sample of master limited partnership (MLP) IPOs that institutional investors are well known to largely avoid; (ii) a sample of regular IPOs. Michaely and Shaw found that regular IPOs experience significantly greater underpricing than MLP IPOs. According to the authors, the prior knowledge of the relative absence of informed investors diminishes the winner's curse problem and thereby the need to underprice. In other words, the lack of MLP IPO underpricing arises from the fact that "investors in the MLP IPOs know a priori that they are competing to a much smaller extent with other investor's who possess superior information."
c) The Incentive of Underwriters to Underprice

i) The Principal-Agent Model

According to Baron, the relationship between issuers and underwriters resemble that of principal and agent. In this model, issuers (the principals) delegate to their agents (the underwriters) the pricing decision and the distribution function with respect to their offerings. In doing so, issuers wish to benefit from the superior knowledge of underwriters about market conditions, investors contacts or industry trends, and the latter’s ability in ensuring a wide distribution of the offerings.

As in any principal-agent relationship, the difficulty for issuers of observing perfectly and costlessly the behaviour of underwriters raises a moral hazard problem. For instance, underwriters may fail to use their superior information about market conditions in setting accurate market-clearing prices. Likewise, underwriters may not devote sufficient efforts to the promotion and the distribution of the offering.

In this context, Baron asserts that issuers will wish to mitigate the moral hazard problem by designing contractual arrangements that induce underwriters to act in their best interests. More particularly, issuers attempt to select a compensation package that induces underwriters to exert a greater sales effort than they would otherwise exert and to use their superior information in setting the offer price. According to Baron, issuers achieve this objective by letting underwriters offer the shares at a discount from the expected aftermarket price, thereby facilitating the sale of their offerings by underwriters. From this perspective, the resulting discount or underpricing will be an increasing function of the issuer's uncertainty about the market demand for its securities.


592 D.P. Baron, supra note 59, at 959-960.
An American study conducted by Muscarella and Vetsuypens tested this model by examining 37 self-underwritten IPOs of investment banks. In accordance with Baron's theory, self-underwritten IPOs should be less underpriced than IPOs where the issuer and the underwriter are not the same since there should be no information asymmetry. Contrary to this prediction, the authors found that the degree of underpricing of self-underwritten IPOs was comparable to that of IPOs of similar size. In a related study, Cheung and Krinsky compared the price behaviour of IPOs of underwriters and that of comparable non-underwriters using all Canadian underwriters that went public on the TSE in the period 1982-1988. The evidence marshalled in their study failed to confirm a smaller degree of underpricing for underwriter IPOs predicted by Baron's model.

Thus, while there is likely some truth to this model, particularly for less sophisticated issuers such as SMEs which are not knowledgeable of market conditions, the explanatory power of Baron's model remains limited.

ii) The Asymmetric Payoffs Hypothesis

According to some commentators, underwriters purposely underprice new issues to reduce their risks and their costs of underwriting. These commentators base their explanation of underpricing on the requirement in securities laws that new issues be offered at a fixed price, and which places underwriters in a risk situation of asymmetric payoffs. Because of the prohibition against adjusting the issue price once distribution has begun, "underwriters bear the risk that an overpriced issue may not sell out and that they will be left 'holding the bag' of shares the public does not care to

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purchase. Conversely, underwriters can't issue shares at a higher price when the demand for the offering is strong once the final price is set. Hence, it is argued that underpricing serves for underwriters "as a method of reducing the chances of ending up with an unsuccessful issue and the associated losses."

In conformity with the asymmetric payoffs model, only IPOs underwritten on a firm commitment basis should be more underpriced. Recall that in a firm commitment contract, the underwriters accept the risk that the securities cannot be successfully resold to the public. Underwriters purchase the whole issue from the firm at a specified price for the purpose of resale to the public. Thus, when underwriters cannot sell all the shares at the offer price, their capital becomes locked in a losing or rather illiquid investment and cannot be used for more profitable purposes. This gives underwriters strong incentives to underprice issues in order to presell the whole issue quickly and avoid having to hold for their own account the securities that have not been sold. Furthermore, according to this model, initial public offerings distributed with a best-efforts contract should not be underpriced because underwriters' risks under this contract are minimal. Underwriters do not purchase the issue in a best efforts offer, but rather only agree to sell as much of the securities offered as they can, earning a commission on the securities sold.

However, empirical results indicate that new issues distributed with best effort contracts tend to be underpriced by a much larger amount than IPOs underwritten with firm-commitment contracts. For example, Ritter found that while underpricing on firm commitment IPOs was 15 per cent on average for the period 1972-1982, best efforts offerings were underpriced by almost 48 per cent. Hence, the asymmetric payoffs model appears to be inconsistent with empirical evidence.

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63 L.A. Stout, *ibid.* at 660.
64 S.M. Tinic, *supra* note 52, at 791.
iii) The Monopsony Power of Underwriters

The monopsony power model considers underwriting to be cartelised, with underwriters possessing a privileged monopoly position with respect to issuers. In this model, the IPO market is composed of two segments. The first segment comprises prestigious underwriters who generally refuse to take small issuers public, arguably for reputational reasons. In the second segment, underwriters exploit some bargaining power over the issuers by forcing them to accept lower offer prices. The intentionally underpriced offerings of these smaller issuers are then rationed to the regular customers of underwriters (who also buy investment services from them) and reap the resulting excess returns. Thus, in sum, the monopsony power model views the underpricing phenomenon as a form of rent seeking by underwriters: "The underwriters are willing to enforce this paradoxical cash give-a-way because they then recoup these excess returns in the form of high trading fees and commissions from favored customers or continued customer loyalty."

As we will see further below, there is strong evidence that the market for underwriters is segmented, with reputable underwriters issuing larger-size offerings and less reputable underwriters being associated with smaller-size IPOs. There are, however, serious theoretical and empirical objections to this model. Anderson et al. summarise the theoretical concerns:

First, why do underwriters engage in this complex charade of recycling profits from monopoly in one market (underwriting and distribution) into profits from another, perhaps competitive market (financial services)? Would it not be simpler and more efficient to merely take profits directly in the form of higher fees and larger gross margins from underwriting? Second, if brokerage customers have access to numerous potential service providers, why don't they "take the money and run", enjoying excess returns today and selecting a cheaper broker tomorrow? While such behavior might lose them future favorable allocations in IPOs, that is irrelevant when service fees consume excess returns. If the fees do

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67 Proponents of this model include, inter alia, J.R. Ritter. supra note 43. For a critical presentation, see S.M. Tinic, supra note 52, at 791-792.

68 J.R. Ritter, ibid. at 237.

69 S.C. Anderson et al., supra note 1, at 59.

70 Infra Chapter III. notes 150-157 and related text.
not consume all the excess returns, then the underwriter is giving money away merely to affect the recycling of monopoly profits.71

On the empirical side, Tinic offers evidence that there is no relation between the amount of brokerage commissions generated from institutional investors and the allocation of underpriced offerings to them by underwriters.72 Moreover, empirical studies indicate that underwriters who misprice IPOs lose subsequent market share and experience a decrease in market value.73 Thus, market segmentation does not appear to give necessarily monopsony power to second-tier underwriters toward smaller issuers.

iv) Underwriter Price Support

Most theoretical models of underpricing assume that this anomaly results from a deliberate decision from either issuers or underwriters to set the issue price below the true expected market value. Recently, in contrast to this current view that IPO underpricing is undertaken deliberately, several authors have suggested that underpricing may be largely attributed to the frequent practice of underwriter price support or stabilisation which involves transactions that prevent or retard a decline in the market price of a security to facilitate the distribution to the public.74

In practice underwriters temporarily support the price of new issues in the after-market by placing a bid for or making a purchase of securities at the offering price during the distribution.75

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71 Ibid.
72 S.M. Tinic, supra note 52, at 792.
73 R.P. Beatty & J.R. Ritter, supra note 38; V. Nanda & Y. Yun, supra note 42.
This technique prevents the price of an IPO from dropping below the offering price before the distribution has been completed when the demand is weak. It amounts to granting investors a put option to sell the securities back to the underwriter during the stabilisation period.\textsuperscript{76}

Support for the proposition that underpricing is caused, at least in part, by the frequent practice of stabilisation is found in the work of Judith Ruud.\textsuperscript{77} This author examined the impact of stabilisation on the after-market price of IPOs by studying not just the mean, but also the distribution, of initial returns of new issues. Ruud’s investigation indicates that the practice of underwriter price support does alter the distribution of initial returns of IPOs:

If IPO underpricing were done deliberately across the board, the distribution of a sample of IPO initial returns would approximate a bell-shaped curve with the peak of the distribution centered on a return greater than zero. In fact, however, relatively few IPOs sink much below their offering price immediately. Instead of forming a bell-shaped curve with a positive mean, the distribution of one-day returns peaks steeply around zero, and the negative tail of the distribution is significantly curtailed.

Underwriter price support affords a plausible explanation for the positively skewed distribution of initial IPO returns. The effect of such price support is to reduce the number of negative initial returns from what would otherwise be observed.\textsuperscript{78}

Ruud’s finding were subsequently confirmed by Hanley et al. who also demonstrated that stabilisation has a significant impact on the secondary market price of IPOs.\textsuperscript{79} More particularly these authors observed that the offerings most likely to be stabilised have significant price declines once stabilisation is discontinued. While this empirical evidence suggests that underpricing may not only be undertaken deliberately, but may also be the result of underwriter stabilisation, a review of the most likely rationale for stabilisation indicates that it is plausible that underwriters maintain the price of IPOs above their offer price, at least in part, for the same reasons that IPOs are underpriced.\textsuperscript{80}


\textsuperscript{77} J.S. Ruud, *supra* note 74.

\textsuperscript{78} *Ibid.* at 140.

\textsuperscript{79} K.W. Hanley et al., *supra* note 74. See also P.H. Schultz & M.A. Zaman, *supra* note 75.

\textsuperscript{80} P.H. Schultz & M.A. Zaman, *ibid.* at 216.
Traditionally, stabilisation has been seen as necessary to offset abnormalities in the new issue market caused by temporary imbalances between supply and demand. These temporary imbalances in the new issue market which destabilise the market and create uncertainty are exacerbated by the presence of free-riders who try to take advantage of underpricing by selling for a quick profit and driving-down the market price of IPOs.

When a new or an additional issue of significant size is offered to the public a temporary glut of the market may often be the immediate result. At the time the demand for the offered security is diverted by the underwriters and the selling group dealers away from the open market and into the channels of the distribution itself. The selling efforts of dealers necessarily attendant upon the making of the offering thus result in taking away from the open market the demand for the offered security which might otherwise there exist. As noted, "free riders", as well as other buyers who change their minds, will sell, and at a time when there is a temporary unbalance between supply and demand created by the offering. These scattered open market sales, taken in conjunction with the sudden influx of supply and the accompanying withdrawal of normal open market demand into the channels of direct distribution, unless counteracted, will exert a market influence which, according to the underwriters, is out of all proportion to their real significance.

Thus, underwriters argued that the activities of free riders in conjunction with the temporary imbalances in the supply and demand for securities did not create appropriate conditions for the pricing of securities. Accordingly, stabilisation was considered to be necessary to ensure that investors can trade at a fair price, i.e. until new issues found their natural and ultimate market level.

Besides, stabilisation was also considered to be essential to facilitate security distribution and ensure the flow of capital to corporations. This argument rested on the view that the role of underwriters was to create market confidence by taking on the risk that the issue would not be fully subscribed. Hence, it was argued that stabilisation was necessary to the successful sale of securities by firm commitment underwriting as underwriters could not otherwise undertake long or even medium term commitments in order to insure the success of billions of dollars of security offerings:

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82 Ibid. at 671.
If an entire issue of securities is to be bought ... at a fixed price, it is said to be vitally necessary that those underwriters be able to protect themselves as well as the selling group dealers, against a 'disorderly' open market during the resale of the issue to the public,83

The value of this argument seems however to be very weak considering the capitalisation of Canadian underwriters, which is sufficient to render untenable the argument that they would not be able to insure the market risk of a whole issue.84 Moreover, the extensive use of the best efforts contract demonstrates that underwriters can protect themselves by not purchasing the issue for resale and therefore not agreeing to take up the shortfall.

In recent years, more sophisticated reasons have been put forward to explain underwriter price support. First, it has been proposed that underwriters may use price support as an alternative way of minimising the winner's curse problem.85 Underpricing is arguably an expensive way for issuers of keeping uninformed investors in the market since it rewards ex ante the informed as well as the uninformed investors. According to Chowdhry and Nanda, it is more efficient for issuers to compensate uninformed investors ex post for their information disadvantage since that, unlike with ex ante compensation through underpricing, ex post compensation benefits mainly to uninformed investors.86 In this perspective, the stabilisation of IPO would constitute a mechanism by which the uninformed investors are compensated ex post for the adverse selection cost they face, as underwriters stand by to buy back the shares at the offer price in the after-market.

An offer to buy back the shares at the issue price is equivalent to giving a put option to investors. The put option is valuable to the uninformed investors. It is less valuable to

83 Ibid.


86 B. Chowdhry & V. Nanda. ibid.
informed investors, because the informed bid only when they expect the true share price to be larger than the offer price.87

While the authors argue that stabilisation dominates underpricing because of its greater cost-effectiveness, they nevertheless stress that underwriters will abandon the stabilisation activity after suffering a given amount of losses. Hence, new issues may also have to be underpriced to resolve the winner's curse problem.87

A related rationale for price stabilisation is provided by Benveniste et al. who focus on market information acquisition by underwriters.88 According to the authors, underwriters can induce investors to reveal their private information by committing to a strategy of rewarding investors who provide strong indications of interest during pre-offering roadshows with relatively large allocations of underpriced shares.89 Benveniste et al. argue that stabilisation is however necessary to mitigate the incentive of underwriters to overstate overall investor interest prior to the pricing and allocation of the offering. Price stabilisation acts as a bonding mechanism as “underwriters capture only a small fraction of any proposed increase in the offer price, but bear the full marginal cost of providing price support in the secondary market.”90 Thus, price stabilisation protects investors against the over-statement of pre-offer interest by underwriters and their subsequent overpricing of the issue.

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87 Ibid. at 26.
871 N.R. Prabha & M. Puri. supra note 76, at 22-23.
90 L.M. Benveniste et al. supra note 88, at 227.
Finally, underwriters may use stabilisation as a marketing technique. Recall that before the filing of the final prospectus, investors only place non-binding indications of interest with underwriters. When they perceive that underwriters have trouble selling the issue, or that the price of the issue falls in the after-market, those investors will decline to buy the shares and will instead buy them in the after-market. Likewise, investors that will have confirmed a buy order when the offering becomes effective will be more likely to exercise their right to renege their purchase when the securities trade below the offer price. From this perspective, stabilisation reduces the advantage for investors of waiting to purchase new issues in the after-market, as well as the likelihood that they renege their orders. Thus, stabilisation is considered to enhance the attractiveness of the securities sold in the primary market.

The practice of stabilisation is arguably manipulative. However, although most securities markets have anti-manipulative rules to ensure that securities prices are set by the independent forces of supply and demand, these rules allow limited types of market stabilisation during the distribution for the traditional reasons mentioned above. Thus, in Canada and the U.S., stabilisation for the sole purpose of preventing or retarding a decline does not of itself violate anti-manipulative rules as long as the possibility of stabilisation is disclosed in the prospectus and that the stabilising purchases are effected at the public offering price of the issue once the offering is made. Further, in both countries, over-allotment options may not exceed 15 per cent of the distributed securities.

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91 P.H. Schultz & M.A. Zaman, supra note 75, at 202.
92 J.A. Shayne & L.D. Soderquist, supra note 74, at 978. According to the Securities and Exchange Commission, stabilisation is a negative type of manipulation since it seeks to retard and not to create affirmative market movements. Exchange Act Release No. 2446, supra note 81, at 665.
and may only be exercised in during a specified period after the offering (60 days in Canada, 30 days in the U.S.).

Nevertheless, critics stress that the possibility for underwriters to interfere with the market through stabilisation is open to abuses that prejudice investors. They assert that the artificial manipulation of securities prices is improper since it distorts "the market's perception of the worth of the securities and thus mislead the investing public in their purchasing decisions." In this respect, the disclosure of the possibility of stabilisation is seen as only partially reducing the potential that stabilisation mislead the public because of the remaining uncertainty as to whether stabilisation may or may not have occurred. Further, doubts are expressed concerning the ability of investors to grasp the significance of such disclosure.

Moreover, it is argued that the practice of stabilisation may facilitate the distribution of over-priced securities when underwriters purchase securities from IPOs to maintain the market price at or near the offer price. For example, Shayne and Soderquist maintain that the poor long-run under-performance of IPOs is the inevitable result of such manipulative practices of underwriters that allow them to set offering prices higher than they should otherwise be. According to these authors, securities laws should not condone stabilisation as it is not a beneficial or innocuous practice. Investors that purchase securities at the artificially high price induced by stabilisation incur losses at the end of the operation when the prices of the shares return to their unsupported level.

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96 Ibid. See also Exchange Act Release No. 2446, supra note 81, at 670.

97 Ibid.; L.A. Stout, supra note 62, at 665 n. 264.

98 J.A. Shayne & L.D. Soderquist, supra note 74, at 979-980.
It is easy to exaggerate the influence of stabilisation practices on the over-pricing of initial public offerings. Indeed, as we will see below, the most convincing explanation of the under-performance of IPOs makes no reference to the possibility that this overpricing results from stabilisation by underwriters.99 Moreover, Beatty and Ritter have shown that persistent mispricing by underwriters results in a loss of market share." Hence, underwriters that engage in stabilisation in order to distribute over-priced securities will inarguably suffer a loss in reputation and will underwrite fewer issues in the future.

Even more importantly, it is worth emphasising that stabilisation is not costless for underwriters as it amounts to giving investors a put option to sell them back the securities sold. For this reason, underwriters will wish to avoid supporting issuers with a high level of ex ante uncertainty.101 Indeed, underwriters’ cost of engaging in price support will increase with the level of ex ante uncertainty as riskier securities will be more likely to end up as unsold and overvalued inventory. Hence, underwriters will stabilise only issues for which they have gathered sufficient information to set accurate market clearing prices. Consistent with this intuition, empirical evidence indicate that underwriters stabilise IPOs that have less price uncertainty than IPOs that they do not stabilise.102

From this perspective, the risk that stabilisation be used to market over-priced securities should not be exaggerated. Of course, there will still remain a risk that underwriters will rely on stabilisation to take to the market new offerings that are overpriced. However, the advantages of stabilisation identified above and the safeguards highlighted should ensure that the benefits of stabilisation in facilitating capital formation will generally outweigh its costs.

99 The notable exception is J.A. Shayne & L.D. Soderquist. ibid. However, the authors do not provide any evidence of the existence of a relation between over-pricing and underwriter price support.


101 N.R. Prabha & M. Puri. supra note 76. at 4-7.

102 Ibid., at 13-19.
d) Insurance Against Legal Liability

Several authors, including Tinic, suggest that underwriters and issuers use underpricing as a form of insurance against claims based on securities laws violations during the offering.103 These authors' explanation rests on the potential securities legislation liability to which underwriters are exposed if the information they provide is false or misleading.104 This risk of liability is arguably high for IPOs as most new ventures are characterised by a paucity of verifiable information.105 Further, it remains difficult to eliminate because the standard of the due diligence investigation required of the underwriters "is fraught with difficulties and uncertainties."106

According to Tinic, it is not possible for issuers and underwriters to jointly purchase an insurance to protect themselves against potential damages from lawsuits. Insurance against potential liability under the securities legislation would be prohibitively expensive because of the ambiguity of the due diligence, and would raise issuers' cost of public equity finance to uncompetitive levels. From this perspective, underpricing is perceived as an alternative mechanism to reduce the risks and costs of litigation. Damages in suits for misrepresentation are based on the difference between the offering price and the stock price at the time of the suit. Thus, the lower the offering price, the lower the damages that can be recovered. From this it follows that large initial returns can reduce the probability that investors will bring a lawsuit: "If the offering price is low enough, there may be no recoverable damages, and therefore no liability, regardless of whether a securities violation was


104 Ontario Securities Act, R.S.O., c. S-5, s. 130 [hereinafter O.S.A.]. The costs of such liability include not only the damages awarded, but also the direct and indirect cost of litigation, including the loss of reputation that would flow from the lawsuit and the resulting judgement.

105 S.M. Tinic, supra note 52, at 799.

committed.\footnote{107} Tinic demonstrated this relationship between underpricing and expected legal liability by examining the underpricing of IPOs both before and after the introduction of the \textit{Securities Act of 1933} in the United States. The results of his study showed that the introduction of the new liabilities by the \textit{Securities Act of 1933} in relation to IPOs was followed by an increased in underpricing thereby supporting the insurance hypothesis.

Despite Tinic’s results, the lawsuit avoidance theory can be challenged both on empirical and theoretical grounds. On the empirical side, a study by Drake and Vetsuypens examined 93 IPOs by issuers that were subsequently sued under the \textit{Securities Act of 1933} in the period 1969-1990.\footnote{108} The authors found that these IPOs had average initial returns similar to other IPOs of comparable size.\footnote{109} Thus, it appeared that underpricing did not work as a means of reducing the risk of lawsuits by disgruntled investors.

Furthermore, the particularities of Canadian securities laws and the institutional features of securities litigation in Canada considerably limit the explanatory power of the lawsuit avoidance theory initially based on the American setting.\footnote{110} Indeed, despite the existence in Canadian securities laws of statutory civil liability for misrepresentation, there has been no reported case so far where a


\footnotetext[109]{\textit{Ibid.} at 69-70.}

plaintiff claimed damages for prospectus misrepresentation. According to several commentators, it is a combination of economic and structural disincentives that have contributed to the relative immunity of Canadian market participants from such lawsuits. While it is not the purpose of this thesis to analyse closely the disincentives built in the litigation system that have hindered misrepresentation actions, it seems necessary to highlight the most salient factors that differentiate the Canadian and American securities litigation environment.

Two difficulties facing investors wishing to bring an action for misrepresentation are noteworthy. The first concerns the funding of the litigation expenses in class proceedings. Class proceedings are an important device in securities litigation:

The loss incurred by each victim of a misrepresentation is not likely to be enough to warrant the financial and time commitments involved in pursuing a civil action, whereas the combined loss of all victims of a misrepresentation would likely provide the critical mass for a class actions. Without the spectre of class actions, issuers may perceive that no one investor would bother to commence an action based on a misrepresentation or delay in disclosure and may not devote adequate resources to ensuring that their continuous disclosure complies with the requirements.

While British Columbia, Ontario and Québec now have legislation facilitating class action proceedings, the limits on the assistance provided for funding the legal expenses of the representative plaintiff severely curtails the use of this procedural vehicle. Unlike in the U.S., the class proceedings legislation only partially supports legal expenses through a form of contingency fees. This regime gives the power to the court to award the plaintiff's counsel a multiplier of their


\[^{113}\] Responsible Corporate Disclosure, supra note 111, at 25. See also J.J. Chapman, ibid., at 502-504.


\[^{115}\] J.J. Chapman, supra note 111, at 512; Responsible Corporate Disclosure, supra note 111, at 31-32.
nomal fees, when they agree that they will be paid only in the event of success. However, there are no guidelines as to what the multiplier, which is compensation for the risk incurred by counsels, should be. Thus, ultimately, “it will depend on the court’s view of the risk undertaken and the benefit to the class from the solicitors taking the risk to prosecute the action.” In the U.S., the widespread use of contingent fee arrangements removes all financial risk from the class representative as the entire risk of the plaintiff’s lawsuit is assumed by the counsels.

The second difficulty relates to the risk of liability for defendants’ expenses. While in the U.S. each party to a lawsuit is responsible for its own costs, the losing party in Canada pays the costs of the winner. This ‘loser pays’ rule acts as a powerful disincentive for modest retail investors bringing an action given the significant costs associated with securities litigation. While deep pocket investors, such as institutional investors, have the capacity to support these potential high costs, Canadian institutions have proved to be far less litigious than their American counterparts. In addition, note that the use of class proceedings does not alleviate this concern since the representative plaintiff still faces the risk of paying the defendants’ legal costs, unless he is funded by the Class Proceedings Fund.

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116 Ontario Class Proceedings Act, supra note 114, s. 33.

117 J.J. Chapman, supra note 111, at 512.


119 See e.g. P.A. Koval, “Trends in Canadian Shareholder Activism”, in Duties and Liabilities of Officers and Directors, (Toronto: Canadian Institute Conference, 1992) at 20-23. Koval argues that ‘behind the scenes’ diplomacy is preferred by institutional investors with respect to strategic governance issues and business transactions.

120 J.J. Chapman, supra note 111, at 511.
Additional factors that may help create a 'pro-plaintiff litigation environment in the U.S. are absent in Canada. Among others, complex securities actions are tried with a jury in the U.S., adding an element of uncertainty and, arguably, a bias in favour of plaintiffs and against corporations. The American statutory remedies also deal with a wider range of conduct, as any statement, written or oral containing misleading disclosure can give rise to liability. Finally, damages may not be limited to actual damages and may include punitive damages in excess of the plaintiffs' loss, thereby making it worthwhile to sue.

These differences between the Canadian and American litigation environment explain, to some extent, the dearth of securities litigation in Canada. While the level of underpricing appears to be lower in Canada than in the U.S., it remains nevertheless at a level that cannot be justified by the risk of legal liability, given the state of securities litigation in this country. Indeed, is it necessary to emphasise that "[n]ot one case based on statutory civil liability has ever been brought to trial, despite the thousands of prospectuses and other transaction documents issued under those provisions and the subsequent availability of class actions."

121 Responsible Corporate Disclosure, supra note 111, at 27, 31.

122 E.D. Tavender et al., supra note 118, at 290-292.

1221 Supra notes 1-16 and corresponding text.

123 Responsible Corporate Disclosure, supra note 111, at 30.
3. **Summation**

The foregoing review of the theoretical models put forward to explain the underpricing of IPOs reveals that it is the winner's curse model proposed by Kevin Rock that is the most satisfying theory. According to this model, issuers are compelled to underprice their offerings to compensate uninformed investors for their informational disadvantage regarding firm value. Since the intensity of the winner's curse problem depends on the level of *ex ante* uncertainty, which influences the informational disadvantage of uninformed investors, underpricing tends to be more severe for SMES.

The foregoing review of theoretical models also suggests that underwriters play a positive role in the going public process. Underwriters are instrumental in enforcing the underpricing equilibrium to preserve their reputational capital and avoid losing market shares. Furthermore, underwriters attempt to reduce the cost for issuers of the winner's curse problem by complementing underpricing with stabilisation.

While many of the theoretical models reviewed have limited explanatory power, they nevertheless shed valuable insight on the relationship between issuers and underwriters. Most importantly, these models underline the necessity to ensure that the investment dealer market is competitive and that adequate safeguards exist to control the risk of opportunistic behaviours by underwriters.

**SECTION B: THE LONG-RUN UNDER-PERFORMANCE OF INITIAL PUBLIC OFFERINGS**

Empirical research examining the IPO market uncovered a second pricing anomaly: IPOs appears to be overpriced in that they under-perform non-IPO securities in the long-run. The long-run under-performance of IPOs has important implications for the functioning of the market and the cost of
capital for issuers. This section reviews the evidence on the overpricing of IPOs and presents the theoretical models offered to explain the phenomenon.

1. **Empirical Evidence of Overpricing**

Studies evaluating the performance of new equity offerings have documented a second less widely understood anomaly in the IPO market: long-term overpricing. While in the short term initial public offerings seem to be underpriced, in the long term, new issue securities underperform non-IPO securities, *i.e.* they appear to be overpriced. This evidence of long-term under-performance is found in most countries with a stock market and has serious implications for the functioning of capital markets, and the cost of raising funds for firms.\(^{124}\)

In the U.S., the seminal study by Ritter documenting the stock price performance of IPOs for the period 1975-1984 indicates that the average total return of IPOs in the three years after the offering is of 34.47 per cent.\(^ {125}\) However, a control sample of similar firms on the New York Stock Exchange produced an average total return of 61.86 per cent over the same three years holding period. Thus, in the long run IPOs under-performed.

In a subsequent study, Loughran and Ritter found that the under-performance patterns of IPOs were pervasive throughout the period 1970-1990 and lasted for five years after the offering.\(^ {126}\) More particularly, these authors examined firms which issued securities during this period, whether through an IPO or an SEO. Their results showed that the average returns during the five years after


the issue was only of 5 per cent for firms conducting an IPO, and 7 per cent for firms conducting an SEO. In comparison, the investment of an equal amount of money in non-issuing firms with approximately the same market capitalisation, held for the same period of time, would have produced an average compound return of 12 per cent per year for IPOs, and 15 per cent for SEOs.

The examination of the patterns of after-market performance in the U.S. yields additional interesting evidence. Firstly, there is a tendency for under-performance to be more pronounced for smaller offerings and younger firms. According to Ibbotson et al., "[t]his is consistent with the patterns in initial returns and hot issue markets, where the smaller offerings by newer, more speculative firms display the highest initial returns and the greatest variance over time." Secondly, the long-run under-performance appears to be negatively related to new issue volume. Thus, this phenomenon is more concentrated among firms that went public in the high volume years of the early 1980s, than among those that went public in the low volume years of the mid- and late-1970s. This finding, which confirms the importance of timing in going public, suggests that firms may be able to take advantage of windows of opportunity during which investors are irrationally overoptimistic and willing to overpay for IPOs.

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127 On seasoned equity offerings, see also D.K. Spiess & J. Affleck-Graves, "Underperformance in Long-run Stock Returns Following Seasoned Equity Offerings", (1995) 38 J. Fin. Econ. 243 (Seasoned equity offerings have similar post-offering performance to that of IPOs).


129 R.G. Ibbotson et al., supra note 1, at 73.


131 J.R. Ritter, ibid. 23. See also J. Lerner, “Venture Capitalists and the Decision to Go Public”, (1994) 35 J. Fin. Econ. 293 at 300 (IPOs are far more likely to occur when the equity values are high).
A third qualification of the stock market performance of IPOs is provided by an interesting study by Brav and Gompers. Replicating the results of Loughran and Ritter, these authors found that firms backed by venture capitalists outperformed nonventure capital-backed IPOs over a five year period, showing thereby that the presence of venture capitalists influences the long-run performance of newly public firms. More particularly, the study revealed that small IPOs backed by venture capitalists significantly outperformed small non venture capital-backed IPOs, while both large venture and nonventure capital-backed companies perform as well as reasonable benchmarks. Thus, according to this study, it is primarily small issuers which drive the long-run under-performance in the nonventure capital-backed segment.

Finally, it is worth mentioning that firms going public not only have a poor post-issue stock performance, but also experience a substantial decline in their post-issue operating performance until five years after the offering. Although, IPO firms exhibit high growth in sales and capital expenditures relative to similar firms in the post-IPO period, their measures of profitability decline after going public. This disappointing post-IPO performance may arise from a change in the incentive structure that results from a reduction of managerial ownership in the post-offering period. However, the empirical evidence provides limited support for this explanation. Hence, it seems more likely that IPO firms incur a decline in operating performance because entrepreneurs are


134 A. Brav & P.A. Gompers, supra note 132, at 1791-1792.

135 B.A Jain & O. Kini, supra note 133.

able to time their issues to coincide with periods of unusually good performance that they know cannot be sustained in the future. In other words, investors value firms going public based on unsustainable pre-IPO performance.

In Canada, the most useful work is the study by Vijay Jog that documents both the long run stock performance and financial performance of IPO firms and leads to similar results. Examining the long-term stock market returns that would have been earned by an investor holding a portfolio composed of the 254 IPOs from 1971-1992, Jog found that the portfolio of IPOs significantly underperformed the market for at least five years.

It is clear from these results that an average IPO ... has under-performed the TSE Index by close to 50 per cent over the first 49 months of trading, and this under performance is also highly statistically significant. From this point on, the under performance, as well as its significance, drops to the point that by the end of 60 months, the under performance is not statistically significant in relation to the benchmark.

Furthermore, Jog found that larger issues performed better than smaller issues over the long run. In this respect, recall that, as mentioned above, Jog's study concerns relatively large firms that are listed on the TSE. Thus, it may not give an adequate account of the stock performance of SMES. In addition, Jog's results also indicate that while the sales and assets of IPO firms increased in the post-offering period, the financial performance of the firms actually worsened after going public.

The work of Jog is complemented by a study by the Canadian Venture Capital Association that yields some support to the results of Brav and Gompers and underlines the crucial role of venture capitalists in the going public process. The study, which examined the price performance of 142 IPOs on the TSE between 1993-1996, indicates that venture-backed IPOs outperformed the

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138 V.M. Jog, ibid. at 369.

139 V.M. Jog, ibid. at 375-386.

140 Canadian Venture Capital Association, "Going Public — How Do Venture-Backed Companies Fare?". Enterprise, February 1997 at 1.
other firms going public in this period, irrespective of their size.141 This performance of venture-backed IPOs was found to be particularly marked in the communications, computer, environmental and manufacturing sectors.

From the perspective of owner-managers, the long run overpricing of IPOs may not appear to be a serious problem since it may offset the high transaction costs of raising public equity financing. Indeed, the cost of public equity depends not only the cost of going public, but also on the after-market returns earned by investors. However, this interpretation certainly over-simplifies the impact of this mispricing as it fails to recognise the importance of secondary market price performance for the firm. In addition, it overlooks the impact of overpricing on the ability of firms to raise capital. Where overpricing is seen as a norm, investors will be unwilling to buy IPOs at issuance and will prefer to wait to buy the issue at a lower price in the after-market.142 Thus, it appears that “an improvement in underlying performance by IPO firms in post-IPO years would be welcome news if Canadian investors were expected to channel their savings into IPOs.”143 More broadly, it is worth emphasising that overpricing may distort capital allocation. Overpricing can create too much incentives to go public by reducing the cost of public equity financing. The lower cost of public equity capital may enable a disproportionate number of poor quality firms to raise financing by making an IPO.

2. The Influence of Investor Sentiment and Over-Optimism on the Overpricing of Initial Public Offerings

The most satisfying explanation for the persistent long-run under-performance of IPOs focuses on investor sentiment and posits that investors are willing to pay more for new issues than they would

141 The average size of venture-backed IPOs was $22 million, or about half of the average IPO for all other firms going public ($43 million).

142 V.M. Jog, supra note 14, at 360.

143 Ibid. at 395.
for shares of comparable companies in the open market because they base their investment decisions not on rational analysis of fundamentals, but on sentiment, rumour, or fads.  

Fads are mean reverting deviations from the intrinsic value of assets caused by social and psychological factors. To understand the concept of fads, it is important to know that, for some time, behavioural economics has challenged the Bayesian principle and suggested that the behaviour of individuals departs from the predictions of rational choice theories under conditions of uncertainty. Transposed in finance, these insights have been used to support the view that psychological factors influence stock markets. Hence, the existence of two types of investors in the market is now recognised: rational investors and noise traders. Rational investors form rational expectations about asset returns. Noise traders, in contrast, form their expectations about asset returns on the basis of sentiment and information unrelated to fundamental value. Thus, in some periods, they overestimate the expected returns, while in others they underestimate them.

The IPO market is a good candidate for the presence of fads for a number of reasons. First, fads are more likely to occur in the new issue market since the estimation of the true intrinsic value

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146 For a summary: D.C. Langevoort, ibid. at 857-861.


148 Camerer identifies three types of fads. First, fads that cause prices to fluctuate because the utility people get from holding assets varies over time. Second, fads that lead to price fluctuation because of mass changes in beliefs about future intrinsic value. Finally, fads in expected returns. See C. Camerer, supra note 145, at 16.

149 R. Aggarwal & P. Rivoli, supra note 130, at 47.
of securities is accompanied by great uncertainty. In this respect, recall that most companies going public are young companies that have shown strong growth up to the time of the IPO, but whose value depends on their future earnings. In addition, as we saw previously, new equity issues of smaller firms are characterised by a high level of uncertainty as owner-managers possess valuable information about the value of the firms’ assets, the return from new investment projects, as well as their own industriousness and moral rectitude, that is not available to potential investors. This setting provides a good basis for arguing that IPO investors will behave as trend-chasers. Indeed, studies in behavioural finance have shown that investors have a tendency to weight recent results too heavily and extrapolate from recent trends too much.\(^{149}\)

Second, the higher level of uncertainty surrounding IPOs implies that there will be greater variance of outcomes for these securities; \textit{i.e.} higher risk.\(^{150}\) It appears that riskier securities are likely to be subject to a substantial volume of \textit{noise trading, i.e.} trading based on information unrelated to fundamental asset values.\(^{151}\) Since noise trading is spurred by expectations that depart from standard rationality expectations, it is therefore probable that investor sentiment and over-optimism will affect the IPO market.\(^{152}\)

Finally, investors in the IPO market are considered to be more speculative by nature than other groups of investors. When they determine the price they are willing to pay for a security in an IPO today, speculative investors “may be less concerned with its fundamental value than with the


\(^{151}\) B. Trueman, "A Theory of Noise Trading in Securities Markets", (1988) 43 \textit{J. Fin.} 83. See, \textit{e.g.} R.J. Shiller, \textit{supra} note 144, at 61 (Survey of IPO investors reveal that 57 per cent of respondents purchase a particular offering on the basis of a theory about the kinds of stocks that becoming attractive to investors rather than on the basis of a theory about fundamentals such as profits or dividends.).

\(^{152}\) D.C. Langevoort, \textit{supra} note 145, at 857-861.
price others will pay for it tomorrow.\textsuperscript{153} Thus, the presence of more speculative investors is likely to induce higher levels of price volatility and larger deviations from intrinsic values.\textsuperscript{154}

While no study has tested directly for fads in IPOs in particular, empirical evidence seems consistent with the hypothesis that fads do influence the IPO market. Indeed, the evidence presented above suggests that the market systematically overestimates the growth opportunities of IPOs. If the market were able to anticipate the performance of new issues, the long-run investment performance of IPOs would be normal. However, the persistence of the under-performance pattern indicates that such is not the case despite the publicity on the poor long-run performance of IPOs in popular media.\textsuperscript{155} In other words, investors seem constantly surprised by the poor performance of IPO firms. Thus, it is investors' irrational over-optimism about the growth opportunities of IPOs that leads to temporary overvaluation in early after-market trading. As time goes by and more information about the issuers becomes available, over-optimistic investors change their forecast and cause the market price to drop. The market then values the shares according to the issuers' performance, resulting in a decrease from the faddishly inflated price. In other words, "[i]t is the triumph of hope over experience."\textsuperscript{156}

Moreover, as mentioned above, the long-run under-performance of IPOs comes essentially from small nonventure capital-backed firms. The securities of these firms, which are typically surrounded by a high level of information asymmetry, are held primarily by retail investors who are


\textsuperscript{156} J.R. Ritter & T. Loughran, ibid. at 47.
more likely to be influenced by fads and to be over-optimistic about new issues. Thus, retail investors are the marginal buyers of small nonventure capital backed IPOs and investor sentiment tends to dominate the price-setting process in this segment of the market. And investor sentiment is sufficiently widespread and systematic in the pricing of small nonventure capital backed IPOs that the cleansing power of the consensus effect, by which uninformed biases of individuals in the market cancel each other out, is considerably diminished.

**SECTION C: SUMMARY**

The empirical evidence reviewed on the pricing of IPOs may seem to be contradictory with new equity offerings appearing to be underpriced as well as overpriced. When examined more closely, the evidence yields some interesting insights into the market that help to understand the causes of these two forms of pricing inaccuracies.

Thus, the foregoing review of the theoretical models explaining the pricing of IPOs reveals that, although it appears anomalous, short-term underpricing "is actually just an equilibrium phenomenon illustrating surprising consequences of rational behavior in a suitably peculiar environment." Indeed, the most satisfying theoretical model, the winner's curse model, suggests that underpricing is essentially a market response to reduce information costs. Specifically, issuers

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158 C.M.C. Lee *et al.*, *ibid* at 82-83 (The fluctuations in discounts of closed-end funds are driven by changes in retail investor sentiment.).


160 S.C. Anderson *et al.*, *supra* note 1, at 83.
underprice their offerings with the assistance of underwriters to compensate uninformed investors for their informational disadvantage regarding firm value. While underwriters attempt to reduce the cost imposed on issuers by underpricing with stabilisation, the underpricing of IPOs remains nevertheless problematic in that it raises the cost of capital for firms by reducing the amount of funds they obtain for their securities. Accordingly, there may be a role for public policy to reduce information costs in order to increase the accuracy of newly issued securities prices. This is a question to which we will turn in subsequent chapters.

The longer term overpricing of IPOs, which leads to their long-term under-performance, is a phenomenon that appears to be limited to a specific segment of the market according to U.S. empirical studies: small non venture-backed firms. While overpricing can reduce the cost of capital for small enterprises, this phenomenon is nevertheless undesirable from a social welfare point of view since it can lead to an inefficient allocation of capital. Indeed, firms which are able to sell over-priced securities can raise capital to finance projects that earn less than their required rate of returns.

The most convincing explanation for the overpricing phenomenon argues that overpricing is caused by temporary fads or over-optimism by retail investors. While information asymmetries may be conducive of investor over-optimism, the fact that emotions and excitement drive the overpricing of IPOs suggests that public policy can only play a limited role in remediating this form of mispricing. This should be kept in mind where revising the regulatory framework of IPOs.
CHAPTER III

THE PRIVATE INFORMATION NETWORKS OF THE INITIAL PUBLIC OFFERING MARKET

The evidence on the pricing of initial public offerings suggests that new offerings are not, on average, accurately priced. Although the mispricing of newly issued securities results from the interaction of a complex web of factors, the most convincing theories of IPO mispricing recognize that this phenomenon is driven by informational asymmetries.

Stock price inaccuracy is especially worrisome when firms issue, or consider issuing, shares as it can lead to an inefficient allocation of capital.\(^1\) Since the efficient allocation of capital is desirable, it is important to determine the role that securities regulation can play to enhance the informational efficiency of the new issues market. To do so, it appears appropriate to examine the existing private information networks of the IPO market. An understanding of the private institutional setting of this market will allow us to identify the nature and source of the imperfections which impede informational efficiency. Furthermore, it will provide insight into the role of securities regulation in enhancing market efficiency. In this perspective, this chapter examines the amount of privately generated information which is available on issuers in the IPO market.

The chapter starts this analysis by examining the incentives of issuers to voluntarily disclose information about their businesses. Secondly, it presents the role of securities analyst research in generating complementary information on issuers and processing information for dissemination to investors. Thirdly, it examines the ability of issuers to rely on information intermediaries’ services to convey information to investors with respect to firm value. The chapter concludes by discussing the importance of the presence of institutional investors for market efficiency.

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SECTION A:  THE VOLUNTARY DISCLOSURE OF INFORMATION BY ISSUERS

The information available to potential investors in the IPO market consists primarily of the information disclosed by issuers. This section examines the incentives of issuers to disclose information to potential investors in the absence of mandatory disclosure requirements.

1. The Self-Interest Model of Disclosure

According to the proponents of the self-interest model of disclosure, mandatory disclosure of information is not necessary because market pressures on managers motivate them to disclose the optimal level of information to investors. The incentives of issuers to disclose the optimal level of information comes more particularly from the impact of disclosure on firm value. Voluntary disclosure arguably enhances firm value in at least three different ways.

Firstly, voluntary disclosure enhances the value of issuers' securities by reducing information costs to investors. Issuers are likely to be the most effective producer of information since they usually know more about themselves than investors. Moreover, the cost of producing and distributing information is less to firms than to potential and present investors since economies of scale are associated with the centralisation of information production. Indeed, if prospective and present investors are left to produce by themselves the information, their efforts are likely to be duplicative. Therefore, the costs of disclosure for firms are less than what would incur investors in aggregate.

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Information costs affect the value of potential investors' investments, as they must be discounted from the returns accruing from the securities. Thus, "the greater the cost to potential investors of obtaining information about the corporation, the less they are willing to offer for a share in the corporation or the higher the interest rate necessary to satisfy them." Hence, by reducing the cost of information production incurred by prospective investors, firms can maximise the value of their shares.

Secondly, voluntary disclosure of information to outside investors tends to reduce the agency costs of equity that depress firm value. Disclosure of information helps to reduce the risk of moral hazard by facilitating the monitoring of the behaviour of managers by shareholders, and thereby decreases agency costs. Accordingly, it is likely that in the absence of legal requirements the monitoring contract between managers and outside shareholders would provide for the disclosure of all material information. Otherwise, owner-managers would bear the costs of failing to take cost-justified steps to reduce the net costs of management.

Thirdly, issuers will voluntary disclose information to signal that their prospects are promising in order to differentiate themselves from low quality firms. According to signalling theory, information that firms disclose or do not disclose is likely to be taken as a signal by investors, and results in a transfer of information to the market. Firms with 'good news' or good investment projects have nothing to hide since the disclosure of information will raise their value.

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5 G. Benston, supra note 3, at 1473-1474.
8 G. Benston, supra note 3 at 1475; F.H. Easterbrook & D.R. Fischel, supra note 2, at 675-677.
9 Where managers do not own 100 per cent of the issuer, they will bear only a portion of the costs that is proportional to their ownership stake. F.H. Easterbrook & D.R. Fischel, ibid. at 684.
and allow them to distinguish themselves from firms with ‘bad news’ or bad investment projects. Firms with no information have also incentives to disclose honest report to avoid being confused with firms with bad news. Firms with bad news or bad investment projects must also disclose their unfavourable information, even if they would prefer not to do so, in order to avoid investors assuming that they have even worse news.

Therefore, firms that start disclosing information cannot stop their disclosure activities because investors will otherwise always assume the worst. Firms that do not disclose information "must suffer the cost of suspicion generated by nondisclosure or must convince investors that the numbers would either not be meaningful or that they would be too expensive to produce." From this it follows that managers have incentives to disclose information to prospective investors because of the effects of disclosure on firm value.

In sum, firms benefit from voluntary disclosure through a lower cost of capital as disclosure leads investors to offer the highest price for their shares by decreasing the impact of information asymmetry, and lowering investors’ costs of obtaining information.

2. The Limits of Voluntary Disclosure

The incentives of issuers to produce socially optimal levels of disclosure can be questioned on two grounds. Firstly, issuers have incentives to refrain from disclosing information where doing so will decrease rather than increase firm value. This will be the case with respect to confidential information whose disclosure can compromise firms’ competitive advantage and reduce their market value. This ‘good reason’ not to disclose information is likely to exercise an important

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12 G. Benston, supra note 3. at 1476.
13 G. Benston, ibid. at 1476; F.H. Easterbrook & D.R. Fischel, supra note 3. at 683.
influence on the owner-managers of small firms — which are usually closely held prior to going public — who will bear most of the costs of disclosing the proprietary information.  

There are several types of information whose disclosure can create competitive disadvantage. For example, the disclosure of information about technological and managerial innovation can lead competitors to make improvements of their own. Likewise, disclosing information on strategies, plans and tactics can prompt competitors to develop similar products leading to a race to the marketplace, or develop counter-products rendering the planned product obsolete or less attractive. It is however the timing of the disclosure that really determines the competitive disadvantage of disclosure:

The key factor in determining whether information ... creates competitive disadvantage is timing. Products in development eventually come to market. Strategies become obvious from actions, and information about them can then no longer lead to competitive disadvantage. At some stage disclosure simply loses its capacity to create competitive disadvantage. A given category of disclosure can be competitively disadvantageous or competitively meaningless depending on when the disclosure is made.

Thus, the fear of losing a competitive advantage may lead managers to conceal information or withhold its disclosure during a certain period of time. This will preclude investors from accessing information that affects firm value in a timely fashion.

Several authors argue that the negative impact of disclosure on firms' competitive position should not be overstated. They remark that disclosure can also have positive effects on firms' competitiveness. Besides the general financial advantages of disclosing information recognised by signalling theory, releasing information can act, for example, as a marketing tool by giving a new

Historical Need for a Mandatory Corporate Disclosure System", (1983) 9 J. Corp. L. 1 at 8 n. 24: "Because of realistic or unrealistic concerns about the competitive market's response to dissemination of material financial information, some firms assumedly would prefer to suffer lower stock market prices or pay higher costs of capital rather than run the risk of inspiring additional or earlier entrants into their product markets."


E.W. Kitch, supra note 15. at 853.


Ibid. at 85-86. See also M. Porter, Competitive Strategy (New York: The Free Press, 1980) at 75.
product “a headstart in name recognition” and keeping the firm’s “name in the public mind associated with progress.”

According to Elliott and Jacobson, even though the information disclosed to investors overlaps, to some extent, with the information that can further the interests of competitors, there is still a significant difference between information disclosed for the purpose of investors and information which can be used by competitors. The authors emphasise that investors need information to estimate the distributions of returns on their investments. In contrast, competitors are not trying to predict a firm’s future cash flows, and information disclosed in this perspective will not be of use in obtaining competitive advantage. Elliott and Jacobson's argument can be criticised on the ground that it understates the importance for competitors of the information disclosed for the benefit of investors. As Kitch stresses, "the very information that will enable investors to value the corporation is information that can and will be used by competitors and others to decrease the value of the issuer." More particularly, the authors overlook the fact that information about profitability is a key ingredient in any competitor's decision to enter or not a market.

Finally, commentators emphasise that firms will consider the 'net competitive disadvantage' when assessing the impact of disclosure, rather than just the gross competitive disadvantage. Firms that lose a competitive advantage from disclosing information will not hold out information since they can gain a competitive advantage from similar disclosure by competitors. Although this concept of net competitive disadvantage is appealing, the possibility for an issuer to gain competitive advantage remains dependent upon the willingness of other issuers to disclose.

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22 Ibid.
231 E.W. Kitch, supra note 15, at 848.
232 Ibid., at 855.
competition-sensitive information.24 Since there are no guarantees that other issuers will disclose this type of information, it can be believed that most issuers will abstain from disclosing confidential information.

While the confidentiality of information may not always lead issuers to withhold it, the existence of such a 'good reason' not to disclose limits the value of voluntary disclosure as a signalling mechanism. In this context, investors cannot assume that non-disclosure implies negative news, unless they know the nature of the information that managers are withholding.25 Thus, issuers with good prospects cannot solely rely on voluntary disclosure to overcome adverse selection and differentiate themselves from firms with bad prospects.

Issuers may however be able to take alternative measures to convince prospective investors of their quality.26 Signalling theory states that entrepreneurs of high quality firms can communicate their information to prospective investors and receive higher market valuation by undertaking actions that lower quality firms find too costly to reproduce.27 In particular, owner-managers can use mechanisms involving endogenous factors to the firm to convey information to outside investors about financial situation and prospects.28 According to Leland and Pyle, information transfer can occur through the willingness of insiders, such as owner-managers, to invest in the firm.29 The higher the level of equity retained by insiders, the greater the risk the latter face by holding less fully

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27 For a given mechanism to be an effective signal, it must be non-optimal for lower quality sellers to imitate the actions of higher quality sellers. That is, the signal must be less expensive for higher quality firms and more expensive for lower quality firms.
28 See however E. Norton, "Capital Structure and Small Public Firms", (1991) 6 J. Bus. Vent. 287 (Survey of managers of small business indicates that the use of these factors as signal does not affect firms' financial policy.).
diversified portfolios. This increased risk costs less for good quality firms that promise higher returns than for poor quality firms with lower expected returns.

In this model, the level of equity retention reflects insiders' expectations with respect to firm value. Given the privileged position of insiders, investors can consider the percentage of equity retained by the latter as a signal of the true expected returns.\textsuperscript{10} Empirical research confirms this intuition. Studies indicate that a lower degree of underpricing is associated with high ownership retention, thereby supporting the proposition that equity retention acts as a signal of firm value and reduces \textit{ex ante} uncertainty in the IPO market.\textsuperscript{31}

The choice made by firms between debt and equity financing can also constitute a signal of their quality.\textsuperscript{32} The use of debt finance increases the probability of financial distress that can lead to bankruptcy.\textsuperscript{33} By using leverage to increase bankruptcy risk, good quality firms can signal their value to investors since managers of low quality firms will not imitate them because of their higher prospective bankruptcy costs. Bankruptcy imposes significant costs on managers' wealth and careers that are higher for firms with lower expected returns for any level of debt.\textsuperscript{34} In this respect, there is strong evidence that investors react positively to announcements of debt issue, and

\textsuperscript{10} K. Keasy & R. Watson, \textit{Small Firm Management}. (London: Blackwell Business, 1994) [hereinafter \textit{Small Firm Management}] at 186 (citing a 1992 U.K. study by Keasy, McGuinness and Short finding a positive and significant relation between the percentage of equity retention and market capitalisation of SMEs). M. Andrews, \textit{Initial Public Offerings - The Experience of Eight Canadian Growth Companies} (Ottawa: The Conference Board of Canada, 1994) at 5. In his survey, Andrews notes that several of the entrepreneurs interviewed "attributed the success of their IPO to the fact that they were not taking cash out of the company, but rather reinvesting for future growth." However, by taking their firms public, the entrepreneurs established a future exit mechanism from their investments.


\textsuperscript{33} R. Brealey \textit{et al.}, supra note 23, at 466.

\textsuperscript{34} N. Strong & M. Walker, supra note 29, at 146.
Negatively to announcements of common stock issues that decrease financial leverage, suggesting that investors take larger debt level as signal of firm quality.\textsuperscript{35}

However, it is possible to question the ability of small firms to use these mechanisms. The cost of ownership retention can be high for entrepreneurs and diminishes thereby their incentives to use this mechanism. Entrepreneurs tend to hold undiversified portfolios as a significant proportion of their financial and human capital is invested in their firm. Indeed, going public is often a means for them of diversifying their portfolios and reducing the risk that they bear by selling a portion of their firms to outside investors.\textsuperscript{36} Retaining a significant level of ownership to signal firm quality requires entrepreneurs to forego the benefits of holding more diversified portfolios. Since entrepreneurs will balance the benefits of using equity retention to signal firm quality with the costs of maintaining undiversified portfolios, this costs will often be too high and will lead entrepreneurs to take advantage of the potential of diversification rather than use equity retention as a signalling mechanism.

A further issue is that ownership retention may not be used in a way consistent with signalling theory perspective by small firms. Entrepreneurs may wish to retain a high portion of ownership for fear of losing control of their enterprise. In this case, equity retention will not be used as a signalling mechanism of firm value, but rather “as a means of reducing potential control loss.”\textsuperscript{37}

Likewise, the sale of equity blocks held by other insiders such as early stage financiers and venture capitalists when firms go public may not necessarily convey negative information about firm value as is suggested by signalling theory. On the one hand, these investors sell a portion of their holdings to exit their investments and realise the bulk of their returns after firms go public.\textsuperscript{38}


\textsuperscript{36} E. Norton, "Capital Structure and Small Public Firms", (1991) 6 \textit{J. Bus. Vent.} 287 at 300 (Major factor motivating the IPO is the management's desire to diversify their personal holdings.).

\textsuperscript{37} \textit{Small Firm Management}, supra note 30, at 186-187. See however M. Andrews, supra note 30, at 6 (Loss of control was not a problem for the founding shareholders interviewed in the survey.).

\textsuperscript{38} W.L. Megginson & K.A. Weiss, "Venture Capitalist Certification in Initial Public Offerings", (1991) 46 \textit{J. Fin.} 879 at 898 (Venture capitalists retain a majority of their holdings after the IPO. While a large number of them give up voting control
On the other, the portion of their holdings which early stage financiers retain will constitute a positive signal of their perception of the firm's potential.

In addition, there are several reasons indicating that SMEs should be inclined to use less debt than larger enterprises. Firstly, the general lower tax rates for small firms in Canada diminishes the tax shield associated with debt financing for larger firms and the attractiveness of this source of financing. Secondly, smaller firms face higher bankruptcy and reorganisation cost, irrespective of their quality. Thirdly, the characteristics of the operations of smaller firms increase the agency costs of debt and should reduce leverage and make monitoring by equity holders more valuable. Therefore, the cost of signalling with debt will tend to be very high for small enterprises, making it an inappropriate mechanism.

Besides, as we saw in Chapter I, SMEs are much more highly leverage than larger businesses because of the inaccessibility of equity markets. Thus, for this reason also, the level of leverage of small firms might not necessarily convey information about firm value as suggested by signalling theory.

of the firm, the majority retains a significant portion of their holdings.). C.B. Barry et al., "The Role of Venture Capital in the Creation of Public Companies", (1990) 27 J. Fin. Econ. 447. (Venture capitalists hold significant equity positions in venture backed-firms before and after the IPO, although it decreases after.)


More generally, it must be stressed that the capital structure choices of SMEs are the result of a complex balancing of interactive factors. The complexity of these choices compromises their effectiveness as a mechanism to convey accurate information on firm value as assumed by signalling theory. In his study of the factors influencing the capital structure decisions of small public enterprises, Norton notes the uncertain relevance of this theory:

The survey responses provide little evidence that supports the theories that suggest that bankruptcy costs, agency costs, or information asymmetries play significant roles in capital structure decisions. However, some support was shown by the survey results for a financial pecking order as well as a desire to refrain from excessive debt use. Of further importance were the effects of market factors and management preferences in determining capital structure policy, particularly the strong aversion to debt that was evident...

The effectiveness of the self-interest model of disclosure requires that potential investors have confidence in the accuracy of the information disclosed. Given the underlined inadequacies of factors such as the level of equity retention by insiders and the capital structure choices as signalling mechanisms, SMEs will have to rely on exogenous factors, such as third party certification or regulation, to ensure investor confidence in the information that they transmit to the market.

Finally, even where information has positive impact on firm value, voluntary disclosure may not produce socially optimal levels of disclosure because of the impossibility of creating a complete ‘community of interest’ between managers and shareholders. Indeed, as many commentators have stressed, maximising profits may not always be management’s primary goal as managers may be concerned with other motives such as: “personal motives; organizational objectives that result from the interaction of the organization’s participants; long-run survival;..."

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46 E. Norton. supra note 36, at 301.

maximizing sales without necessarily maximizing profits; and making merely satisfactory profits.\textsuperscript{48} Where management pursues any of these objectives, their incentives to produce an optimal amount of information is diminished.

The foregoing analysis reveals the limits of the self-interest model of disclosure. Firms will not voluntarily produce socially optimal levels of information because they do not little incentives to disclose information that has the potential to decrease their value. Furthermore, agency problems restrain information production, as mentioned above, even where disclosure is not likely to damage the issuer's competitive advantage. These constraints on voluntary disclosure reduce the amount of information that is available to the market and make it more expensive to prospective or actual investors to acquire information.\textsuperscript{49}

In this context, firms with good prospects cannot solely rely on voluntary disclosure to overcome the adverse selection problem and differentiate themselves from firms with bad prospects.\textsuperscript{50} However, the presence of these disincentives does not imply inevitably that there is a need for mandatory disclosure.\textsuperscript{51} Even though the effectiveness of signalling mechanisms is limited for SMEs, the market does provide other 'economising techniques' that can reduce information costs for investors.\textsuperscript{52} It is therefore necessary to examine the costs and effectiveness of these techniques in order to determine whether there is a need for mandatory disclosure.

\textsuperscript{48} M. Mendelson, \textit{ibid.} at 54.

\textsuperscript{49} R.J. Gilson & R.H. Kraakman, \textit{supra} note 26, at 592-595.

\textsuperscript{50} This problem is recognised by Easterbrook and Fischel. \textit{supra} note 2, at 687-688.

\textsuperscript{51} J.C. Coffee, \textit{supra} note 47, at 739-740 (it is debatable whether the lack of congruence between the interests of shareholders and managers demonstrates the need for mandatory disclosure).

SECTION B: THE LEVEL OF SECURITIES RESEARCH

The research activities of securities analysts are essential to the informational efficiency of the market. Analysts from brokerage firms, independent research services, and institutional investors, search issuer and non-issuer sources for information that can affect the value of securities and supplement thereby the information disclosed by issuers. They also evaluate and verify the information provided by issuers to prevent fraud and reduce the bias necessarily colouring this information. In addition, securities analysts possess firm- and industry-specific knowledge that enables them to appraise the projects, current performance and prospects of issuers and make recommendations to investors. The presence of analysts is particularly important for high technology issuers whose innovation-based ventures are very difficult to appraise by investors.


54 The information can concern idiosyncratic or exogenous factors. Note that managers do not have a monopoly over the production of idiosyncratic information. Information production is decentralised in firms and much of the data cannot be contained with the firms themselves. Analysts can also interview corporate officials and consult sources such as government reports, industry and trade associations' forecasts, economy-wide indicators published by government agencies or private firms. See D.C. Langevoort, ibid. at 1026; Note, ibid. at 1054.

55 J.C. Coffee, supra note 47, at 724; R.J. Gilson & R.H. Kraakman, supra note 26, at 600. This is a form of certification of information quality. D.C. Langevoort, ibid. at 1030. However, where securities analysts are employed by the securities firms underwriting the issues, the latter's analysis may not be without bias. See R.E. Mendales, “Looking Under the Rock: Disclosure of Bankruptcy Issues Under the Securities Laws", (1996) 57 Ohio St. L.J. 731 at 754-755.


The information that analysts uncover, assess and verify, generally helps investors value securities, and make their own decisions as to buy or sell them. Analysts research and verify information at a lower cost than investors because of the economies of scale associated with these activities. Their presence tends therefore to reduce the information costs of investors and fosters a wider distribution of information in the market. Indeed, the analysts’ work is disseminated in the marketplace and influences investors’ decisions directly or indirectly through financial services, investment advisors and brokers. This contributes to ensuring ultimately that prices reflect all available information.

Market forces should induce analysts to invest in searching and verifying information about issuers until the marginal cost of this information equals its value represented by the compensation paid by investors contracting for securities research. The compensation can be paid directly in cash but is generally paid indirectly through the all-inclusive commission charged by brokerage firms to the investors that direct some of their trading activities to these firms to get information from their analyst service, or through other investment banking business.

However, several authors argue that securities research produced by analysts is similar to a public good and that therefore the market will not produce an optimal amount of information in the absence of mandatory disclosure. The principal characteristics of a public good are the non-excludability of consumers who have not paid for it and the indivisibility of the good itself. Non-

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60 In this respect, analysts play an important role in ensuring that unsophisticated investors make intelligent investment decisions. See A.R. Rodier, supra note 3, at 36-37.


excludability means that people can use a public good whether or not they support the costs of acquiring the good. Indivisibility implies that the availability of the good is not diminished by its consumption. If securities research is a public good, an unregulated market will underprovide securities research because of the impossibility for analysts to realise the full value of their research activities. Indeed, since users of public goods can consume them without paying for them, “each potential user will conceal his preference and the owner will have great difficulty charging anyone for the good.”63 Differently stated, analysts will capture only a portion of the benefits of their research activities while bearing the full costs of them.

There are reasons to believe that, at least in the IPO market, securities research is not a public good, but rather a hybrid good with some characteristics of public goods and some of private goods.64 Indeed, it is possible to question the non-excludability of investors from securities research in the new issue market. Investors have no incentive to propagate information on the value of new issuers that is purchased from security analysts since this propagation does not yield any benefits for them. For example, if an analyst report indicates that a security is underpriced, an investor will benefit by withholding this information, buying the securities at the low initial price, and selling them at the informed price in the aftermarket.65 Conversely, disseminating this information would likely cause oversubscription and force the rationing of the issue. This would prejudice the investor since when rationing occurs, there is no guarantee that an investor will obtain the desired holdings of securities.66 Similarly, there is no incentive for an investor to propagate securities research information indicating that the issue is accurately priced or overpriced.

63 J.F. Barry, supra note 4, at 1324.
66 This is central to the winner's curse model. K. Rock, "Why New Issues Are Underpriced", (1986) 15 J. Fin. Econ. 187 at 188: "the investor with the highest valuation need not obtain the shares, even if the valuation exceeds the issuer's reservation (offer) price." See also Chapter II text accompanying notes 34-58.
Several models explaining the underpricing of IPOs propose that this phenomenon is the result, at least in part, of the private aspect of securities information that allows investors to exclude those who have not contributed to the costs of securities research. The winner’s curse model developed by Kevin Rock suggests that investors are asymmetrically informed about issuers and that underpricing is necessary to keep uninformed investors in the market.\textsuperscript{67} Benveniste and Spindt also recognise the presence of informed investors in the IPO market but argue rather that underwriters underprice new issues to compensate “investors with positive information about the value of the stock for truthful disclosure of their private information.”\textsuperscript{68}

Note however that there is information leakage in the IPO market that allows uninformed investors to gain some of the knowledge possessed by informed investors about the value or quality of the shares offered. The information leakage concerns more particularly aggregate investor demand that is critical in the determination of the initial price at which the issue will trade in the aftermarket.\textsuperscript{69} Leakage of information about market demand can occur in the period between the end of the waiting period, where the offering price is set, and the time where the final prospectus receipt is issued and the selling actually begins.\textsuperscript{70} It can also happen during the sale of the issue. Because of underwriters’ limited distribution channels, sales inevitably occur over a period of time, permitting later-stage investors to observe "how well [the] offering has sold to date - or at least how successful it has sold relative to offerings previously undertaken" by the underwriter.\textsuperscript{71}

The possibility to appropriate the benefits from information in the IPO market allows analysts to capture a significant portion of the benefits of their activities and alleviates part of the

\begin{itemize}
  \item \textsuperscript{67} K. Rock, \textit{ibid.} at 188.
  \item \textsuperscript{68} L.M. Benveniste & P.A. Spindt, \textit{supra} note 65, at 358.
  \item \textsuperscript{69} B. Chowdhry & A. Sherman, "International Differences in Oversubscription and Underpricing of IPOs", (1996) 2 \textit{J. Corp. Fin.} 359; I. Welch, "Sequential Sales, Learning and Cascades", (1992) 47 \textit{J. Fin.} 695.
  \item \textsuperscript{70} In Canada, this period is of at least 10 days. See B. Chowdhry & A. Sherman, \textit{ibid.} at 361, 363-364 (10 days); M. Weisbrod, \textit{Going Public and The Public Equity Market}, (Toronto: Wood Gundy, 1996) at 18-19 (14 days). During this period, leakage occurs, \textit{inter alia}, through rumours and investors applying for bank loans in order to bid for the shares. Note that this period can be shorter where the issuer makes an offering using the prompt offering prospectus (POP) system. See
  \item \textsuperscript{71} I. Welch, \textit{supra} note 69, at 695.
\end{itemize}
public goods argument. However, wasteful securities research can be conducted to the extent that analysts duplicate their effort in compiling and verifying information about issuers because they do not have access to each others’ information. This redundant production of information will happen when analysts search and expend resources for the same information.

While the hybrid character of securities research in the IPO market leaves open the possibility of both under- and over-production of securities research, it must be stressed that there are other more compelling factors indicating that SMES going public will not attract a high level of securities research. The first factor concerns the degree of institutional investor ownership of SMES. Institutional ownership exercises significant influence on the level of securities research. On the demand side, institutional investors consume more securities research than retail investors do as the large sums they invest allow them to gain potential high profits from research. Moreover, institutions are the most important clients of brokerage firms given the level of their trading activities. Since the revenue generated by the analyst services of brokerage firms comes from the commissions paid by investors on their trading, the presence of institutional investors is likely to affect the supply of analysts. In this respect, evidence shows that analyst supply increases with the number of institutions holding firms' securities. However, institutional investors are not active purchasers of small firm IPOs for reasons that will be examined further below. Therefore, the low degree of institutional ownership will influence negatively the demand and supply of analysts for small IPOs.

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72 G. Herder, supra note 64, at 188.
73 F.H. Easterbrook & D.R. Fischel, supra note 2, at 681.
74 Institutional investors are the most active traders on the market, accounting for about 70 per cent of all transactions. "Agency Volume Business", Toronto Stock Exchange Review, December 1995 at 3.
75 J.C. Coffee, supra note 47, at 732
76 A. Arbel et al., "Giraffes, Institutions and Neglected Firms", (1983) Fin. Anal. J. 57 (May-June); R. Bhushan, supra note , at 256. It is necessary to point out that while institutional investors utilise outside analysts, many of them have their own internal research analysts. The size of the portfolio of these investors allows them to benefit from economies of scale that renders such activity economically justifiable.
77 Infra Section D.
Secondly, firm size influences the demand for analysts' services. The demand for analyst's information is related to the potential economic value of the information generated. Information on larger firms is likely to be more valuable to investors than information on smaller firms because the profits generated by trading on the basis of this information are likely to be higher. Accordingly, the demand for analyst services will be higher for larger firms than smaller firms.

In addition, since smaller firms have fewer shares and are less widely held, they offer a lower number of potential business transactions for brokerage firms. This problem is magnified by the lower volume of transactions in the IPO market in comparison with in the secondary market. Moreover, the volume of IPOs tends to be irregular because of the cyclical nature of the market. This lower volume of transactions limits considerably the potential compensation that generates research for analysts and reduces their incentives to supply research. Thus, "[w]ith such relatively small volumes in shares for which no prior market exists, security analysts find few opportunities and, therefore, invest their time elsewhere".

In sum, securities analysts play an important role in market efficiency. They enhance the level of information in the market by researching new information, integrating it with other information relevant to the value of issuers, and conveying all of this information to investors. The role of analysts is however very limited in the small firm IPO market due to supply-side and demand-side factors which limit the profitability of securities research in this segment of the market. Although public policy should not subsidise securities research, it should consider the

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79 K.H. Chung et al., ibid. at 1028.


82 B.M. Barber et al., supra note 53, at 291.

possibility to increase the demand for research by stimulating the interest of institutional investors. Likewise, it would seem appropriate for public policy to attempt to reduce the regulation-induced cost of producing securities research. These issues will be examined in more detail below.\textsuperscript{84}

\textbf{SECTION C: THIRD PARTY CERTIFICATION OF FIRM VALUE}

Issuers have incentives to voluntarily disclose information to investors to obtain higher prices for their shares. However, there exist disincentives in parallel that prevent issuers from voluntarily disclosing a socially optimal amount of information to the market. The impact of those disincentives on the amount of information available on the market is magnified in the small firm IPO market by the dearth of securities research. The disinterest of securities analysts toward SMEs going public, though economically rational, deprives the market of relevant information on the assessment of the value of smaller issuers.

How, in this context, can issuers convey reliable information to prospective investors to reduce information asymmetries? According to signalling theory, an effective method is to use outside specialists acting as information intermediaries to help in the transmission of voluntary information to the market.\textsuperscript{85} These information intermediaries, who can also serve as an alternative source of information on issuers, enhance investor confidence by providing an independent check on information accuracy. In fact, information intermediaries act as certifying agents by offering their reputation in lieu of the issuers' as a guarantee of quality.\textsuperscript{86}

For prospective investors to be convinced of the accuracy of the information disclosed, the signal conveyed by certifying agents must itself be believable. This requires that three conditions be

\textsuperscript{84} See \textit{infra} notes 253-302 and related text and \textit{infra} Chapter IV notes 256-277 and related text.


\textsuperscript{86} R.J. Gilson & R.H. Kraakman, \textit{ibid.} at 604.
met." Firstly, the certifying agent must have reputational capital at stake which would be adversely and materially affected by certifying as accurately priced an issue which was actually overvalued. Secondly, the value of the agent’s reputational capital must be greater than the gains to be made from false certification. Thirdly, it must be costly for issuers to purchase the services of the certifying agent, “and this cost must be an increasing function of the scope and potential importance of the information asymmetry regarding intrinsic firm value.”

This section presents the most important certifying agents in the IPO process and discusses their accessibility for SMEs.

1. Venture Capitalists Participation and the Importance of an Exit Mechanism

Venture capitalists are defined as investors who provide long-term financing and expertise to high-growth, high-risk promising firms, often in the high technology sector. Venture capitalists take concentrated equity positions in such firms and assume an active role within the latter to add value. While venture capitalists play a variety of roles in their portfolio firms, I would like to emphasise in this section their ability to reduce the information asymmetry that exists between corporate insiders and prospective investors, and to facilitate the access of their portfolio firms to


88 W.L. Megginson & K.A. Weiss, ibid.


the public equity market." Before turning to this question, it appears necessary to briefly describe the Canadian venture capital market.

The Canadian venture capital industry is fairly young, dating back only to the early 1980s. The industry is compact in terms of the number of firms and amount of capital managed as there are less than 100 professional venture capital firms in managing about $6 billion of capital. Venture capital activities are highly concentrated geographically with Ontario and Québec generating the bulk of Canada’s output of venture capital. Venture capitalists play a determining role in financing young emerging firms as they provide a third of the equity requirements of these firms.

Canadian venture capitalists typically make long term investments in firms, expecting to hold their investment for about three to eight years. They share in the growth potential of their investments through equity or debt instruments with equity opportunities, expecting high annual returns of at least 25 per cent. These returns are primarily made on the capital gains at realisation or exit of their equity stake through company buyout, or the sale or the flotation of the business on

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93 Canadian Venture Capital Association, Venture Capital in Canada: Annual Statistical Review and Directory (Toronto: CVCA, 1996) at Table 11 [hereinafter Annual Statistical Review]. See also M. MacDonald, Venture Capital in Canada: A Guide and Sources (Toronto: Association of Canadian Ventures Companies, 1992); D. Paterson, Financing Canadian Software Company Development (Ottawa, Industry Canada, 1996). Five types of investors comprise this industry: private independent funds, corporate industrial, corporate financial, public sector, and hybrid. Private independent funds are the most important investors of the Canadian venture capital industry. They manage about 45 to 50 % of the venture capital in Canada.
94 R. Amit et al., "Venture Capital Financing and Entrepreneurship in Canada", in P.J.N. Halpern, supra note 92, at 242-244.
95 Business Development Bank of Canada, Economic Impact of Venture Capital, (Montreal: Venture Capital Division, Business Development Bank of Canada, 1996) at 8 [hereinafter Economic Impact of Venture Capital]. In 1995, 60 per cent of the funds were invested in firms with revenue less than $9 million. See Annual Statistical Review, supra note 93, at Table 3.
96 M. MacDonald, supra note 93, at 7, 13.
97 R. Amit et al., supra note 94, at 252-253; Financing Innovative Enterprise, supra note 53, at 35; M. MacDonald, ibid. at 51.
the stock exchange. In this respect, IPOs and subsequent sales represent the most profitable mechanisms for exiting investments, even though they remain less popular than company buybacks. Thus, in 1996, only 9 per cent of all dispositions were made through IPOs and subsequent sales, returning 6.1 times the aggregate cost of investments to investors, while in 1995, 15 per cent of such dispositions were made and yield returns of 5.1 times. Note however that the use of the various exit mechanisms by venture capitalists varies significantly over time, reflecting changes in the economic environment.

Venture capitalists reduce information asymmetries through their information gathering activities, their monitoring, as well as by their own certification of firm quality. Venture capitalists engage in intensive screening and evaluation of the projects submitted which allow them to gather substantial amounts of information prior to investing. Thus, a venture capitalist typically reviews the business plan of the firm to evaluate the project in light of factors such as the competitive position of the product or service, the management capabilities and past record, the resources that will be required of the venture capital firm, and the potential financial returns. Once the project passes screening, the venture capitalist engages in due diligence before committing money to the venture. This due diligence work involves a series of meetings with management, a review of financial statements, and, possibly, interviews with suppliers, customers, bankers, other investors, and various experts. Venture capitalists are very rigorous in the evaluation of the projects and invest only in one or two per cent of investment opportunities they review every year.

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98 J. Lerner, "Venture Capitalists and the Decision to Go Public", (1994) 35 J. Fin. Econ. 293; J.G. MacIntosh, supra note 92, at 284-285. The growing involvement of venture capital firms in high technology as been associated with the flurry of IPOs of many high-tech companies. See M. Evans, "Take my Cash Please". Fin. Post, March 16, 1996 at 6; S. Yellin, "Venture Funding Surged in Fourth Quarter", Fin. Post, March 16, 1996 at 16.

99 J.G. MacIntosh, ibid. at 322-341.

100 MacDonald & Ass., Key Observations on 1996 Venture Capital Activity, (Toronto: CVCA, 1997) at 2.

1001 J.G. MacIntosh, supra note 92, at 327-329.


102 D. Paterson, supra note 93.
Venture capitalists take an active participation in the governance of the firms in which they invest. They exercise close monitoring of their portfolio firms by holding seats on the board of directors, helping recruiting and compensating key individuals, working with suppliers and customers, helping establish tactics and strategy, and structuring transactions such as mergers and acquisitions. In this respect, the significant size of their equity investments gives them strong control levers which are buttressed by the contractual arrangements negotiated with the investee firms. Sometimes, venture capitalists will even assume a more direct managerial role by changing management and taking over the day-to-day operations of the firm. These activities protect venture capitalists’ own interests and reduce the level of information asymmetry. In this respect, venture capitalists generally try to concentrate their investments in industries in which their expertise and their ability to monitor are the greatest.

The monitoring of portfolio firms by venture capitalists is further ensured by the staging of their capital infusions. Venture capitalists invest their capital at distinct stages in the development of firms rather than committing up-front all the capital needed to accomplish the project. In this system, entrepreneurs have only enough capital to reach the next stage of financing, which is contingent on the realisation of stated objectives. This allows venture capitalists to review periodically the performance of their investments and preserves the possibility of abandoning failing projects. Furthermore, the willingness of entrepreneurs to accept this form of financing conveys information about their beliefs in their project and the time and cost that each stage

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105 C.B. Barry et al., supra note 38, at 11; Economic Impact of Venture Capital, supra note 95, at 11.

106 B.S. Black & R.J. Gilson, supra note 89, at 253.

107 C.B. Barry et al., supra note 103, at 450; Economic Impact of Venture Capital, supra note 95, at 11; P.A. Gompers, supra note 42, at 1461; W.A. Sahlman, supra note 101, at 506-507. The principal stages of financing are: seed financing, start-up, first-stage financing, second-stage financing, mezzanine financing, liquidity stage (cash out or exit).
requires. As the ventures mature and more information is disclosed with each round of financing, firms can receive greater amounts of capital in subsequent rounds of financing at better conditions.

Staged financing gives strong incentives to entrepreneurs to use capital efficiently and thereby mitigates the agency conflicts between venture capitalists and entrepreneurs. According to Sahlman, staged financing is the most important mechanism that venture capitalists possess for controlling portfolio firms: "The credible threat to abandon a venture, even when the firm might be economically viable, is the key to the relationship between the entrepreneur and the venture capitalist."\textsuperscript{108}

Besides, venture capitalists provide resources and knowledge to their portfolio firms which increase return potential and reduce risk.\textsuperscript{109} Their expertise plays a particularly central role when firms seek to raise additional capital on the IPO market. Their knowledge of the going public process helps entrepreneurs prepare their IPO and gain access to other financial specialists.\textsuperscript{110} Even more importantly, experienced venture capitalists can time their firms' offerings, taking them public when their market valuation is particularly high, and relying on private financing when valuations are lower.\textsuperscript{111} In other words, experienced venture capitalists 'nurture' their firms in anticipation of a hot issues market. This ability contributes to a lower cost of public equity financing for firms.\textsuperscript{112} It also provides benefits for venture capitalists that sell shares after the offering to exit their investment, in the form of higher returns, and reduces the dilution of the ownership stake of those who retain their investments.\textsuperscript{113}

\textsuperscript{108} W.A. Sahlman, \textit{ibid.} at 507.


\textsuperscript{110} \textit{Infra} text accompanying notes 128-130.

\textsuperscript{111} J. Lerner, \textit{supra} note 103, at 313-314. See however P.A. Gompers, "Grandstanding in the Venture Capital Industry", (1996) 42 \textit{J. Fin. Econ.} 133 (Less experienced venture capitalists have incentives to bring a portfolio firm prematurely.).


\textsuperscript{113} J. Lerner, \textit{supra} note 98, at 294.
In the IPO market, the presence of venture capitalists further reduces the information asymmetry between insiders and other market participants through its certification effect. Megginson and Weiss remark that there are strong reasons to believe that venture capitalists are effective certifying agents. Firstly, venture capitalists are repeat players. They bring portfolio firms to the market on a regular basis and invest directly on an ongoing basis in new ventures. Thus, they have incentives to establish and maintain a trustworthy reputation that will ensure them continuous access to the IPO market on favourable terms. Indeed, a good reputation will allow venture capitalists to attract high-quality portfolio firm candidates for which they compete with other venture capitalists. Furthermore, venture capitalists' reputation will exercise a determining influence of their ability to raise capital for new funds from investors.

Secondly, the value of the reputation of venture capitalists exceeds the benefit that can yield false certification for four reasons, according to Megginson and Weiss:

1. successful venture capitalists are able to achieve very high returns on relatively modest capital outlays;
2. these returns are directly related to the age and historical performance of the VC fund, as well as to the size of its investment portfolio;
3. successful VC fund managers are able to establish profitable "follow-on" funds and are also able to achieve an enhanced deal flow from entrepreneurs; and
4. the VC fund manager market is a relatively small, tight-knit, and efficient labor market where individual performance is constantly monitored and valued.

Thirdly, the services provided by venture capitalists are very costly to obtain by issuers and the cost of these services increases with the level of information asymmetry concerning firm

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114 B.S. Black & R.J. Gilson, supra note 89, at 254-255.
115 W.L. Megginson & K.A. Weiss, supra note 38, at 881.
116 B.S. Black & R.J. Gilson, supra note 89, at 254.
value. As we saw, venture capitalists invest in new ventures after stringent screening and evaluation, turning down most of the investment opportunities that they are offered. Moreover, venture capitalists require very high rates of returns and structure their investments in a way that shifts a great deal of the risk of the firm onto management. This makes it very difficult for poor quality firms to imitate good quality firms by purchasing the services of venture capitalists.

The level of ownership retained after the IPO further enhances the value of the certification provided by venture capitalists. While they could benefit from false certification by selling their shares in the IPO, evidence indicates that venture capitalists retain a substantial portion of their share ownership after the offering. Ownership retention acts as a bonding mechanism for credible certification as it signals their belief in the firms' prospects, and provides also assurance of continued monitoring to prospective investors.

There is strong evidence that capital markets recognise the value of venture capitalists' monitoring and certification functions. Most noteworthy, Barry et al., who studied 433 IPOs by venture-backed firms during the period 1978-1987, found that "the quality of venture capitalists' monitoring skills reduces investor uncertainty and that lower uncertainty is associated with less IPO underpricing." Megginson and Weiss, who compared a sample of venture-backed IPOs with non-venture-backed IPOs for the period 1983-1987, corroborate this role of venture capitalists. The authors also found that venture capital backing resulted in significantly lower underpricing.

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120 Ibid. at 882.

121 For example, convertible preferred stock is the most usual form of investment of venture capitalists. Preferred stock gives them a superior claim to cash flow and to distributions in liquidation in the event that the venture is unsuccessful. In addition, the conversion feature allows venture capitalists to participate in the good performance of the firm. See W.A. Sahlman, supra note 101, at 509-510.

122 C.B. Barry et al., supra note 103, at 460-461. In the U.S., venture capitalists own on average 34.3 per cent of the pre-IPO equity of the issuer, and 24.6 per cent of it after the IPO. No data exist precisely on this subject in Canada. However, some evidence suggests that venture capitalists remain involved after the IPO. For example, 19 per cent of investee firms are publicly traded. See Economic Impact of Venture Capital, supra note 95, at 11.

123 C.B. Barry et al., supra note 38, at 469.

Furthermore, the study by Megginson and Weiss suggests that an important function of venture capitalist certification is to act as a catalyst in reducing information asymmetry. Indeed, their study shows that venture capital-backed firms are able to attract higher quality auditors and underwriters than non venture capital-backed firms. This can be explained by the fact that the past experience of auditors and underwriters with venture capitalists allow them to infer information on the IPOs brought to the market. More specifically, these intermediaries will have knowledge about the value of the monitoring performed by venture capitalists as well as about their reputation in revealing information about issuers. And because venture capitalists have reputational capital at stake, the information disclosed about new issues will likely be truthful, allowing these issuers to attract high quality auditors and underwriters. Since both auditors and underwriters also have certifying functions, part of venture capitalists’ contribution to reducing information asymmetry and underpricing lies therefore in their ability to attract these high quality intermediaries.

In addition, the relationships built by venture capitalists with other market participants facilitates the access of firms to the IPO market by helping them economise on search cost and auditor and underwriter compensation. Searching for suitable underwriters and auditors can be particularly costly and time consuming for entrepreneurs with no prior knowledge of public equity financing. The experience of venture capitalists in the IPO market will facilitate this research and arguably reduce search cost for issuers. The reputation of venture capitalist will also diminish the underwriters’ and auditors’ cost of due diligence by making it easier for the latter to acquire and

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125 T.H. Lin, ibid. at 62; W.L. Megginson & K.A. Weiss, ibid. at 887-891.

126 In Canada, the small size of the venture capital market makes it easy for market participants to know the most active venture capitalists.

127 T.H. Lin, supra note 124 at 62; W.L. Megginson & K.A. Weiss, supra note 38, at 887.

128 J. Higgins, Canada and U.S. Cost Comparisons of Initial Public Offerings (IPOs) (Ottawa: The Conference Board, 1994) at 6; National Advisory Board on Science and Technology, Report of the National Advisory Board on Science and Technology Committee on Financing Industrial Innovation (Ottawa: National Advisory Board on Science and Technology, 1991) at 12 (noting that owner-managers of high technology firms are not knowledgeable about financing).

129 W.L. Megginson & K.A. Weiss, supra note 38, at 887.
verify information about issuers, thereby lowering the compensation that issuers have to pay these intermediaries.130

The importance of the monitoring and information gathering function of venture capitalists is further confirmed by the pattern of their investments. The number of technology firms attracting venture capital financing constitutes an important portion of total investments.131 In Canada in 1996, 62 per cent of the 525 companies that received financing from venture capitalists were technology-based businesses. These firms secured 69 per cent (or $749 million) of total venture capital investments.132 Besides, venture capitalists concentrate an important portion of their investments in firms in early stage development. Almost 40 per cent of the investee firms in 1996 were in their early stage and received close to a third of the total funds invested.133

As the evidence indicates, venture capitalists tend to concentrate their investments in early stage firms and technology firms where information asymmetries are likely to be severe.134 This is arguably because the value of their monitoring is considerable for these firms.135 Early stage ventures have short or no histories available for examination and are therefore difficult to evaluate. Likewise, firms in the technology sector with significant growth opportunities and high R&D intensities require close oversight.

130 T.H. Lin, supra note 124, at 63; W.L. Megginson & K.A. Weiss, ibid. at 894-895.

131 The technology sector includes biotechnology, communications, computer related, electronics, energy and environmental technology, industrial automation and equipment, and medical and health related. MacDonald & Ass., Technology Exposure Continues to Grow - Venture Capital Investment by Sector (Toronto: CVCA, 1997) [hereinafter Venture Capital Investment]. See also R. Amit et al., supra note 94, at 244-245; Financing Innovative Enterprise, supra note 39, at 35.

132 Venture Capital Investment, ibid.

133 Ibid.

134 The evidence marshalled by Amit et al, supra note 94, at 255-256, indicate that about 30 per cent of venture capital investments can be classified as early stage. While this finding seems to be relatively low and suggests a preference for later stage investments, Winter aptly underlines that "the greater involvement of venture capital in the development stage may reflect the fact that this is the point of greatest investment for all sources". R.A. Winter, "Comments", in P.J.N. Halpern, supra note 92, at 405. See also Financing Innovative Enterprise, supra note 39, at 29-33 (noting an increase in venture capital early stage investments since 1988).

135 P.A. Gompers, supra note 42, at 1462-1463.
The foregoing discussion suggests that the existence of a vibrant venture capital market has important implications for the efficiency of the IPO market. At the same time, as many commentators have remarked, a dynamic venture capital market requires efficient exit mechanisms to allow these investors to realise their investments — at a rate of return that fully compensates them for the risk incurred and the services provided — and commit funds to new ventures.\textsuperscript{136} In this respect, the IPO market plays a critical role in the venture capital process since IPOs are the most profitable means of exit.\textsuperscript{137} Thus, one way in which public policy can encourage the development of a strong venture capital market is by enhancing the efficiency of the IPO market and nurturing an active secondary market.\textsuperscript{138} Both of these issues are considered in this dissertation.

2. Initial Public Offering Performance and Underwriter Reputation

Going public is a lengthy and complex process involving legal and market requirements with which issuers are generally not familiar. For this reason, issuers rely on investment dealers to assist themselves in the offering process. Investment dealers perform four economic functions which may be of value for issuers.\textsuperscript{139} Firstly, investment dealers can advise issuers on their financial situation and provide information on the various alternatives to raise capital and the ways to structure the transactions. Secondly, investment dealers assist issuers in the distribution of their securities offerings by locating investors and conducting transactions with them. Thirdly, they perform a risk-bearing function when they execute firm commitment underwriting by purchasing the issues they distribute. Finally, the participation of underwriters in IPOs can provide a ‘seal of approval’ on

\textsuperscript{136} See e.g. J.G. MacIntosh, \textit{supra} note 92; B.S. Black & R.J Gilson, \textit{supra} note 89.

\textsuperscript{137} \textit{Supra} Chapter I notes 68-70 and related text.

\textsuperscript{138} This was suggested, among others in: \textit{Quinquennial Report on the Application of the Québec Securities Act} (Québec: Ministère des Finances, 1993) at 64-65; L. Robic, \textit{L'appui au secteur financier: des dividendes pour le Québec} (Québec: Ministère des Finances, 1993) at 38-39. See also C.J. Milhaupt, \textit{supra} note 89, at 895-896. It is beyond the scope of this dissertation to examine the issues which raise the development of a vibrant venture capital market. Among the most salient issues that should be addressed is to ensure that there are no impediments to the investment activities of venture capital firms in the private placement market. H.R. Stoll, “Small Firms’ Access to Public Equity Financing” in E.I. Altman & I. Walter, \textit{supra} note 39, at 230-231; \textit{Financing Innovative Enterprise}, \textit{supra} note 39, at 94-105. Furthermore, public policy should attempt to remove any unnecessary legal constraints which affect the choice of exit, including tax factors. For an overview of those issues see J.G. MacIntosh, \textit{supra} note 92, at 295-296.

offerings that will convey information on firm value to prospective investors. This section discusses the certification function of underwriters.\textsuperscript{140}

a) The Ability of Underwriters to Act as Gatekeepers

The ability of underwriters to certify the quality of offerings comes from their reputation for pricing issues and assessing market conditions accurately.\textsuperscript{141} Reputation is valuable for investment dealers since it allows them to charge higher fees for their services.\textsuperscript{142} The value of this reputation is magnified by the fact that it can be used over time in investment dealers' repeat underwriting business.\textsuperscript{143}

Underwriters' reputational capital is at stake when they sign the prospectus and certify to the market that they have evaluated an issuer and that the information disclosed is truthful.\textsuperscript{144} Indeed, if the securities sold by an underwriter are always mispriced, because of misstatements or undisclosed information, investors will stop buying securities from this underwriter and issuers will not want to do business with it either. Thus, underwriters certifying falsely the accuracy of information run the risk of jeopardising their whole business.\textsuperscript{145}

\textsuperscript{140} The other functions of investment dealers are discussed infra Chapter V.


\textsuperscript{142} The reputation of underwriters varies across the industry. It is determined by factors such as "(1) the repute of the partners, (2) the capital strength of the firm, (3) its marketing power in the distribution of securities, and (4) the on-going generation of major business." S.P. Ferris \textit{et al.}, "An Analysis and Recommendation for Prestigious Underwriter Participation in IPOs", (1992) 17 J. Corp. L. 581 at 586. This implies that underwriter services are not homogeneous across potential suppliers. See D.A. Simunic & M.T. Stein, \textit{Product Differentiation: Auditor Choice in the Market for Unseasoned New Issues} (Vancouver: Canadian Certified General Accountants' Research Foundation, 1987). The value of underwriters' certification is further enhanced by their liability under the \textit{Securities Act} that assures investors that underwriters are confident that the "due diligence" defence is available to them. S.M. Tinic, "Anatomy of Initial Public Offerings of Common Stock", (1988) 43 J. Fin. 789 at 798. See also infra Chapter V notes 154-185 and related text.


For this reason, reputable underwriters have incentives to screen closely prospective offerings and issue those only that will not adversely affect their reputation.\textsuperscript{146} Their presence will therefore guarantee to prospective investors that the price of the securities reflects all available information. And the higher the reputation of underwriters, the higher the value of their certification will be since they have more to lose if their reputation gets damaged by false certification.\textsuperscript{147}

In this context, it appears that underwriter certification can alleviate information problems in the IPO market to the extent that both investors and issuers rationally believe that underwriters would not risk damaging their reputation by mispricing new issues. Studies by financial economists support this role of certification and shows that IPOs sold by prestigious underwriters tend to be less underpriced.\textsuperscript{148} Hence, the presence of prestigious underwriters seems to reduce the \textit{ex ante} uncertainty that drives the winner's curse that is responsible, in part, for underpricing. Furthermore, the certification of issue price by reputable underwriters also enforces the underpricing undertaken to overcome the winner's curse.\textsuperscript{149}

b) The Accessibility of Underwriter Certification for Small and Medium-sized Enterprises

To the extent that reputable underwriters reduce the \textit{ex ante} uncertainty that induces underpricing, firms with greater level of \textit{ex ante} uncertainty, such as SMEs, should employ higher quality underwriters because of the higher benefits of the certification services. However, empirical studies

\begin{itemize}
  \item \textsuperscript{146} Gillen argues that underwriters' loss of reputational capital is likely to be less significant for small new issues thereby reducing the level of certification provided to smaller issuers. According to Gillen, this is because "underwriters may find that large expenditures on verification are not justified given that they will be less likely to be able to recoup such costs from small issuers". See M.R. Gillen, "Capital Market Efficiency Assumptions: An Analytical Framework with an Application to Disclosure Laws", (1994) 23 \textit{C.B.L.J.} 346 at 371-372. However, evidence appears to contradict Gillen as the compensation charged by underwriters varies with the costs of certifying offerings. \textit{Infra} text accompanying notes 136-137.
  \item \textsuperscript{149} R.P. Beatty & J.R. Ritter, \textit{supra} note 87. at 216-217.
\end{itemize}
indicate that reputable underwriters tend to issue larger-size offerings while less reputable underwriters are associated with smaller-size IPOs.150 This finding is particularly troubling since it implies that underwriter certification may not be available for SMES. It is therefore important to examine this issue closely to understand the cause of this segmentation and determine whether policy interventions are warranted to increase the availability of underwriter certification for smaller issuers.

Two concurrent explanations are offered for the segmentation of the market for underwriters. Segmentation can be explained, on the supply-side, by the fact that prestigious underwriters protect their investments in reputational capital by avoiding smaller issues that are inherently more risky.151 Being associated with poorly performing IPOs is likely to have a negative effect on the reputation and wealth of underwriters.152 For this reason, prestigious underwriters price themselves out of the reach of risky small firms by charging a higher risk premium than less reputable underwriters to cover litigation and reputation losses.153

Alternatively, the segmentation of the market for underwriters may be the product of demand side factors. In particular, it may result from SMES' attempt to minimise the cost of underpricing and the cost of underwriting when selecting the level of underwriter quality. In other words, the certification of SMES offerings by reputable underwriters may not yield sufficient benefits to outweigh the costs of hiring the services of such underwriters.


151 C.B. Barry et al., "Underwriter Warrants, Underwriter Compensation, and the Costs of Going Public", (1991) 29 J. Fin. Econ. 113 at 121-122 (Smaller IPOs have high aftermarket standard deviation.); R. Carter & S. Manaster, "Initial Public Offerings and Underwriter Reputation", (1990) 45 J. Fin. 1045 at 1062 (Prestigious underwriters tend to market low risk IPOs to maintain their reputation.); R.B. Carter et al., supra note 148 (same).

152 On the wealth effect of overpricing see supra Chapter II note 73 and related text.

153 S.P. Ferris et al., supra note 142, at 598; P.M. Clarkson & J. Meckley, supra note 31, at 67. Support for this explanation can be found in studies that find a positive relationship between the quality of underwriters and their compensation, showing that underwriters can charge a fee for their reputational capital. I. Krinsky & W. Rotenberg, supra note 31 (Higher quality underwriters can charge a higher fees notwithstanding the cost of performing information Intermediation services.); R.P. Beatty & I. Welch, "Issuer Expenses and Legal Liability in Initial Public Offerings", (1996) 39 J. Law & Econ. 545 at 576 (Underwriters earn a return on their reputational capital primarily from large less risky firms.)
There are strong reasons to believe that for smaller offerings the benefits of reputable underwriter certification increase more slowly with *ex ante* uncertainty than the cost charged by such reputable underwriters. The cost of certification comprises two elements: a production element and an expected loss element. The production element refers to the search costs incurred by underwriters to discover the information needed to certify pricing accuracy. Since smaller issuers are characterised by higher level of information asymmetry, the search costs incurred by underwriters will likely be higher for SMES.154

The expected loss element includes the litigation costs and the cost of reputation loss. Both of these costs are affected positively by *ex ante* uncertainty which is conducive of mispricing and increases the probability of damages to underwriter reputation.155 In this respect, note that the level of reputation losses will be higher for reputable underwriters.

To the extent that the cost of underwriter certification increases with the level of *ex ante* uncertainty, the level of underwriter compensation charged to SMES should therefore be higher. Consistent with this intuition, the level of underwriter compensation charged by underwriters is found to be significantly related to the costs of certifying offerings.156 Furthermore, evidence shows that firm-specific risk, a proxy for inside information, is significantly related to underwriter compensation.157 In this context, the dearth of reputable investment dealers issuing small firm IPOs suggests that the incremental cost of using a reputable underwriter increases more rapidly with *ex ante* uncertainty than the incremental benefit, making thereby the use of reputable underwriters not cost-effective for small risky issuers. In other words, the segmentation of the market for underwriters is the product of demand side factors.

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154 See for example P.M. Clarkson & J. Meckley, *ibid.* at 66 (noting that smaller firms are more underpriced).


In any event, while prestigious underwriters tend to be associated with large less risky offerings, there is a group of SMES that will be able to rely on the services of these underwriters. As mentioned above, the presence of venture capitalists is generally associated with reputable underwriters. Venture capitalists make small-size issuers more likely to afford higher quality underwriters as the certification they provide lowers search costs for underwriters and reduces the overall riskiness of the issues. Reputable underwriters are therefore more willing to issue smaller offerings and will charge lower compensation for their services.

For non-venture-backed small issuers, the benefit of using reputable underwriters as certifiers will probably not justify the high cost associated with their services. This does not mean that non-venture-backed IPOs cannot be certified by underwriters. Although underwriters with lower prestige bring these offerings to the market, other techniques may allow non-venture-backed issuers to get a certain level of underwriter certification.

According to professors Gilson and Kraakman, less reputable underwriters use underpricing as an alternative way of certifying firm quality.\(^{155}\) Underpricing passes on to customers “a portion of the return the underwriter receives for pledging its reputation”.\(^{159}\) It disposes customers favourably toward future issues by ensuring that their “ex post experience will be consistent with the issuer’s and investment banker’s ex ante representations”.\(^{160}\) In other words, underpricing is used to build up underwriters’ reputation for accurate pricing by “leaving a sweet taste in investors’ mouth”.\(^{161}\)

This explanation could be seen as consistent with the evidence that indicates that issues distributed by lower-tier underwriters are more underpriced than those offered by prestigious underwriters. However, as we saw previously, there is little empirical support for the hypothesis

\(^{155}\) R.J. Gilson & R.H. Kraakman, supra note 52, at 621 n. 197. See also J.R. Booth & R.L. Smith, supra note 37, at 62.

\(^{159}\) R.J. Gilson & R.H. Kraakman, ibid.

\(^{160}\) Ibid.

\(^{161}\) This was also suggested by R.G. Ibbotson, "Price Performance of Common Stock New Issues", (1975) 2 J. Fin. Econ. 235 at 264.
that underpricing is a signal of firm quality.\textsuperscript{162} Therefore, it is doubtful that underwriters can use it as a means to enhance their credibility as suggest Gilson and Kraakman.\textsuperscript{163}

In fact, it appears that less reputable underwriters use another way to certify the issue they take to the market. Most non-venture backed IPOs are issued through best efforts underwriting agreements rather than firm commitment agreements.\textsuperscript{164} A best efforts offering arguably does not use the reputational capital of underwriters to certify the value of the issue.\textsuperscript{165} Under a best efforts contract, the underwriter does not buy the issue at a predetermined price but only agrees to act as a marketing agent for the issuer, implying that he is not willing to make a more binding commitment.\textsuperscript{166} Indeed, unlike in a firm commitment underwriting, the success of the issue is not guaranteed by the underwriter with a best-effort agreement since if the minimum sales requirements are not reached within the stated period of time, the underwriter withdraws the offering.\textsuperscript{167} Moreover, the best efforts agreement places the issuer and the underwriter in an arms-length relationship. Since the underwriter does not purchase the offering taken to the market, he does not devote considerable resources to information-gathering prior to selling the issue, preferring to engage in this activity during the selling period.\textsuperscript{168} Thus, where he sets the issue price, the underwriter has limited access to inside information, thereby lowering the quality of certification.

\textsuperscript{162} Supra Chapter II and text accompanying notes 26-33.


\textsuperscript{168} P.C. Kumar & G.P. Tsetseko, supra note 165, at 121; A.S. Sherman, supra note 164, at 783.
Several commentators suggest that the warrants issued to compensate underwriters in best efforts offerings are used by less reputable underwriters to certify the values of issues they bring to the market. Warrants can be assimilated to long-term call options issued by firms on their securities that allow underwriters to acquire a given number of securities at a specific exercise price at a specified time period. Since the exercise price of warrants is tied to the price of the offering, their value, to which underwriter compensation is related, depends on the securities' performance in the aftermarket. If the securities are overpriced in the IPO, their price will go down after the offering and the warrants will become less valuable. From this it follows that warrants align the interests of underwriters with those of potential investors and allow underwriters to "credibly communicate that they are not selling overpriced securities". Accordingly, warrants can be seen as a mechanism that enhances the certification provided by less reputable underwriters and best efforts offerings. In this respect, a recent study by Dunbar shows that firms using warrants are less underpriced than if they had not used them, suggesting that warrants reduce informational asymmetry facing prospective investors.

One risk raised by the use of warrants arises out of the principal-agent relationship existing between underwriters and issuers. It is possible that underwriters use the monopsony power they possess over issuing firms to impose the use of warrants to extract excessive compensation from

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169 C.B. Barry et al., supra note 151, at 121-123, 132 (Issuers that grant warrants tend to be young small firms brought to the market by lower-tier underwriters.); C.G. Dunbar, "The Use of Warrants as Underwriter Compensation in Initial Public Offerings", (1995) 38 J. Fin. Econ. 59 at 64 (Almost all best efforts IPOs use warrants as underwriter compensation.).

170 R. Brealey et al., supra note 23, at c. 22.


172 C.G. Dunbar, supra note 169, at 62.


174 C.G. Dunbar, ibid. at 76; C.K. Ng & R.L. Smith, ibid. at 361 (Seasoned issuers using warrants experience less underpricing.). See however C.B. Barry et al., ibid. at 124-125 (IPOs with underwriter warrants are more underpriced.). Note that these studies were only examining firm commitment offerings.

175 This possibility is proposed and rejected by C.G. Dunbar, ibid. at 63-64.
issuers. Since underwriters control the pricing of offerings and have better information than issuers, they could increase the underpricing of issues to augment their security-based compensation over and above the limit permitted by regulation. However, as we saw previously, no empirical evidence supports either the principal-agent theory of underpricing nor the monopsony power hypothesis.176 Furthermore, more specific evidence "indicates that underwriters do not force issuers to accept costlier compensation contracts".177

By certifying, directly or indirectly, the value of new issues, underwriters foster the efficiency of the IPO market by reducing the level of information asymmetry between insiders and potential investors. Entrepreneurs that wish to maximise the value of their IPO firms can select a form of underwriter certification that balances the benefit of less underpricing with the cost of certification. In this perspective, it is important, when reviewing the regulation of IPOs to examine whether there are legal requirements that raise the cost of underwriter certification above what the value of these services should mandate. The most important issue in this respect will undoubtedly be the litigation risk imposed by securities legislation on underwriters.178

3. The Contribution of Auditors to Financial Information Credibility

Audit service is used to add credibility to the financial information of issuers. Auditors scrutinise the financial statements of the issuers they audit to reduce the risk of misrepresentations and report any deviations of accounting principles.179 Thus, auditing makes the information disclosed in financial statements more accurate and this allows "uninformed investors to estimate more precisely the distribution of firm value."180

176 Supra Chapter II. text accompanying notes 59-62.
177 C.G. Dunbar, supra note 169, at 76.
178 Infra Chapter V.
The credibility conferred by the audit service to financial statements depends on the reputation of the auditing firms.\textsuperscript{181} Indeed, prestigious auditing firms have substantial investments in reputation capital to protect. For this reason, they will avoid getting associated with lower-quality issuers because of the adverse affect it may have on their reputation in the IPO business and on their entire activities.\textsuperscript{182}

Further, prestigious auditors provide high quality service to maintain their investment in reputation capital when they audit financial statements of IPO firms. They usually have high investments in technology, physical facilities, personnel, and organisation control systems, that allow them to produce efficiently a high credibility level through powerful audit tests.\textsuperscript{183} Thus, audit quality reduces the probability that financial statements contain material omissions or statements.\textsuperscript{184}

In corollary, the reputation of auditing firms also sends a signal to investors about the reputation of underwriters. Underwriters exercise a significant influence on the selection of auditors for firms that are going public.\textsuperscript{185} Prestigious underwriters will likely select high quality auditors since better financial information will make it easier for them to price issues accurately and maintain their reputational capital.\textsuperscript{186} Likewise, the selection of prestigious auditors will also minimise the risk of audit failure that could damage underwriters’ reputations.\textsuperscript{187}


\textsuperscript{183} D.A. Simunic & M.T. Stein, supra note 142, at 19.


\textsuperscript{187} R.J. Balvers et al., supra note 185; K. Menon & D.D. Williams, ibid. at 316-317. This will be even more the case when the offerings are issued using a firm commitment underwriting, where the underwriters’ wealth is at risk.
Besides, prestigious auditors charge higher fees to issuers renting their reputational capital. High quality firms benefit from having their quality revealed and are willing to incur the fees charged by reputable auditors. Lower-quality firms will have less incentive to enlist their services because of the lower benefits of auditor certification.  

The foregoing discussion suggests that the reputation of auditors selected by issuers has the potential to convey information about firm quality and reduce \textit{ex ante} uncertainty in a similar fashion as the selection of prestigious underwriters. This intuition is supported by empirical evidence indicating that use of reputable auditors results in lower IPO underpricing.  

Accordingly, when selecting auditors, issuers should try to minimise the sum of underpricing and auditor compensation by trading off the benefit of hiring a high quality auditor with the potentially greater audit fee.  

From this it follows that firms with greater \textit{ex ante} uncertainty, such as SMEs, should employ higher quality auditors: “the greater the riskiness [of future cash flows], the more value that attaches to an audited report which, on average, reduces the percentage of ownership the entrepreneur needs to retain in order to avoid an undervaluation of his shares.” Such a prediction assumes that the cost of higher auditor quality is relatively fixed and independent of \textit{ex ante} uncertainty. However, there may be reasons to believe that the cost of hiring a high quality auditor will increase with \textit{ex ante} uncertainty about firm value.

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188 R.P. Beatty, supra note 179. at 696.
190 R.P. Beatty, \textit{ibid.} at 696; C.E. Hogan, \textit{supra} note 186. Note that other signalling mechanisms such as ownership retention, underwriter reputation, direct disclosure, and leverage, may nevertheless be used to convey information to prospective investors.
191 G.A. Feltham \textit{et al.}, "Empirical Assessment of the Impact of Auditor Quality on the Valuation of New Issues", (1991) 14 \textit{J. Acct. & Econ.} 357 at 376. \textit{Ex ante} uncertainty refers to the uncertainty of an issue's value prior to going public. This can be measured by the standard deviation of returns in the aftermarket, proxied by cash flow risk and the estimation risk in estimating cash flows.
The cost of audit service is made up of two elements: a production element and an expected loss element. The production cost element will increase with the size of the issuer and the complexity of its operations. The level of uncertainty will also affect the production cost, as auditors must engage in more research when firms are surrounded by high uncertainty and do not have other quality intermediaries that can reduce the cost of information.

The expected loss element comprises the litigation costs as well as the potential cost of repairing reputation which is arguably more important than the production cost element. These costs increase with the degree of uncertainty surrounding firms’ financial conditions that affects the probability for auditors of being sued. Further, note that the cost of repairing reputation will likely be greater for prestigious auditing firms than for lower-tier auditors with less reputation capital at stake.

If the production cost element and the expected loss element both increase with ex ante uncertainty, the cost of hiring a high quality auditor may not be cost-effective for SMES. A recent Canadian study by Clarkson and Simunic examined this question by studying the relationship between the incremental cost of higher quality audit and the level of ex ante uncertainty. The authors found a positive relation between ex ante uncertainty, as measured by issuer-specific riskiness of future cash flows, and audit quality, suggesting that issuers using high-quality auditors are more risky than issuers using low-quality auditors. Their findings imply that the incremental cost of employing a high quality auditor increases more slowly with ex ante uncertainty than the incremental benefit and, accordingly, does not dominate the latter. Further, the results mean that

192 C.E. Hogan, supra note 186, at 69.
193 R.P. Beatty, supra note 179, at 703.
194 D.A. Simunic & M.T. Stein, supra note 142, at 61 (Potential liability losses seem to be a significant component of auditor costs.).
196 C.E. Hogan, supra note 186.
riskier firms can rely on the services of high quality auditors to reduce the uncertainty that surrounds them, even when prestigious underwriters that can reduce the level of information asymmetry do not issue them.\textsuperscript{198}

This study contrasts with American studies that report an inverse relation between audit quality and firm-specific risk and that suggest that high-risk firms choose lower-quality auditors rather than prestigious auditors.\textsuperscript{199} Clarkson and Simunic argue that this difference can be attributed to the lower liability risk facing auditors in Canada compared to the United States.\textsuperscript{200} The differences in the litigation environment in the two countries, examined previously, reduce the potential liability losses for Canadian auditors.\textsuperscript{201} For this reason, “an increase in uncertainty surrounding a Canadian IPO client's future cash flows [has] relatively little impact on the auditor's future costs and hence supply price of the audit service.”\textsuperscript{202}

In sum, the services of reputable auditors appear to be accessible for SMEs in Canada. However, the contrast between the Canadian and American situations indicates that regulators should proceed with caution before imposing new liability to auditors.

\textsuperscript{198} C.E. Hogan, \textit{supra} note 186, at 84 (Issuers associated with lower-tier underwriters select the auditor which minimises the costs of underpricing and auditor compensation.).

\textsuperscript{199} R.P. Beatty, \textit{supra} note 195; G.A. Feltham \textit{et al.}, \textit{supra} note 191; D.A. Simunic & M.T. Stein, \textit{supra} note 142.

\textsuperscript{200} P.M. Clarkson & D.A. Simunic, \textit{supra} note at 210-211. See also D.A. Simunic et M.T. Stein, \textit{ibid.} at 61: the "legal liability provisions of the \textit{Securities Act} of 1933 appear to have a significant, and perhaps, unintended, effect on the supply of audit services to the small companies which are the typical new issuers of securities."

\textsuperscript{201} \textit{Supra} Chapter II, text accompanying notes 110-123.

\textsuperscript{202} P.M. Clarkson & D.A. Simunic, \textit{supra} note 197, at 211.
4. **The Limited Role of Banking Relationships**

Banks are the most common sources of business financing and the dominant lenders to small and medium-sized businesses. An analysis of the structure of banking relationships suggests that the existence of such relationships may influence the degree of *ex ante* uncertainty surrounding a firm going public.

Banks engage in collection and processing of information to screen out low quality firms and reduce the risk of lending to failing firms. The information gathering activities of banks is facilitated by their insider status that gives them access to inside information about borrowers. Further, the confidential nature of banking relationships allows banks to have access to strategic information that can affect the value of the project.

Moreover, loan covenants provide for bonding and monitoring mechanisms that reduce the probability of opportunistic behaviours by firm managers. The monitoring power of banks is

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203 Several other loan products exist to suit the needs of firms. First, personal loans secured by personal assets are available to entrepreneurs in the early stages of the venture. Operating loans, or line of credit, are another type of loan used by the majority of SMEs to get short term credit to finance their working capital needs. Finally, firms may get term loans to finance the purchase of fixed assets or to secure long-term funds. See generally L. Wyant & J. Haich, *Banks and Small Business Borrowers* (London: Western Business School, 1991); A. Riding et al., "The Canadian Small Business-Bank Interface: A Recursive Model", (1994) 18:3 *E.T. & P. 5*; Canada, House of Commons, Standing Committee on Industry, *Taking Care of Small Business* (Ottawa: Supply and Services, 1994) at 71, 72 [hereinafter *Taking Care of Small Business*] at 9.


buttressed by their capacity to withdraw credit or refuse to provide additional financing to failing firms, or firms that do not comply with the debt covenant.\textsuperscript{208} This exit mechanism allows banks to exercise a significant influence in the governance of firms as notes professor Triantis: "The lender's voice in this respect may be as direct and effective as the voice of a shareholder who threatens to vote to replace the incumbent directors."\textsuperscript{209} And the impact of banks' exit will be magnified by the information it conveys to outside equityholders about the borrowers.\textsuperscript{210}

From this it follows that the existence of banking relationships should signal to outside investors the creditworthiness of firms as investors can assume that bankers would not approve or extend a loan if inside information acquired in the lending process were negative.\textsuperscript{211} In corollary, the information conveyed by banking relationships about the creditworthiness of firms should reduce information costs for other market participants. Empirical research indicate that this seems to be the case as the existence of bank debt significantly reduces the level of IPO underpricing thereby suggesting that banking relationships diminish \textit{ex ante} uncertainty surrounding firms going public.\textsuperscript{212}

If banking relationships constitute an adequate signalling mechanism for SMEs in the IPO market, these firms "will incur the costs associated with bank lending to the point where [the]
marginal costs are equated with the marginal increase in the proceeds of initial public offerings.\textsuperscript{213} However, the cost-effectiveness of this signalling mechanism appears to be limited for small firms. Firstly, it seems likely that the cost of this signal will increase with the level of uncertainty, and consequently dominate the benefits it yields to SMES. Secondly, it is possible to question the effectiveness of banks screening and monitoring firm activities.

Debt-related agency problems are potentially serious for small firms.\textsuperscript{214} The characteristics of SMES give owner-managers the incentive and ability to engage in wealth-redistributing actions that increase the cost of using banking relationship as a signal. Owner-managers can take advantage of the flexibility of the operations of SMES to dispose of the assets firms hold when the funds are borrowed and substitute them for riskier assets at the detriment of lenders.\textsuperscript{215} This ability to shift risk is heighten by the control that entrepreneurs possess over their firms' operations and assets. Further, the high level of inside-ownership concentration in SMES increases the incentives of owner-managers to engage in asset substitution since "as their equity ownership rises, they capture a larger and larger share of the redistributed wealth."\textsuperscript{216a}

Owner-managers can also rely on the same factors to redistribute wealth to themselves by stripping assets out the firm and convert them to their own use after debt has been issued. For example, they can devalue debt interests through the payment of dividends or wages, or the repurchase of shares. The asset-stripping problem will be particularly severe for SMES since owner-

\begin{itemize}
  \item \textsuperscript{213} M.B. Slovin & J.E. Young, \textit{ibid.} at 732.
  \item \textsuperscript{215} R.R. Pettit & R.F. Singer, \textit{ibid.} at 52, 54-55
  \item \textsuperscript{216} \textit{Financing Innovative Enterprise}, \textit{supra} note 39, at 64; P. Halpern et al., "An Economic Analysis of Limited Liability in Corporation Law", (1980) 30 \textit{U.T.L.J.} 117 at 141.
\end{itemize}
managers "have a direct interest in the operations of the firm and ... obtain the full benefits of an alteration in the firm's operations."  

The great level of asymmetric information that surrounds SMEs will exacerbate the agency problems of debt. Information asymmetry enhances the capacity of owner-managers to engage in opportunistic behaviours by making them more difficult to detect.\(^\text{218}\) In this respect, note that high technology firm managers will enjoy additional freedom to substitute assets because of the intangible non fixed nature of assets that makes it particularly difficult for creditors to detect these forms of wealth redistributing actions.

The risk of redistributive actions should raise the direct cost of borrowing for SMEs as lenders require adequate compensation, through higher interest rates, for the greater possibilities of wealth expropriation, or for the additional monitoring that they must do to prevent opportunistic behaviours.\(^\text{219}\) While a study by Wynant and Hatch indicates that small businesses are charged higher rates of interest than larger firms, the variation between the rates of interest charged to the smallest business accounts and the largest was found to be rather small, even when accounting for loan fees.\(^\text{220}\) This may suggest that Canadian banks undercharge riskier SMEs and that wealth-redistributing actions have little impact on the direct cost of borrowing for these firms. As MacIntosh argued, it seems more likely however that banks simply do not service these firms, leaving them either to their merchant banking subsidiaries, or to non-bank affiliated merchant banks, venture capitalists or mezzanine financiers.\(^\text{221}\) If this is the case, it will be difficult for risky SMEs going public to establish a banking relationship to reduce ex ante uncertainty.

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\(^{217}\) P. Halpern et al., ibid. According to these authors, an unlimited liability regime "would seem to be the most efficient regime" and would reduce the moral hazard problem. Banks attempt to reduce the risk of asset stripping by requiring personal guarantees when loaning money to small enterprises. See L. Wynant & J. Hatch, supra note 203, at 8-9, 165-167.


\(^{220}\) L. Wynant & J. Hatch, supra note 203, at 350, 351. See also Taking Care of Small Business, supra note 203, at 11.

\(^{221}\) Financing Innovative Enterprise, supra note 39, at 11-16. Before the Berger Committee, banks have stated that "[t]hey do not want to offer riskier and more costly loans, such as subordinated debtor or mezzanine financiers". Taking Care of Small Business, ibid. This segmentation of the market is demonstrated by the opening by banks of merchant banking and venture capital subsidiaries to serve the needs of small firms. See e.g. J. Partridge, "CIBC Launches Fund for Brain-Powered
While no empirical studies have examined directly the impact of size on the use of banking relationships, some evidence seems to confirm this argument. In Slovin and Young’s research, 57.4 per cent of the sample of firms that used best efforts offerings did not have bank relations.222 The best efforts offerings had an average size of about $4.6 million and were therefore likely conducted by SMEs. In contrast, 64 per cent of firms in the sample that used firm commitment offerings (average offering size of $13.34 million) had bank relations. Although the results of their study remain inconclusive, James and Weir also argued that larger and older firms were more likely to have bank relationships:

We expect that firms with longer operating histories, higher level of sales, and higher ratios of plant and equipment to total assets are more likely to have credit relationships at the time of their offerings, either because it is easier for lenders to estimate their values or because these variables measure assets in place.223

Even more importantly, the effectiveness of banks’ screening and monitoring of small business lenders should not be overstated. Indeed, it appears that extensive investigations of potential is not cost justified for many small businesses.224 Small business loans have a low profitability for banks which compels them to use fast routine evaluation procedures in order to reduce information acquisition costs.225 Thus, small business lenders usually do not find it economic to investigate the collateral offered or require inventory audits, and very few conduct visits of the firm’s premises.226 Furthermore, the evaluation of small business borrowers operating in the high

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222 M.B. Slovin & J.E Young, supra note 204. at 733.

223 C. James & P. Wier, supra note 212. at 167.

224 L. Wynant & J. Hatch, supra note 203. at 17.

225 Information costs are the most important cost of a loan transaction. Other costs include documentation costs and filing fees. R.J. Mann, “The Role of Secured Credit in Small-Business Lending”, (1997) 86 Geo. L.J. 1 at 19-20 (This study presents the result of an interview-based empirical study of small business lenders) [hereinafter The Role of Secured Credit]; R.J. Mann, “Explaining the Pattern of Secured Credit”, (1997) 110 Harv. L. Rev. 625 at 659-663 [hereinafter The Pattern of Secured Credit]. On the profitability of small business loans in Canada, see L. Wynant & J. Hatch, *ibid.* at 129.

226 *The Role of Secured Credit*, *ibid.* at 19.
technology sector is impeded by the lack of expertise of bank managers underlined by many critiques.  

In this respect, while the growing competition among banks in small business lending may enhance the expertise of banks’ loan officers, it may also lead to a reduction in the level of investigation conducted as banks redesign their lending process to simplify loan transactions for SMEs and get a bigger share of this growing market. The new small business lending services provided by banks are designed to be easier to access for SMEs, meaning that they are faster, inexpensive, and allow these firms to borrow money with ease. Anecdotal evidence reports that an increase in the amount of borrowing approved for SMEs has accompanied this transformation of banks’ lending process. However, this simplification of loan transactions for SMEs also reduces the information gathered by banks as the latter conduct less thorough investigations to evaluate the creditworthiness of firms.

Likewise, because of the small profit margins of SME loans, banks cannot perform a substantial amount of costly monitoring after loans have been issued. Robert Mann who interviewed a dozen of American small business loan officers remarks:

Lender after lender explained to me that once a loan is 'put to bed', the lender will do nothing whatsoever to monitor the loan on an ongoing basis: as long as the borrower makes the scheduled monetary payments, the loan is completely ignored.


\[\text{230}\] Thus, small business can have loans up to $50 000 approved right away without the need to provide a business plan. R. Ray, ibid. The interviews conducted by Mann with small business lenders confirm this more lenient attitude of bankers. The Role of Secured Credit, supra note 225, at 20 n. 72-73.

\[\text{231}\] The Role of Secured Credit, ibid. at 21.
This problem is exacerbated by the high turnover rate of loan officers that prevents them from getting a better understanding of their clients' business, as well as the limited training and expertise of loan officers.232

While banks still can rely on debt covenants to restrict wealth-redistributing actions of managers, these contractual constraints are not cost-effective for several reasons. Firstly, the fixed costs of negotiating and writing debt contracts will make it more expensive to do so for small business loans.233 In addition, while these covenants may lower the compensation demanded, they will, on the other hand, reduce the flexibility of firms' operations and impede their efficiency, thereby decreasing the firms' value. For example, covenants to reduce the risk of asset substitution will interfere with the firms' production and investment decisions. Since these decisions are at the heart of the operations of any firms, the inclusion of contractual constraints will deprive, to some extent, managers from their decision-making authority and, by extension, firms from managers' expertise.234 Thus, in attempting to control wealth-redistributing actions, these constraints will often be both over-inclusive and under-inclusive, and restrict "firm-value maximizing as well as wealth-redistributing decisions."235 Finally, these restrictive covenants will only be effective to the extent that firms believe that banks monitor compliance and punish violations, which does not seem the case, as mentioned.236


233 Financing Innovative Enterprise. ibid. at 77-78. Loans of under $200 000 do not have covenant restrictions. In loans between $200 000 and $500 000 even though it may be economical to include covenants, these remain generally simple and limited. More covenant restrictions are found in loans over $500 000. See also The Role of Secured Credit. supra note 225, at 22 (Reporting that the dominant trend is to "abjure any substantially restrictive loan covenants at all"). See however V.P. Apilado & J.K. Millington. supra note 214 (Finding evidence that small American firms use more debt covenants than larger firms).

234 G.G. Triantis. supra note 214, at 240.

235 Ibid.

236 Financing Innovative Enterprise, supra note at 77; R.J. Mann, The Role of Secured Credit, supra note 225, at 22.
The grant of collateral can improve the effectiveness of bank oversight of lenders.²³⁷ Indeed, besides enhancing the likelihood that lenders will be able to recover their loans, the grant of a collateral allows lenders to exercise considerable influence over the actions of the borrowers as the latter desire to avoid the loss that lenders can inflict on them by exercising the legal remedies they hold.²³⁸

The lender's ability to inflict severe losses on the borrower through the exercise of the lender's rights in the borrower's collateral enhances the borrower's incentive to refrain from conduct that the lender views as unduly risky and to operate its business in accordance with the lender's desire.²³⁹

Furthermore, it is argued that the grant of collateral increases the ability of lenders to prevent borrowers from engaging in wealth-redistributing actions by lowering the costs of monitoring.²⁴⁰ Secured credit limits the extent of lenders' monitoring by allowing them to focus on the specific assets given as collateral. Accordingly, narrowing the scope of lenders' attention to particular assets should make monitoring less expensive for lenders, and thereby more cost-effective for small business borrowers. In addition, lenders will be able to monitor more effectively the loan covenants imposed on borrowers. From this it follows that by reducing the risk of opportunistic behaviours and reducing monitoring costs, the presence of collateral should be associated with lower borrowing costs in the form of lower interest rates.²⁴¹

However, it is easy to overstate the leverage that the collateral pledged by small businesses actually confers to banks over the latter. Recall that SMES tend to have little collateral to secure bank credit in the form of tangible assets such as equipment, machinery or inventory. In fact, the most important part of SMES’ value flows from the intangible assets of the business such as the


²³⁹ The Pattern of Secured Credit, supra note 225, at 655.

²⁴⁰ Ibid. at 649-658.

²⁴¹ D.G. Carlson, supra note 237, at 2182.
entrepreneurs' and employees' ideas and specialised skills, and their knowledge of customers and suppliers. Intangible assets are even more prevalent in high technology firms that are essentially knowledge-based and lack tangible or fixed assets.

In this context, banks have collateral over assets that have a poor liquidation value. While generally speaking the liquidation value of tangible assets is higher than intangible assets, the value of SMEs' tangible assets tends nevertheless to be rather limited as the majority of small firms operate in the service sector. Furthermore, firms that operate in the high technology sector generate assets that are very firm- or industry-specific. Asset specificity significantly impairs the liquidation value of property given as collateral since no alternative use or effective demand exists for it. Lower liquidation values imply that default is costly for lenders. Besides, banks that rely on accounts receivable and inventory as collateral for small business loans will also face difficulties. Indeed, it appears that the liquidation of such collateral does not allow banks to recover any significant value.


243 National Advisory Board on Science and Technology, Committee on Financing Industrial Innovation (Ottawa: Supply and Services, 1991) at 16; P. Toriel, supra note 227, at 14.


245 Supra Chapter I note 21 and related text.


247 S.M. Myers, "The Capital Structure Puzzle", (1984) 39 J. Fin. 575 at 581; O.E. Williamson, "Corporate Finance and Corporate Governance", (1988) 43 J. Fin. 567; L. Wynant & J. Hatch, supra note 203, at 161. No demand may exist for firm- or industry-specific assets because industry buyers are likely to be themselves credit constrained when the owners of these assets need to sell.

248 The Role of Secured Credit, supra note 225, at 15-16.
The limited value of foreclosure for small business lenders mitigates the extent of the leverage that the grant of collateral confers to these lenders over their borrowers. Since the realisation value of the secured assets is rather low, it is likely that lenders will be reluctant to take possession of the collateral of their borrowers to realise their values as this will considerably diminish the lenders' chance of getting a complete repayment.\textsuperscript{249} This will be exacerbated by the fact that the realisation of the collateral pledged by small business will often mean the end of their ongoing business operations and the destruction of their income stream. For these reasons, the threat of the loss that could inflict banks of small business borrowers by the exercise of their legal rights is considerably mitigated. This diminishes the real influence that bankers can exercise over SMES as the latter will understand that it is not in the interest of their lenders to close down their operations to get repayment.

Given the limited liquidation value of small business collateral, most bankers obtain personal guarantees over the entrepreneurs' own assets to protect themselves more fully against borrower wealth-redistributing actions.\textsuperscript{250} Personal guarantees give lenders a powerful leverage as these guarantees confront borrowers with the loss of their own assets, rather than the loss of their business.\textsuperscript{251} However the reliance of bankers on this type of guarantee will probably contribute to a reduction of their interest in the monitoring of the borrowing firms' operations. Indeed, this additional security will provide bankers comfort that the credit risk is adequately covered by the collateral.\textsuperscript{252}

\textsuperscript{249} The Role of Secured Credit. \textit{ibid.} at 18.

\textsuperscript{250} P. Halpern \textit{et al.}, \textit{supra} note 216, at 141 (The use of personal guarantees is an attempt to remove the moral hazard problem). The study of Wynant and Hatch found that personal guarantees were associated with 87 per cent of small business loans, and pledges of personal assets were required for one-third of the loans. L. Wynant \& J. Hatch, \textit{supra} note 203, at 8-9, 165-166. See also D. Paterson, \textit{supra} note 93 (noting that banks engaging in "knowledge-based banking" still require extensive personal guarantees from small information technology and software firms).

\textsuperscript{251} Personal guarantees actually creates an unlimited liability regime for the firm. P. Halpern, \textit{ibid.} at 147-148.

\textsuperscript{252} The Role of Secured Credit, \textit{supra} note 225, at 19; L. Wynant \& J. Hatch, \textit{supra} note 203, at 160 (Noting the heavy emphasis that banks place on collateral).
While banks undoubtedly have relationships with small business lenders, a close analysis of these relationships suggest that they are not likely to reduce the level of *ex ante* uncertainty surrounding issuers.

**SECTION D: THE DEGREE OF SOPHISTICATION OF INVESTORS PARTICIPATING IN THE INITIAL PUBLIC OFFERING MARKET**

In the last three decades, the staggering growth of institutional investors portfolio has transformed significantly the ownership structure of Canadian corporations. The total equity holdings of these investors has grown from $4.7 billion in 1969 to more than $160 billion in 1995 representing about 38 per cent of the value of corporation shares.253 Thus, institutional investors are replacing progressively individual investors as shareholders of public corporations and hold more than 50 per cent of the shares of the largest widely held Canadian corporations.254 Furthermore, they are now the most active participants of the securities market, accounting for about 70 per cent of all trading activity on the Toronto Stock Exchange.255

The presence of institutional investors exercises a significant influence on the pricing efficiency of the IPO market.256 Firstly, the participation of institutional investors affects the amount and quality of information available on the market. Institutional investors have the expertise to

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analyse the information disclosed by issuers and verify its accuracy. In this respect, since institutional investors tend to participate in many different securities offerings, they will have great experience in analysing the value of issuers. Institutions have also the resources to investigate further issuers to uncover undisclosed information that can affect firm value directly or indirectly by buying securities research. Moreover, institutional investors' knowledge of the market allows them to assess the information disclosed in light of the more general market trends and the perspective of the issuer's industry, and thereby to evaluate more accurately the value of the ventures.

Besides, the expertise and economic clout of institutional investors leads underwriters to give the latter special access to information from issuers during the marketing activities preceding the offering. As a leading Canadian underwriter puts it: "The institutional sector of the market ... is extremely important as it represents a significant portion of the potential purchasers in most cases." Thus, institutions are usually invited to attend elaborate road shows that promote offerings and where important details about the firms and the deals are disclosed. Underwriters and managers also meet with select institutions to provide them with more specific information on the venture, tailored to their particular interests, and to allow them to fully evaluate management.

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257 For instance, many cases arising under SEC Rule 10b-5 (the anti-fraud rule) treat sophisticated investors differently and impose on them positive investigation and due diligence obligations. See C.E. Fletcher, "Sophisticated Investors under the Federal Securities Laws", [1988] Duke L.J. 1081.


260 M. Weisdorf of Wood Gundy, supra note 70, at 15.


262 S.J. Shulte, ibid. at 540-542: M.A. Weisdorf, supra note 70, at 15.
Throughout these activities, underwriters gain access to valuable information on the interest of the largest buyers that allows them to set the market-clearing price.\textsuperscript{263} From this it follows that the price of new issues set by underwriters will be the “product of the knowledge, acumen, and investigative efforts of institutional investors.”\textsuperscript{264} Given the fact that institutional investors are less likely to be noise traders than unsophisticated retail investors,\textsuperscript{265} their presence will ensure that prices in the IPO market are being formed on the basis of relevant parameters rather than on the basis of fads or investor sentiment.\textsuperscript{266} Accordingly, the participation of institutional investors in new securities offerings contributes to investor protection by reducing significantly the possibility that issues are overpriced.

Secondly, by enhancing the reputational penalty associated with mispricing, institutional investors act as gatekeepers of the pricing of IPOs by underwriters.\textsuperscript{267} Indeed, underwriters will be particularly concerned to set an accurate price for new issues to maintain their reputation and secure further business with institutional investors. Indeed, as repeat players in the IPO market, institutional investors have the possibility “to inflict damage on opportunistic underwriters by withdrawing lucrative brokerage and other business from the underwriter.”\textsuperscript{268}


\textsuperscript{264} J.G. MacIntosh, ibid.

\textsuperscript{265} Noise refers to the irrational behaviour of traders when the latter's expectations about asset returns are influenced by their sentiment. Ill-informed investors usually drive noise trading. While institutional investors are usually more informed than retail investors, some suggests that institutions may nevertheless be noise traders being prone to herding or positive feedback. F. Black, "Noise", (1986) 41 J. Fin. 529; D.C. Langevoort, "Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited", (1992) 140 U. Pa. L. Rev. 851; R.J. Shiller, Market Volatility (Cambridge: MIT Press, 1990).

\textsuperscript{266} A. Brav & P.A. Gompers, "Myth or Reality? The Long-Run Underperformance of Initial Public Offerings: Evidence from the Venture and NonVenture Capital-backed Companies", (1997) 52 J. Fin. 1791; C.M.C. Lee et al., "Investor Sentiment and the Close-End Fund Puzzle", (1991) 46 J. Fin. 75 (Fluctuations in discounts of closed-end funds driven by changes in retail investor sentiment). See also Chapter II supra notes 145-159 and related text.


\textsuperscript{268} R.J. Daniels & J.G. MacIntosh, "Toward a Distinctive Canadian Corporate Law Regime", (1991) 29 Osgoode Hall L.J. 863 at 870.
However, the presence of institutional investors has a paradoxical impact in the IPO market. On the one hand, it promotes the interests of retail investors as the latter can buy new issues with reasonable confidence that they are not overpriced. Retail investors free ride on the gatekeeping and information production and verification activities of institutional investors that enhance the pricing accuracy of IPO securities. On the other hand, the participation of sophisticated informed institutional investors in the new issue market induces a winner’s curse problem that can threaten retail investors confidence and lead to a breakdown of the market.269 As we saw, the winner’s curse problem forces issuers to underprice their securities in order to keep uninformed investors in the market thereby raising their cost of capital. Since the winner’s curse problem is driven in part by imperfect information in the IPO market, there may be a role for public policy to enhance the information efficiency of the market in order to reduce the negative impact of the presence of institutional investors in the new issue market. We will turn to this question in the next chapter.

A second challenge for public policy comes from the fact that while institutional investors are active purchasers of new issues, these investors usually avoid smaller IPOs.270 This disinterest of institutional investors in small IPOs may stem from the institutions’ conservative investment policies induced by regulation.271 Legal restrictions limit the percentage of the equity of a single company that institutional investors can hold.272 Those ceilings may allow institutions to make substantial investments in large enterprises. Applied to investments in SMEs, the limits on the

269 Supra Chapter II notes 34-40 and related text.


271 See for example Ontario Municipal Employees Retirement System (OMERS), Omers Investment Practices (Toronto: 1995) at 11: "OMERS strives to remain alert in the pursuit of all prudent investment opportunities that may be expected to enhance the Fund's total return."

272 See e.g. Bank Act, S.C. 1991, c. 46, s. 466(1) (banks may not own more than 25 per cent of the equity or controlling more than 10 per cent of the voting rights of an issuer); “National Policy 39: Mutual Funds”, (1989) 12 OSCB 52 at s. 2.04, para(1) (same); Insurance Act, R.S.O. 1990, c. I-8, s. 435(1)(d) (insurers may not own more than 30 per cent of the common shares or 30 per cent of the total issued shares of a company);
ownership stake of institutions compel the latter to make very small investments which may not be cost-effective. 273

The investments of institutional investors in SMEs are further constrained by the "legal for life" investment restrictions which still exist in Ontario. Legal for life restrictions prohibit certain institutional investors from making investments in non-qualifying issuers, with the exception of investments made through "basket clauses" that allow investments of a given percentage of the institutions' portfolios in non-qualifying issuers. 274 Legal for life restrictions have the effect of discouraging issuers from investing in SMEs without an adequate history of earnings or solvency. 275

Undoubtedly, Ontario should follow the initiatives of the federal and Québec Legislatures and replace the legal for life standard with a general prudent person standard. 276 The prudent person standard requires that institutions establish and adhere to "standards and procedures that a reasonable and prudent person would apply in respect of a portfolio of investments and loans to avoid undue risk of loss and obtain reasonable returns." 277 Even then, the considerable uncertainty surrounding the nature and extent of these responsibilities may still preclude institutions from investing in smaller IPOs. 278 Indeed, the enactment of the prudent person standard should imply that, consistent with modern portfolio theory, the duty of prudence of fund managers is to be judged in the context of the portfolio as a whole, instead of with respect to the particular securities of the portfolio. 279 However, in the absence of judicial interpretation of this new standard, it remains

273 Infra notes 282-283 and related text.


275 See e.g. Insurance Act, supra note 272, s. 433(1)n).


277 Ibid.

unclear whether the duty of fund managers to avoid "undue risk of loss" can allow courts to reintroduce a prudence standard directed at particular securities of portfolios. This uncertainty can possibly maintain a chilling effect on institutional investors and curtail their willingness to invest in small risky offerings.

In fact, relaxing the restrictions on institutional investments may not have a significant impact on the interest of institutions in SMEs. Many have noted that institutional investors prefer, because of cultural factors, following more conservative investment policies. More importantly, institutions may be reluctant to purchase small firm IPOs because of the high cost of investing and trading in SME securities. As we have seen previously, there generally tends to be less publicly available information on SMEs, forcing potential investors to engage in their own research. Since the size of institutional investments in these firms tends to be relatively small in comparison with larger firms, the relative cost of this information acquisition per dollar of investment will likely be greater for institutional investors than when they invest in larger firms, thereby making small capitalisation issuers less attractive to institutions.

Furthermore, the securities of small issuers tend to have a relatively low liquidity. The low liquidity of small firm securities imposes an implicit trading tax that raises the cost of investing in


280 J.G. MacIntosh. ibid. at 417 n. 194.


284 The liquidity of SMEs securities will be examined thoroughly infra Chapter VI. See in general K.H. Chung et al., "Production of Information, Information Asymmetry, and the Bid-Ask Spread: Empirical Evidence from Analysts'
small firms and influences negatively the level of institutional ownership.\textsuperscript{285} Institutional investors prefer securities with active trading markets in that such markets allow them to trade their large positions with minimum price impact. Moreover, since institutions turn over their portfolios and trade more often than individuals, they value liquid securities that can be traded with minimum transaction costs.\textsuperscript{286} For these reasons, institutions are more reluctant to invest in these firms as they find it uneconomical to deal in the relatively illiquid stocks of companies with small market capitalisation.\textsuperscript{287}

Evidence seems to confirm that institutional investors avoid SMEs securities because of the high cost of investing and trading in such securities. Indeed, SMEs that are brought to the market by venture capitalists or that have high quality auditors and underwriters are found to elicit more institutional interest.\textsuperscript{288} One likely reason for this is that the presence of these certifying agents significantly reduces the cost of information acquisition for institutional investors and offers an

\begin{itemize}
  \item \textsuperscript{285} P.A. Gompers & A. Metrick, \textit{supra} note 281, at 16-17. The illiquidity of a security is reflected in the ease of executing the trade as measured by the cost of the transaction. There are two dimensions to the ease of trading a security: (1) the cost in terms of time and money for buyers and sellers to find each other; (2) the reasonableness of the prices at which trades can be made. See e.g. Y. Amihud & H. Mendelson, "Liquidity and Asset Prices: Financial Management Implications", (1988) 17 \textit{Fin. Mgmt.} 5; J. Hasbrouck & R.A. Schwartz, "Liquidity and Execution Costs in the Equity Markets", (1986) \textit{J. Port. Mgmt.} 10; J.G. Maclntosh, \textit{ibid.}
  \item \textsuperscript{288} W.L. Megginson & K.A. Weiss, \textit{supra} note 38, at 892 (The average percentage of IPOs held by institutional investors is significantly higher for venture capital-backed IPOs than for non venture capital backed IPOs). See also J.P. Williamson, \textit{supra} note 278, at 918-919, citing American and Canadian studies of the 1970s suggesting that institutions can accommodate holding securities of second-tier firms. See also U.S., Securities and Exchange Commission, \textit{Institutional Investor Study: Report of the Securities and Exchange Commission}, vol. 5 (Washington: U.S. Government Printing Office, 1971) at 2371-2373. In its institutional investor study, the SEC found that the composition of the underwriting syndicate was the most important determinant of institutional investors participation in new offerings. The SEC was however unable to determine whether this could be attributed to the quality of underwriters' offerings or to the continuity of business relations with institutional investors. The Commission argued that issuer quality, rather than size, exercised a significant influence on the extent of institutional purchases. And since issuer quality is not manifest in its financial statistics, institutional investors must rely on the reputation of underwriters.
\end{itemize}
assurance of firm quality. Moreover, the lower degree of information asymmetry surrounding such issuers also contributes to a higher liquidity of their securities in the aftermarket, thereby reducing the cost of trading for investors. In this respect, note also that reputable underwriters provide liquidity for the firms that they bring to the market subsequent to the offering "to maintain a reputation for providing high quality secondary markets for the issues they have underwritten in order to attract new business in the future." Accordingly, while it is true that institutions favour securities that are marketable, \textit{i.e.} that have an active secondary market, this does not imply that they refrain totally from investing in small firms.

Given the importance of institutional investors for the pricing efficiency of the IPO market, public policy should aim at enhancing the marketability of the securities of small and medium-sized firms in order to increase institutional ownership of these firms. An interesting policy instrument, which could be considered by governments to enhance institutional investments in SMEs securities, is a tax incentive that would offset the high cost of investing and trading in securities.\footnote{J. Macey & H. Kanda, "The Stock Exchange as a Firm: The Emergence of Close Substitutes for the New York and Tokyo Stock Exchanges", (1990) 75 Corn. L. Rev. 1007 at 1017-1018.} In this respect, the most relevant experience is the Québec Stock Savings Plan (QSSP). A few comments are warranted.

Introduced in 1979, the QSSP originally intended to lower income taxes for high-income taxpayers, and to encourage investors to channel their savings in a greater proportion toward equity investments.\footnote{This option has been proposed by various commentators see: P. Johnston, \textit{Nothing Ventured — Investing in Canada's Winners} (Toronto: The Toronto Stock Exchange, 1980) at 62; G. Bannock, \textit{supra} note 270, at 137.} To do so, the program provided for an income tax deduction for part of the cost of purchasing "eligible shares" of "eligible corporations".\footnote{\textit{Income Tax Act.} R.S.Q., c. I-3, s. 965.1 ss. D. Lacroix, "Les régimes d'épargne-actions: nouvelles orientations au Québec, premiers pas dans l'Ouest — première partie", (1987) 35:2 Can. Tax J. 50. A useful English summary is found in J.-M. Suret & E. Cormier, "The Quebec Stock Savings Plan: Overview and Assessment", in P.J.N. Halpern, \textit{supra} note 92, at 525.} After its creation, the program underwent

\footnote{We do not intend to analyse thoroughly the provisions of the program. Suffice it to say that to be eligible, a corporation had to have at least five full-time employees. The corporation had to make an offering of shares conferring at least one voting right. Investors had to hold the shares acquired for two years to enjoy the deduction, although the shares could be replaced by other eligible shares.}
several revisions the most important of which, for our purpose, is its modification in the early 1980s to promote investments in SMES. Thus, starting in 1984, investments in “developing corporations” with assets of under $25 million offered a higher deduction that investments in larger, more established corporations.

Although innovative, the use of tax incentives to promote investments in small growing corporations appears to have been a failure according to several studies. Most notably, professors Suret and Cormier, who tracked the performance of QSSP-issued shares up to 1994, report that small firm IPOs issued under the program performed poorly, generating substantial losses for investors that were only partially offset by the tax credit. While the under-performance of small firm IPOs is not unique to QSSP issues as we saw previously, a comparison with similar issues in Ontario indicated that QSSP issues performed even worse than the latter.

Moreover, the researchers found that the program failed to improve the capitalisation of small businesses. After a period of two to three years, most firms that issued shares under the QSSP had the same debt level — or a higher one — as before their equity offerings. Even more disquieting, these firms were found to be significantly less profitable following their equity issues than before. These disappointing results lead Suret and Cormier to conclude that “using fiscal measures to encourage stock listing has, in this case at least, been ineffectual.”

In fact, the experience of the QSSP demonstrates that the use of tax incentives to channel institutional investments in SMES securities can cause significant distortions to the allocation of

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293 For an overview of the many revisions: J.-M. Suret & E. Cormier, supra note 291, at 528-532, 560-562.

294 Ibid. at 528.


296 J.-M. Suret & E. Cormier, ibid. at 541.

297 Ibid. at 549-558.

298 Ibid. at 526.
Indeed, it appears that the tax credits offered by the QSSP altered the judgement of investors and magnified their over-optimism in reviewing investment opportunities. Furthermore, to the extent that it reduced the cost of equity for growing small businesses, the program may have encouraged and permitted firms without viable investment projects to raise financing and thereby increase the level of poor quality issuers in the market.

The performance of the Québec Stock Savings Plan serves as a cautionary note on using tax incentives to enhance institutional investments in SMES. It seems preferable to encourage institutional investments in small growing enterprises by enhancing the liquidity of the secondary market for these enterprises’ securities. Increased liquidity will reduce transaction costs for all investors and thereby enhance their interest in SME securities without distorting their investment decisions. We will examine more specifically how to increase the liquidity of the secondary market for securities in Chapter VI.

SECTION E: SUMMARY

This chapter examined the private information networks of the IPO market which determine how information is distributed and impounded into securities prices. The analysis reveals that although issuers have incentives to voluntarily disclose information on firm value, there exist disincentives preventing them from disclosing an optimal amount of information to the market. The impact of those disincentives is magnified in the small firm IPO market by the dearth of securities research.

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299 See G. Bannock, supra note 270, at 137-138.


The disinterest of securities analysts toward SMEs going public, though economically rational, deprives the market of relevant information on the assessment of the value of smaller issuers. This suggests that the cost of information acquisition for investors will be higher in the small firm IPO market as investors have to individually incur the cost of securing access to information. Since informational efficiency is a function of information cost, as the latter influences the distribution of information in the market, regulation may have a role to play in collectivising information acquisition to reduce overall information costs.

While it appears to suffer from shortcomings in the production of information, the market seems to be working relatively well where it comes to information verification. Indeed, small issuers can choose from a wide range of information intermediaries to certify the accuracy of the information that they disclose. Furthermore, issuers can select the type and quality of information intermediaries that will allow them to balance the cost of certification with the cost resulting from uncertainty, *i.e.* underpricing. Public policy should therefore avoid duplicating the certification services provided privately by the market. Instead, it should focus on ensuring that there are no legal hurdles to the operations of information intermediaries which unnecessary raise the cost of their services for issuers.

A final feature of the small firm IPO market that was uncovered by the above analysis is the low level of institutional investments in smaller issuers. The reluctance of institutional investors to purchase securities in smaller offerings explains, at least in part, the disinterest of securities analysts toward SMEs securities. Moreover, the relative absence of institutions in this segment of the new issue market exercises a significant influence on pricing accuracy as it implies that the available information is not scrutinised and assessed by a high number of sophisticated investors. Although the presence of institutional investors in the small firm IPO market is desirable, it was argued that regulators should not attempt to subsidise institutional investments in smaller enterprises. Rather, regulatory intervention should be directed at ensuring that SMEs going public have access to a liquid secondary market for trading their securities.
CHAPTER IV

RE-ENGINEERING PROSPECTUS LEGISLATION FOR SMALL AND MEDIUM-SIZED ENTERPRISES

Securities legislation compels issuers conducting an initial public offering to comply with a complex set of rules which purport to protect investors and foster market efficiency. Those rules enact mandatory disclosure requirements for issuers and regulate the way in which securities are marketed to the public. The keystone of this regulatory framework is the prospectus which issuers must prepare when making an IPO to provide investors with full, true and plain disclosure about the securities being distributed. Failure to comply with the applicable legal requirements can subject the firm, its principals, and its advisers to substantial liabilities.

The regulatory framework governing IPOs established by the Securities Act\(^1\) can impose significant compliance costs on issuers. Although all issuers incur these costs, the expenses generated by regulation can be especially burdensome for SMES because of the high fixed-cost component of such expenses. The combination of the regulatory costs with the costs arising out of remaining market imperfections has the effect of increasing the cost of public equity capital for SMES and making this source of financing less accessible for smaller enterprises.

Thus, the regulatory regime needs to be modified to become more adapted to the needs and characteristics of SMES. This requires that the costs of regulatory requirements, which are disproportionately high for smaller issuers, be balanced against the benefits of such requirements for SMES. Relaxation of Securities Act requirements will be justified where the costs for smaller issuers are too high to justify the benefits, even if those benefits are substantial.

In this context, this Chapter purports to undertake a revision of the regulation governing IPOs in order to reduce the regulatory burden of SMES raising public equity financing. The starting point of the discussion is the work of the Task Force on Small Business Financing formed by the

\(^1\) The Securities Act refers to the Ontario Securities Act, R.S.O. c. S-5, s. 53 [hereinafter O.S.A.].
Ontario Securities Commission to review the legislative framework governing the raising of equity capital by SMES. The Task Force produced its Final Report in 1996 that proposes substantial modifications to the Securities Act to increase the accessibility of private and public equity financing to smaller enterprises. This chapter and the following present and criticise the proposals contained in the Task Force’s Report, which address the most important aspects of the going public process, in light of the general goal to implement a cost-effective regulatory régime governing SMES IPOs.

The first section presents an overview of the prospectus disclosure process which is the subject of the proposed reform. The next section examines the cost-effectiveness of the mandatory disclosure requirements that are at the heart of prospectus legislation. The Chapter then turns to a more specific analysis of the proposals of the Task Force on Small Business Financing informed by the two previous Chapters.

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SECTION A: AN OVERVIEW OF THE PROSPECTUS DISCLOSURE PROCESS

Pursuant to the Securities Act, a corporation that considers making a ‘distribution’ of its securities to the investing public must prepare a prospectus that will be filed with the securities commission and transmitted to investors. The Act defines ‘distribution’ as involving a trade in a security where the term security refers not only to previously unissued securities but also to previously issued securities that is part of the holding of a control person. The concept of trade is defined broadly in the Act to include “any act, advertisement, solicitation, conduct or negotiation directly or indirectly in furtherance” of the sale or disposition of a security for valuable consideration, or of any of the activities deemed to be a trade.

The prospectus is a document that contains information regarding the issuer and its securities to assist investors in making informed investment decisions. The prospectus must provide “full, true and plain disclosure of all material facts relating to the securities issued”. More precisely, this requirement translates into an obligation to present the information in a straightforward narrative and plain language style, and to include all facts that significantly affect or would reasonably be expected to have a significant effect on the market price or value of the securities.

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4 O.S.A., s. 1(1) "security"; "distribution". A control person is defined as a person (or group of person acting together) holding a sufficient number of the voting rights attached to all outstanding voting securities of an issuer to materially affect the control of the issuer. Ibid. "control".


6 O.S.A., s. 58(1).

7 Ontario Securities Regulation, s. 46. 49 [hereinafter O.S.R.].

8 See O.S.A., s. 1(1) "material fact"; Pezin c. B.C. (Superintendent of Brokers) [1994] 2 R.C.S. 557.
Aside from the general requirement to provide full, true and plain disclosure, the regulatory framework sets out specific disclosure requirements. Among others, the prospectus of industrial issuers must disclose information on the attributes of the securities offered, the method of distribution of the securities, the risk factors, the expected proceeds of the issue, and the purposes for which those proceeds will be used. In addition, issuers must describe their business and property, the development of their business over the last five years, the occupation of their directors and officers over the last five years, the background of the latter and any material interest they have in the issuer, and executive compensation. The prospectus must also disclose the interest of any holders of more than 10 per cent of the issuer’s voting securities including the number and percentage of securities held.

In addition, there are requirements with respect to financial statements. Issuers must provide audited financial statements for the five most recent years in the case of statement of income, surplus and changes in financial position, and two years in the case of the balance sheet. Financial statements must be prepared in accordance with Generally Accepted Accounting Principles (GAAP). If they find it relevant, issuers may also include future-oriented financial information.

Under the prevailing régime, issuers must file a preliminary prospectus that will be followed by a final version of the prospectus. The filing of the preliminary prospectus is an important step in the going public process. Indeed, prior to its filing, no marketing or advertising in furtherance of a trade may take place. Once the preliminary prospectus is filed with the relevant securities commissions and a receipt has been issued, issuers may conduct limited marketing
activities. Issuers can identify the securities offered and its price, transmit a copy of the preliminary prospectus, solicit expression of interests and indicate where the issue can be bought. However, securities cannot be sold until a receipt has been issued for the final prospectus.

Securities commissions review this prospectus looking for both the adequacy of disclosure and the substantive merit of the offering. When the review process is complete, the commissions issue a comment letter or deficiency letter informing the issuer with respect to any inadequacies of the preliminary prospectus. Issuers must correct the deficiencies identified by the commissions in order to file the final prospectus and obtain a receipt for it. Once the receipt for the final prospectus is issued, the issuers may begin the actual sale of their offering.

SECTION B: THE COST-EFFECTIVENESS OF MANDATORY DISCLOSURE FOR SMEs

Securities legislation relies on mandatory disclosure as the central regulatory instrument to govern IPOs. Mandatory disclosure was traditionally justified by the need to protect investors from fraud and other forms of exploitation. The investor protection rationale has however become increasingly controversial as critics challenge the need to protect investors and the ability of regulation to achieve this goal.

The demise of investor protection is accompanied by the emergence of a competing efficiency-based rationale in support of mandatory disclosure. According to this rationale, mandatory disclosure can contribute to efficiency by ensuring that prices reflect all available information. The accuracy enhancement goal of mandatory disclosure receives wide support in the literature. Critics of mandatory disclosure generally agree with this objective in principle and only question whether the legislation has achieved it.

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14 O.S.A. s. 65(2).
15 O.S.A. s. 61(1).
16 O.S.A. s. 61(2).
Given the shortcomings of the private information networks of the small firm IPO market, it would seem indisputable that disclosure requirements, which purport to enhance the accuracy of securities prices, are justified. However, the goal of accuracy enhancement should not be implemented without consideration to the costs that disclosure requirements generate. Indeed, it may be possible that the market cannot produce cost-effectively the same amount of information for smaller issuers than for larger seasoned issuers.17

This section presents the two competing justifications for mandatory disclosure and discusses the cost-effectiveness of mandatory disclosure for small issuers.

1. The Appropriate Goal of Mandatory Disclosure
a) Protective Disclosure

The traditional justification offered for mandatory disclosure is that it is necessary to protect investors from fraud and other forms of exploitation in order to preserve public confidence in the market.18 According to proponents of a protective role for mandatory disclosure, fraud depends for its success on secrecy and misinformation. Since it cannot stand ‘sunlight’, fraud is therefore less likely to occur if full and true disclosure is mandated.19 In this respect, commentators point to the unethical and fraudulent conduct of underwriters and issuers during the 1920s and 1930s, which took the form of manipulation of stock prices, exclusive promotional benefits, conflict of interests and self-dealing, that happened in the absence of extensive disclosure requirements to support the need for stringent disclosure requirement.20

17 M.R. Gillen, supra note 5, at 373.
19 A.G. Anderson, ibid. at 318-319. The ‘sunlight effect’ of disclosure comes from Brandeis’ famous expression: “sunlight is said to be the best of disinfectants; electric light the most efficient policeman”. L. Brandeis, Other People’s Money and How the Banker Use It (Augustus M. Kelley Publishers 1971) at 92.
The importance of protective mandatory disclosure is further justified by reference to the inadequacies of an anti-fraud provision in protecting investors.\textsuperscript{21} Although commentators acknowledge that such provision can deter fraud, they assert that it is insufficient since it addresses fraudulent conduct after the fact and only after some loss or damage has occurred. In contrast, as they argue, mandatory disclosure has the potential to prevent fraud \textit{ex ante} by requiring that information be disclosed and submitted by issuers to the scrutiny of a regulatory body.\textsuperscript{22}

A related argument offered in support of mandatory disclosure is that it is necessary to ensure that information available in the market will be equally accessible to investors. Proponents of protective mandatory disclosure assert that, if left unregulated, the market will lead to an uneven possession of information among investors, and a situation which is inherently unfair and violates the meaning of fair disclosure.\textsuperscript{23} Equal access to information will arguably prevent unsophisticated investors from being exploited by informed investors and will foster the confidence of investors in the market, ensuring that they will not withdraw their capital from the market to the detriment of social welfare.\textsuperscript{24} When investors believe that the market is a ‘fair game’, they invest “more resources in equity securities and spend less time investigating thereby causing economic gains.”\textsuperscript{25}

\begin{thebibliography}{99}
\bibitem{22} D.L. Johnston, \textit{Canadian Securities Regulation} (Toronto: Butterworths, 1977) at 3.
\bibitem{24} D.J. Shulte, “The Debatable Case for Securities Regulation”, (1988) 14 \textit{J. Corp. L.} 535 at 539-540. Note that the objective of mandatory disclosure is to ensure an equality of opportunity for investors, as opposed to an equality of outcomes that would “not only eliminate all incentives ... but also strip the stock market of its main attraction – the provision of a wide variety of risk-return alternatives to investors.” Thus, this objective of mandatory disclosure is not to prevent economic loss that results from unwise investment by investors, but rather to ensure that investors are equally endowed with information. See Kimber Report, supra note at par. 1.12; B. Lev., “Toward a Theory of Equitable and Efficient Accounting Policy”, (1988) 43 \textit{Acct. Rev.} 1.
\bibitem{25} D.J. Shulte, \textit{ibid.} at 540.
\end{thebibliography}
Both of these aspects of protective disclosure rest on the premise that investors are defenceless in the absence of regulation and are left on their own against issuers and informed investors. However, this assumption overlooks the existence of several private protective devices in the market. With respect to the information asymmetry among investors, it fails to acknowledge that the latter can protect themselves from the threat posed by informed investors by incurring expenses to obtain better information about a particular issuer either by themselves, or by purchasing the services of financial analysts.26 Investors who do not have the resources to rely on the services of analysts can protect themselves by investing their funds through institutional investors to benefit from the information advantage that these professionals are deemed to possess.27 In addition, investors can form well-diversified portfolios and expect the same return for their level of risk as sophisticated investors.28 Thus, the decision to remain relatively uninformed may result from the fact that investors are indifferent to being more informed, given the costs and benefits of becoming more informed.29

More generally, retail investors can free ride on the efforts of sophisticated institutional investors who increasingly dominate both the IPO and the secondary markets and are instrumental in setting the price of securities.30 Indeed, investors can benefit from the research efforts of institutional investors that pervade the market and contribute to ensuring that prices rapidly reflect


27 F.H. Easterbrook & D.R. Fischel. supra note 21, at 695; D.J. Schulte, supra note 24, at 540.


29 J.G. MacIntosh, Legal and Institutional Barriers to Financing Innovative Enterprise in Canada (Kingston: Government and Competitiveness School of Policy Studies, Queen’s University, Discussion Paper 94-10, 1994) at 121-122 [hereinafter Financing Innovative Enterprise].

all new information. This reduces the risk that informed traders possessing undisclosed information will exploit uninformed investors.31

There is however a caveat to this positive contribution of informed investors to market efficiency and investor protection. As we saw previously, in the IPO market, uninformed investors risk getting a disproportionate level of over-priced securities in the presence of informed investors when there is significant uncertainty about the true value of the offering.32 Although portfolio diversification cannot protect unsophisticated investors from this risk,33 they are nevertheless far from defenceless in this situation as indicated by the winner’s curse model of underpricing.34 Faced with this perspective, it appears that uninformed investors rationally will withdraw from the market unless they are compensated for this risk. Hence, the underpricing of IPOs is, at least in part, a form of compensation paid by issuers to keep uninformed investors in the market. The extent of issuers’ reliance on underpricing to resolve the winner’s curse will depend on the availability and cost-effectiveness of other private information networks to reduce uncertainty about firm value.

The case in favour of mandatory disclosure as a device to protect investors against fraud and deceit is not very solid either.35 Indeed, market mechanisms do exist to limit fraud and deceit by issuers. Recall that the third-party certifying agents who lend their reputational capital to issuers in the IPO market play a central part in ensuring that the offering is priced fairly.36 These agents are repeat players in the market and incur substantial losses if their reputation is damaged by being

31 No data suggests that sophisticated investors systematically outperform the market. Supra Chapter I, text accompanying notes 103-123.

32 The presence of informed investors will reduce the level of ex ante uncertainty. However, since ex ante uncertainty will not be totally eliminated, informed investors will still have an advantage over uninformed investors.

33 While the ex ante uncertainty which is responsible for the winner’s curse does not correspond to systematic risk, according to Beatty and Ritter, the “representative investor who diversifies by submitting purchase orders for many initial public offerings in the face of the winner’s curse problem merely guarantees that the realized average initial return will be less than the unconditional average initial return on the issue for which purchase orders were submitted.” See R.P. Beatty & J.R. Ritter, “Investment Banking, Reputation, and the Underpricing of Initial Public Offerings”, (1986) 15 J. Fin. Econ. 213 at 216.

34 Supra Chapter II, notes 34-40 and related text. See also B. Lev, supra note 24, at 6-7.


36 Supra Chapter III, section C.
associated with a fraudulent or grossly mispriced issue. The certification provided by these intermediaries, coupled with the information generated by the activities of analysts and sophisticated investors, provide strong assurance to investors that offerings will be fairly priced. Finally, it must be remembered that the rule against misrepresentations complements these private mechanisms and protects investors by making it costly for issuers to engage in false or misleading disclosure.37

As we mentioned, there is however a segment of the IPO market composed essentially of small nonventure capital-backed firms which is characterised by a paucity of private party certification. Investors that buy securities from this segment of the market are arguably aware of the greater risk associated with these poorly certified issues.38 Indeed, investors could significantly reduce their risk exposure by refraining from buying these securities which are surrounded by high ex ante uncertainty.39 Nevertheless, as our analysis of the over-pricing phenomenon indicates, investors persist in getting involved in this segment of the market even though the poor performance of the firms of this segment is well known because they hope to find the new Microsoft. Accordingly, mandatory disclosure in this segment of the market remains rather irrelevant given that investors are driven by fads and sentiment, rather than by information on fundamentals.391

In sum, it appears that investor protection constitutes a weak justification for mandatory disclosure. Given the costs that generate disclosure requirements, public policy should attempt to streamline disclosure requirements that attempt to protect investors to reduce the unjustified burden that those requirements impose on issuers.

37 Infra notes 179-182 and related text.
38 J.R. Macey, supra note 28, at 929-930 (Arguing that noise traders choose to be noise traders).
39 G. Herder, supra note 28, at 193.
391 Financing Innovative Enterprise, supra note 29, at 117-122
b) Informative Disclosure

The second competing justification offered for mandatory disclosure is that it is needed to enhance the informational efficiency of the market in order to foster the formation of accurate stock prices and promote the efficient allocation of resources in the economy.40 Supporters of the accuracy enhancement rationale stress that market failures preclude private information networks from producing all information or the right amount of it.41 Accordingly, regulatory intervention is necessary to correct these market failures and ensure appropriate level of information disclosure.

Mandatory disclosure can arguably improve informational efficiency by reducing the cost of information acquisition, processing and verification. Mandatory disclosure makes available information that is necessary for accurate investment analysis but that would not be voluntarily disclosed by issuers because of imperfect incentives.42 In addition, by collectivising the costs of information production, mandatory disclosure is seen as eliminating the repetitive costs incurred by market participants to acquire information, in comparison to a world without disclosure. Thus, the collectivisation of information acquisition increases the net returns accruing to investors and makes it more profitable for investors to invest in smaller offerings.43 In corollary, it may also increase analyst interest because the cost of following firms is reduced.

Furthermore, disclosure regulation contributes to the standardisation of information production by enacting rules concerning the format and time of disclosure. This standardisation helps to create an efficient disclosure language that facilitates the comparison of investments by


41 See generally Chapter III where the role of private information networks and their possible shortcomings are reviewed.


The use of standard forms may also make it easier for investors to identify the scope of information that benefits from the certification of gatekeepers. Investors know that the issuer’s representations that are fitted in the standardised prospectus are scrutinised by multiple gatekeepers. In the absence of the prospectus, the contours of the information certified would vary from firm to firm depending on the disclosure format used. From this it follows that the costs borne by investors and analysts to assess and verify the information produced by issuers is reduced by standardised disclosure.

To the extent that mandatory disclosure contributes to a wider distribution of information in the market by reducing information costs, it is beyond dispute that it enhances the pricing mechanism given that the buying and selling is conducted by better informed investors. Indeed, since investors know more about the truth of issuers, it is probable that they will make better investment decisions resulting in more accurately priced securities. Even more importantly, the increased presence of institutional investors and analysts, which results from the lower information costs, will improve the pricing mechanism because of their greater expertise in assessing information. Accurate securities prices will promote efficient securities markets and lead to a better allocation of economic resources. In addition, by increasing the net returns to informed traders through savings in information costs — rather than through trading profits — mandatory disclosure will enable securities markets to allocate funds to higher valuing users.

Stock price accuracy can also promote investor confidence and facilitate capital formation. When securities prices best reflect their true value, investors can be confident that they will not have to sell in the future the securities they possess at a price that is inaccurate given the available information. The reduction of this uncertainty will increase the propensity of investors to

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47 M.R. Gillen, *supra* note 5, at 64-69.
save and to channel their resources to the securities market into good quality securities, thereby improving the allocation of financial resources. The reliability of estimates of firm value will also make it easier for investors to assess the quality of securities and identify high quality issuers. Hence, by increasing market confidence, compulsory disclosure will tend to reduce the premium that issuers have to pay because of the adverse selection problem, thus increasing the funds available for growth.49

Finally, this second rationale for mandatory disclosure is not unrelated to the goal of investor protection as underlined by the Kimber Report:

Establishment of the conditions and practices in the capital markets which best serve the investing public will normally be consistent with the best interests of the whole economy. For example, disclosure of financial information which depicts adequately the operations and financial position of companies is vital to the investing public; such disclosure also provides the capital market with the information necessary to make a more satisfactory allocation of resources.50

In fact, to the extent that it enhances market efficiency, mandatory disclosure contributes to foster the protection of investors. In an efficient market, there are less chances that investors be the victims of an unfair trade since prices will tend to reflect the true value of the securities.51 The market is then a 'level playing field' where informed investors do not possess a systematic advantage with respect to uninformed investors: "the outcome of the game is predetermined a tie."52

It seems therefore that there are good reasons to support mandatory disclosure on the basis that it contributes to the informational efficiency of the market. However, it is important to keep in mind that regulators should attempt to implement rules that are cost-effective. Accordingly, the presence of market failures does not necessarily imply that regulation is needed to increase the level of information available. Since information is not costless, whether additional information is


49 Ibid.

50 Kimber Report. supra note at par. 1.07.

51 See e.g. Note. supra note 30. at 1069.

needed depends on whether the marginal benefits of increments in information exceed the marginal costs. In this perspective, it is far from certain that the shortcomings of the private information networks for small issuers, which limit the amount of information available in the market as well as the ability of investors to assess the information disclosed, call for increase mandatory disclosure.

Several qualifications to this argument should be noted. Firstly, it is very difficult for regulators to determine the amount of information that would be available in the absence of market failures. This involves assessing the wealth, risk preferences, and beliefs of investors, which is a nontrivial demand for information by the regulatory agency. The public good aspect of information that leads investors to overstate their demand further complicates the task of estimating investor demand for information.

The tendency in regulation, however, is to oversupply the public good, because the perceived demand is for a good with no cost. Thus, users of information will overstate their demand. The users of free disclosure (investors) arguably would not demand the same quantity or quality of information if it had to be purchased based on its economic value.

Accordingly, regulation will tend to compel issuers to supply information for which the cost of production will exceed its value to investors.

Secondly, mandatory disclosure may compel issuers to produce some information when they are not the least-cost providers of it. This may be particularly the case for information that is not firm specific, such as information concerning a firm's industry and comparative data, but

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53 On the difficulty to assess the cost and benefit of mandatory disclosure, see M. Mendelson, supra note 46, at 62-63.
54 W.H. Beaver, supra note 23, at 321.
55 D.J. Shulte, supra note 24, at 547.
56 Note, supra note 30, at 1068. More crudely: “the demand for disclosure is almost insatiable when its cost to the user is almost nil.” M. Mendelson, supra note 46, at 55. See also H. Demsetz, “The Exchange and Enforcement of Property Rights”, (1964) 7 J. Law & Econ. 11 (Arguing that when the market does not provide a public good, it is because the total costs of production, distribution and payment are greater than any benefit received); Paul G. Mahoney, “Mandatory Disclosure as a Solution to Agency Problems”, (1995) 62 U. Chi. L. Rev. 1047 at 1102-03.
57 One rationale that forms the basis of the disclosure policy is that firms are the least cost providers of information. See e.g. A.R. Rodier, “Prospectus Disclosure Under the Proposed Securities Act in Ontario: Problems in a Changing Environment”, (1985) 23 U.W.O. L. Rev. 21 at 23.
essential to evaluate an investment. Information that is not firm specific can be produced at a lower cost by financial and security analysts because of the economies of scale and scope associated with their operations. For instance, analysts can recoup the cost of collecting and compiling industry information and comparative data by using this information to evaluate a high number of issuers. In addition, part of the costs of the facilities used by analysts to produce this information can be spread among the other functions for which these facilities also serve. When firms are not the most efficient producers of the information required, resources are wasted complying with disclosure regulation.

Thirdly, as we will see below, mandatory disclosure tends to be relatively inflexible and imposes requirements that are not adapted to the characteristics of small issuers. Thus, the costs generated by mandatory disclosure requirements are disproportionately high for SMES, which raise relatively small amounts of capital, and impose a considerable burden on these enterprises.

Finally, it is worth underlining that the mispricing of IPOs occurs despite the existence of extensive mandatory disclosure requirements, casting thereby doubts on the relevance of mandatory disclosure.

These qualifications serve as a cautionary note on the use of mandatory disclosure to improve the informational efficiency of the IPO market. As we will see below, they suggest that

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58 Easterbrook and Fischel argued that regulation should compel the production of information that is not firm specific by issuers because the latter would not have the incentives to disclose it voluntarily. They stressed that firms would benefit collectively from the disclosure of this type of information if they were compelled to do so. F.H. Easterbrook & D.R. Fischel, supra note 21, at 685-687. In a recent decision, however, Judge Easterbrook has stated that a duty to disclose cannot arise under the securities laws except with respect to firm-specific information. One of the rationales of this proposition is that disclosure duties should be assigned to those in the least-cost position to provide the information. See Wielgos v. Commonwealth Edison Co., 892 F2d 509 (7th Cir. 1989); L.A. Cunningham, "Firm-Specific Information and the Federal Securities Laws: A Doctrinal, Etymological, and Theoretical Critique", (1994) 68 Tul. L. Rev. 1409.

59 On the economies of scale and scope of information intermediaries, see R.J. Gilson & R.H. Kraakman. supra note 40, at 600 n. 147; Note, supra note 30, at 1066.

60 Note, ibid. at 1068.


62 Financing Innovative Enterprise, ibid. at 117.
rather than expanding disclosure requirements, the latter should be streamlined to become more cost-effective for SMES. In doing so, special attention should be given to the current rules that hinder the free flow of information in the market.

2. The Costs and Benefits of Mandatory Disclosure

a) The Uncertain Benefits of Mandatory Disclosure

It is generally acknowledged that the principal benefits of mandatory disclosure accrue to investors. Mandatory disclosure may benefit investors in two ways. It may enable investors to assess more accurately the value of issuers and thereby increase their returns. Alternatively, it may reduce the risks of investments by permitting investors to evaluate with greater certainty expected returns. However, three important empirical studies cast doubts on the significance of the benefits provided by mandatory disclosure.

In a seminal study undertaken in 1964, George Stigler examined the returns to investors of new issues before and after the enactment of the U.S. disclosure requirements in 1933 in order to measure the benefits of mandatory disclosure. Stigler found that there was no statistically significant evidence that the introduction of mandatory disclosure requirements enhanced investors’ returns. However, when he examined the effect of regulation on the risk of new issues, Stigler found that the variance of IPO securities prices, i.e. the degree of dispersion of the returns associated with these securities, had declined significantly after 1933. Although this reduction in the variance of returns may be taken as implying that mandatory disclosure reduced investment risk, Stigler conjectured rather that it was the result of disclosure regulation making it more difficult for riskier issuers to access the market. Thus, Stigler concluded that there was little evidence to support the alleged positive effect of mandatory disclosure on securities prices.

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65 Ibid. at 121.
66 Ibid. at 121-122.
67 Ibid. at 122.
In a later study of IPOs using the Capital Asset Pricing Model (CAPM), Jarrell confirmed Stigler's study and produced similar results. Most notably, Jarrell's study indicates that the introduction of mandatory disclosure did nothing to improve the returns of new issues. In addition, the results show a clear reduction in the risk of new issues after the enactment of mandatory disclosure, in the form of lower unsystematic risk after the enactment of disclosure regulation. The average systematic risk (β) of new issues remained almost the same in both periods, although fewer high β issues were found in the post-regulation period. Jarrell sided with Stigler and argued that these results were consistent with the hypothesis that mandatory disclosure prevented higher risk issuers from accessing the public equity market. In this respect, he showed that the highest risk issues prior to mandatory disclosure appeared to be among the best performers, rather than the fraudulent ones. Moreover, he found that "[t]he availability of new common stock issues decreased relative to total volume of all security issues after the advent of SEC regulation."

The last study of the trilogy is by Simon and provides a more detailed account of the impact of the enactment mandatory disclosure requirements in 1933 by focusing on both the new issue and seasoned equity markets listed on the New York Stock Exchange (NYSE) and on regional exchanges. For IPOs and seasoned offerings listed on the NYSE, there is no evidence that the issues were over- or underpriced relative to the pre-1933 period, in that the issues performed as well before as after the introduction of compulsory disclosure provisions. However, IPOs listed on regional exchanges are found to be significantly overpriced prior to 1933, while there was no evidence of overpricing after the introduction of mandatory disclosure. Finally, the study indicates that issue-specific (or 'diversifiable') risk was significantly reduced on both the NYSE and the

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69 Ibid. at 666.

70 The average systematic risk (β) of new issues remained almost the same, although there were fewer high β issues in the post-regulation period.

71 Ibid. at 665.


73 Ibid. at 305, 313.
regional exchanges after 1933, with the difference more pronounced for IPOs listed on regional exchanges. Thus, this study suggests that mandatory disclosure produced more benefit on smaller markets where the private information costs are likely to be greater. Mandatory disclosure contributed to eliminating a price bias in smaller IPOs that lead to unfairness.

The results of Simon’s study on the impact of mandatory disclosure for issues listed on regional exchanges are particularly interesting for Canada, in the absence of empirical evidence on this question. Indeed, the listing requirements of American regional exchanges are closer to those of Canadian stock exchanges than are those of the NYSE. This suggests that issuers listed on Canadian exchanges are likely to be similar to those which gained the most from mandatory disclosure in Simon’s study.

There is however a caveat. The study conducted by Simon did not examine whether the reduction in the risk of new issues was the result of the foreclosure of risky firms from the public market rather than the improvement of the information environment, a possibly that cannot be easily dismissed according to several commentators. This suggests that even though mandatory disclosure can improve investor welfare in the small firm IPO market, regulatory requirements should be reviewed to ensure that they do not unnecessarily hinder the access of smaller issuers to the market.

These three studies, mount a serious challenge against mandatory disclosure by showing that regulation. Unsurprisingly, this challenge is the subject of a flurry of criticisms led by Friend and Herman. Friend and Herman attacked Stigler’s study on both methodological and theoretical

74 Ibid. at 309, 313.
75 Financing Innovative Enterprise, supra note 29, at 120.
grounds, challenging the design of the study and the inferences it drew. In particular, these authors argued that the evidence marshalled by Stigler was consistent with a better performance relative to the market for new issues after the introduction of mandatory disclosure requirements.\(^{77}\)

Even more interesting, Friend and Herman offered a counter-explanation for the reduction of the risk of new issues found by the three studies. They urged that the decline in risk was the result of a reduction in fraudulent and manipulative practices, as well as the improvement of the disclosure of risk that led to a greater reluctance by investors to buy risky new issues.\(^{78}\) Even assuming that such is the case, it is important to stress that the diminution of issue-specific risk provides little benefit to investors. According to modern portfolio theory, most of the issue-specific risk can be eliminated through diversification.\(^{79}\) Thus, the riskiness of an individual security is completely encapsulated in its systematic risk, \textit{i.e.} the portion of risk that cannot be eliminated through diversification and that contributes to the overall risk of the portfolio.\(^{80}\) Since the market only rewards investors for bearing risk they cannot avoid, they do not receive a premium for unsystematic risk that can be eliminated by diversification.\(^{81}\)

Still, the reduction of the variance of new issues may yield a more important social benefit, according to Professor Coffee, who emphasises the impact of accurate securities prices on the efficient allocation of capital rather than their importance for investor protection.\(^{82}\) He stresses that the variance associated with securities returns directly influences the uncertainty and heterogeneity of investor expectations that contribute to inaccurate securities prices.\(^{83}\) Accordingly, Coffee claims that the evidence’s most logical implication is that mandatory disclosure led to better pricing and

\(^{77}\) I. Friend & E.S. Herman. \textit{ibid}. at 391-392.

\(^{78}\) \textit{Ibid}. at 392-393.


\(^{80}\) M.B. Fox. "Rethinking Disclosure Liability in a Modern Era", (1997) 75 \textit{Wash. U.L.Q}. 903 at 908: “The investor, however, can protect himself much more effectively and at less social cost by simply diversifying more.”


\(^{82}\) J.C. Coffee. \textit{supra} note 42, at 734-736.

\(^{83}\) See in this respect M. Kahan, \textit{supra} note 40, at 988-994.
enhanced allocative efficiency, benefiting thereby to all members of the society, not just investors.84

While this interesting interpretation suggests that mandatory disclosure may provide significant social benefits, it still leaves open the question as to whether this reduction in risk is caused by an improvement in the quantity and quality of available information, or rather by a regulation-induced exclusion of risky issues from the market. And while mandatory disclosure may have positive impact on stock price accuracy and capital allocation, it is also necessary to consider the social costs of foreclosing risky new issues from the public equity market.

The riskiest new issues are likely to be those sold by relatively small firms without public track records, particularly those sold in initial public offerings. In a dynamic economic environment in which entrepreneurship and innovation is critical, these firms constitute an increasingly vital sector, of the economy, and excluding them from the public market is likely to result in diminished entrepreneurial activity and less competition for established firms. If this is indeed a primary effect of mandated disclosure, it at least raises the possibility that it has caused more social harm than good.85

As we will see now in the examination of the costs of mandatory disclosure, it may well be the case that the alleged benefits of disclosure are overweighed by the burden imposed on new ventures.

b) The Costs Associated with Disclosure Requirements

i) The Cost of Preparing the Prospectus

Securities regulation requires that firms making a public offering of securities prepare a comprehensive document called a prospectus.86 The prospectus is a costly document to assemble. The costs associated with the preparation of the prospectus encompass the direct costs of issuing a prospectus which result from regulation such as the fees of legal and accounting/auditing advisors,

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84 J.C. Coffee, supra note 42, at 735-736.
85 Financing Innovative Enterprise, supra note 29, at 119.
86 Supra notes 3-14 and related text.
the printing expenditures, the filing fees for the securities commissions, and other related expenses.87

The cost of assembling the prospectus is particularly high for smaller issuers. SMEs do not generally have sophisticated information and accounting systems and usually lack a good track record of their past performance. Lawyers, underwriters and auditors must therefore spend considerable time gathering information and setting up appropriate information systems to ensure that disclosure requirements will be met.88

In Canada, the existence of provincial securities commissions creates additional costs for issuers as they must comply with the varying disclosure requirements of every province in which the offering is made.89 Thus, issuers must incur significant professional fees to resolve the comments of non-principal jurisdiction because of the lack of regulatory co-ordination between provincial securities commissions, despite the existence of National Policy No. 1 which is intended to facilitate and accelerate multi-province offerings. A recent survey on the costs of this multiple review process indicates that these additional costs are estimated to be, as a percentage of the total transaction costs of the offering, less than 5 per cent (or $10,000) by the majority of respondents.90

The costs of preparing the prospectus are enormous when viewed in the context of a small enterprise. Indeed, as Table I illustrates, they have a large fixed-cost component and represent, therefore, a higher percentage of proceeds for small issues than for larger issues.91 For example, the non-underwriter costs for offerings of less than $1 million (U.S.) represent about 8.5 per cent of

90 G.V. Sawiak et al., ibid. at 9.
issue price, while they represent only 0.9 per cent of issue price for offerings of $100 to 200 million (U.S.).

Table I  

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<tr>
<th>Size of Offering (U.S. $ millions)</th>
<th>Number of IPOs</th>
<th>Expenses(^{\dagger}) (%)</th>
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<td>0.1 – 0.9</td>
<td>47</td>
<td>8.47</td>
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<td>1-9.9</td>
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<td>100-199.9</td>
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<td><strong>Average</strong></td>
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\(^{\dagger}\) Include professional fees, printing costs, registrar and transfer agent fees, filing fees, and listing fees.

**SOURCE:** The Conference Board of Canada, 1994.

In addition to these direct expenses, the cost of preparing the prospectus includes the opportunity costs of complying with regulatory requirements. Opportunity costs refer to the cost of the management time devoted to the preparation of the prospectus and diverted from the day-to-day operations of the company. During the preparation of the IPO, some members of the management team must spend considerable time dealing with the auditors, lawyers and underwriters, as well as marketing the issue.\(^{92}\) This diversion of management attention from the direction of the firm’s operation will have a more disruptive effect in SMEs given the smaller size of the management team.\(^{93}\) In this respect, it is interesting to note that the cost of the management

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\(^{92}\) M. Andrews, *Initial Public Offerings – The Experience of Eight Canadian Growth Companies*, (Ottawa: The Conference Board of Canada, 1995) at 9-10 (Survey reveals that the average time spent on the IPO by senior executive was 20 weeks, with a range from a low of 8 weeks to a high of 42 weeks. This time frequently involved more than one executive).

\(^{93}\) *Financing Innovative Enterprise, supra* note 29, at 45-46.
time has a high fixed-cost component and declines, as a percentage of the amount raised, as the size of issues increase.\textsuperscript{44}

It remains difficult to assess precisely the direct costs of mandatory disclosure for issuers since they would incur some of these costs even in the absence of regulation to produce a information for their own operating needs.\textsuperscript{45} In addition, public firms would also voluntarily incur considerable costs to inform actual and potential investors, although what things firms would disclose, and to whom, in the absence of regulation is unascertainable.\textsuperscript{46} However, it is likely that firms would not disclose the same level of information that current mandatory disclosure rules require, given the continuous increase of disclosure requirements.\textsuperscript{47}

\textit{ii) The Cost of Delays}

Another cost of mandatory disclosure results from the delays associated with the prospectus approval process. An average period of three months elapse between the time where an issuer decides to make a public offering of securities and the time when it can actually start selling securities and receive the proceeds. This delay, which may be longer in the case of multi-province offerings,\textsuperscript{48} negatively affects issuers in that issuers may miss a window in the market and be compelled to settle for a lower selling price or a smaller offering.\textsuperscript{49} Moreover, the delayed receipt of the proceeds of the offering can have a severely disruptive effect on the operations of SMES given their financial fragility.

\textsuperscript{44} M. Andrews. supra note 92, at 10: Financing Innovative Enterprise, \textit{ibid.}


\textsuperscript{46} F.H. Easterbrook & D.R. Fischel, supra note 21, at 709.

\textsuperscript{47} Financing Innovative Enterprise. supra note 29, at 50-51.

\textsuperscript{48} G.V. Sawiak \textit{et al.}, supra note 89, at 8 (67 per cent of respondent stated that non-principal jurisdiction did not reply within the requisite period). The authors report that the costs of these delays coupled with the additional professional fees of dealing with multiple regulators act as a strong deterrent on small issuers. \textit{Ibid.} at 11.

\textsuperscript{49} \textit{Ibid.} at 8-9: Financing Innovative Enterprise. supra note 29, at 47.
iii) **Underwriting Fees and Selling Commissions**

Another variety of operational cost generated by mandatory disclosure is the expenses that issuers must incur to compensate investment dealers for underwriting and distributing the offering. We will examine the influence of regulation on the level of underwriter fees and selling commissions in the next chapter.

iv) **Loss of Competitive Advantage**

Mandatory disclosure involves also non-operational costs which result from the loss of confidentiality for issuers. As mentioned, the disclosure of confidential information by issuers can increase their costs or reduce their revenues where competitors, suppliers, and customers can use this information to their advantage. Professor Meritt Fox summarises:

> Competitors can act in ways that reduce the issuer's rents, if they know the issuer's lines of business that are unusually profitable or the kinds of products or activities that the issuer's research suggest will be unusually profitable in the future. Suppliers and customers who deal with the issuer on a negotiated basis can strike bargains more favorable to themselves when armed with this kind of information. The information enhances suppliers' and customers' bargaining positions because it gives them a better idea of the size of the potential surplus created by their deals with the issuer.

It is important to emphasise that the cost at the firm level which can result from the loss of confidentiality are essentially borne by investors: “Investors can have the information, but at a price: their investment will be worth less.” Thus, mandatory disclosure of confidential information may actually compel managers to disregard the best interest of the corporation, in contravention with their fiduciary duties.

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101 M.B. Fox, *supra* note 40, at 2551.

102 E.W. Kitch, *supra* note 100, at 848.

The competitive losses resulting from disclosure of confidential information are difficult to assess. In a mandatory disclosure system, issuers will gain advantages from knowing more about their competitors as every issuer have to disclose such information. Thus, it remains unclear whether disclosure of proprietary information will consistently generate net competitive disadvantages for issuers.

v) Enforcement Costs

Mandatory disclosure also generates cost at the public sector level in the form of administration and enforcement costs. These costs occur because of the necessity to employ a large number of staff (investigative, prosecution, and judicial) to ensure that disclosure requirements are complied with. They include, in addition, the costs of litigation that will be especially high when the Commission loses and must pay the defendants’ costs.

In addition, enforcement costs encompass the costs of over-enforcement or inaccurate enforcement of the regulatory requirements. In the primary market, those costs are not likely to be substantial for disclosures that concern verifiable objective statements as the chances of error are lowest with respect to these statements. The risk of over-enforcement or inaccurate enforcement is however higher with respect to soft information, such as projections or predictions,

104 L. Lowenstein, supra note 18, at 1356-1357. See also United States, House Committee on Interstate and Foreign Commerce, Report of the Advisory Committee on Corporate Disclosure to the SEC (95th Congress, 1st Sess., 1977) at 22-23.
105 M.B. Fox, supra note 40, at 2551. See also supra Chapter III, notes 15-24 and related text.
106 C.S. Bradford, supra note 75.1, at 608 (Emphasising the difficulty of quantifying the loss of competitive advantage).
107 C.S. Bradford, ibid. at 606-608.
108 J. Azzi, supra note 63, at 215.
because of the greater difficulty of separating "untruths from statements that, although true, do not accurately predict the future."\textsuperscript{111}

3. \textbf{Summary}

The appropriate goal of mandatory disclosure is to enhance informational efficiency in order to foster the formation of accurate securities prices. While informational efficiency is an important component of market efficiency, the goal of accuracy enhancement should not be implemented without consideration of the costs that disclosure requirements generate. Indeed, operational efficiency is necessary to market efficiency.

Unfortunately, the current disclosure requirements appear to neglect the costs that they impose on issuers, and especially SMEs. At the theoretical level, this is shown by the lack of flexibility of the disclosure requirements. Disclosure regulation has adopted a one size fits all approach which prevents issuers from tailoring their disclosure documents to strike a balance between the costs and benefits of disclosure. At the empirical level, the lack of consideration for the costs generated by disclosure regulation is demonstrated by the distribution of the costs of mandatory disclosure which indicates clearly that they are not established with recognition of the capabilities of SMEs.\textsuperscript{112}

The high fixed-cost component of securities regulation serves as a regressive tax on SMEs attempting to tap public equity financing: "The smaller the enterprise, the higher the tax rate on the organization."\textsuperscript{113} This regressive tax has significant negative consequences on social welfare. On the one hand, by punishing smallest firms going public, securities regulation reduces potential competition by preventing these firms from entering in competition with larger firms. On the other hand, by raising the cost of public equity financing, it compels SMEs to forego investments that would generate high social benefits.

\textsuperscript{111} Ibid.

\textsuperscript{112} This problem is not specific to securities regulation but concerns government regulation in general. See Small Business Working Committee, \textit{Breaking Through Barriers – Forging Our Future}, (Ottawa: Supply and services, 1994) at 29.

\textsuperscript{113} D.B. Baysinger, supra note 91, at 91.
Accordingly, public policy should move away from an overly standardised prospectus disclosure system to a more permissive disclosure approach that can provide a range of acceptable options suitng the diversity of issuers' characteristics. This is the approach that appears to underly the Report of the Ontario Securities Commission Task Force on Small Business Financing to which we now turn.

**SECTION C: REFORMING PROSPECTUS LEGISLATION: THE REPORT OF THE ONTARIO SECURITIES COMMISSION TASK FORCE ON SMALL BUSINESS FINANCING**

In 1994, the Ontario Securities Commission established a Task Force on Small Business Financing (the Task Force) with the mandate to review, and make recommendations in respect of, Ontario legislative and regulatory framework governing the raising of equity capital by SMEs from sources other than governments and financial institutions. In 1995, the Task Force released a *Proposal for Comment* where it listed several recommendations intended to reform the regulation of the IPO and private placement markets in order to facilitate SME equity financing. The bulk of those initiatives have been maintained in the *Final Report* of the Task Force that was issued in 1996. However, it is important to note that the Ontario Securities Commission has not reviewed or endorsed the recommendations that are presented in the Final Report.

While in keeping with the provincial and federal governments' efforts to improve access to capital for growing enterprises, it must be recognised that the work of the Task Force lags several years behind that of American regulators. Nevertheless, its work remains timely given the

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117 Concerns were raised early after the enactment of the *Securities Act of 1933*. See G.B. Margraf, “Does Securities Regulation Hinder Financing Small Business?”, (1945) 11 *Law & Contemp. Prob.* 301. Amongst the landmark reforms are the adoption by the U.S. Congress of the *Small Business Investment Incentive Act of 1980* [Pub. L. No. 96-477, 94 Stat. 2275 (1980)] in the wake of which the SEC deferred to the states the oversight of many offerings of $1 million or less, and which led to a flurry of rules and exemptions to assist small business. Throughout the 1980s, the SEC liberalised and
growing importance of SMES in the Canadian economy. This section reviews the most important proposals of the Task Force’s Final Report which relate to the regulation of IPOs.


Two general philosophical premises form the basis of the Task Force proposals. The first premise is that any capital raising regulation should be justified on a cost/benefit basis, balancing investors’ interests and small companies’ needs for capital.

The focus of the Task Force’s mandate has been on the regulatory framework for SME equity investments: improving the comprehensibility and utility of that framework to market participants, eliminating regulatory costs which are disproportionate to the significance of the underlying objective, and ultimately improving the efficacy of the regulatory scheme.118

The second premise, implicit if not explicit in the Task Force’s proposals, is that a majority of Canadian enterprises are now over-regulated on a cost/benefit basis. It is certainly unusual to see in a report sponsored by a regulator an admission – tacit if not direct – that so large a portion of its constituency is currently over-regulated.119

More specifically, several guiding principles are stated by the Task Force as underlying the proposals.

1. The methods by which SME equity capital may be raised should be easy to use and easy to understand.

2. The regulatory framework governing SME capital formation should assist legitimate SME financing activities and the participants in that marketplace.

3. The regulatory regime governing SME capital formation should both balance SMES’ capital formation needs and the investor protection and other objectives of the regulatory regime and be proportionate in scope and effect to the significance of the regulatory objective(s) sought to be realized.

118 Task Force Report, supra note 2, at 16.

119 See especially ibid. at 32-35.
4. Reform of the securities regulatory framework to facilitate SME equity capital formation should be guided by considerations of business practicality rather than legal theory.

5. The Task Force's proposed reform should, to the greatest extent possible, be focused upon, and limited in application to issues relating to SME equity capital formation. These guiding principles should be supported as they are consistent with the needs of small issuers to access the public capital market within a reasonable cost structure that does not effectively foreclose them from public financing. Furthermore, they represent a laudable attempt to curtail the over-emphasis of regulation on investor protection and foster a more balanced approach taking into account capital formation. As we argued previously, this shift appears necessary if securities regulation is to fully reflect the structure and realities of the small firm IPO market.

2. Simplifying Prospectus Disclosure: The Small Business Prospectus Form

The Task Force recommends the development and adoption of a 'Small Business Prospectus Form' (SBPF) which would reduce the direct and indirect costs of preparing and qualifying the prospectus that burden excessively SMES. For the purpose of this new prospectus, the Task Force proposes that the revenue ceilings of the enterprise be used as the sole criterion to define an SME. Thus, the use of the SBPF would be limited to issuers with no more than $10 million in gross revenues in their most recently completed financial year, and a market capitalisation of $35 million or less. While we saw previously that there were several criteria commonly used to define an SME, gross revenues remain the easier criterion to use to measure the size of enterprise. Since this threshold is quite high, most SMEs should be able to meet it. However, as some of the

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120 Ibid. at 21-23.
122 Task Force Proposals. supra note 114, at 71.
123 Ibid. at 18-20. The OSC Policy Statement No. 5.10, which deals with junior resource issuers, uses a $10 million revenue threshold.
124 The Berger Report noted that small firms usually had revenues not exceeding $2 million, or $5 million in the manufacturing sector, without mentioning a similar threshold for medium-sized firms. Canada, House of Commons Standing Committee on Industry, Taking Care of Small Business (Ottawa: Supply and Services, 1994) Appendix A. See also Letter from D.M. Hyndman, Chair, British Columbia Securities Commission, dated September 26, 1995, in response to request for comments, Appendix A at 14; Letter from KPMG, dated September 15, 1995, in response to request for comments; Letter from M. Walsh, Chair, Committee on Financial Reporting, Financial Executive Institute.
respondents to the Task Force’s proposals point out, it would be important to base this threshold on the consolidated revenues of the issuer to include the revenues of related entities, in order to minimise the risk of abuse of the exemption.\textsuperscript{125}

The Task Force refrains from placing any limits on the amount of money that issuers could raise arguing that “disclosure prepared in accordance with the new form will in fact, be ‘better’ than disclosure which complies with current requirements in most cases.”\textsuperscript{126} Although this may be true, the purpose of the proposed prospectus is to reduce the costs of raising public equity capital for smaller issuers that currently fall disproportionately on the latter. Since there appears to be economies of scale in the production of large offerings, it is submitted that a ceiling could be placed on the amount of money that could be raised through the SBPF.\textsuperscript{127} This would ensure that the new prospectus brings SMES to a level playing field with larger issuers when going public, without making them better off than the latter when they raise large amounts of money on the market.

Indeed, SMES that issue offerings of size comparable with larger firms are likely to be market ready and have the requisite information and accounting systems. Thus, when they go public, these firms do not have to incur unusually high professional costs to comply with disclosure requirements and are not at a disadvantage, in this respect, in comparison to larger issuers. Support for this proposition is found in evidence indicating that the degree of underpricing, which measures the level of \textit{ex ante} uncertainty of an offering, is found to decrease with the size of the gross
proceeds from the offering.\textsuperscript{128} This suggests that firms with greater proceeds tend to have a better information environment that necessitates lower preparation costs. The determination of the exact threshold of admissibility remains an empirical question that can be resolved by a careful study of the cost structure of the preparation of the prospectus.

The Task Force does not elaborate on the specific disclosure requirements of the SBPF. Instead, it underlines the principal differences that would exist between the proposed prospectus form and the existing prospectus forms. At the broadest level of generality, it is interesting to see that the SBPF would be oriented not only to the needs of investors, but also to those of SMES. This manifests in concrete terms the willingness of the Task Force to balance investor protection and capital formation. At a greater level of specificity, the Task Force attempts to implement a more cost-effective prospectus by streamlining the information requirements and modifying the disclosure format. This section reviews the major proposals put forward by the Task Force.

a) The Reduction of Historical Information

Under the current regulatory regime, the prospectus is intended to be the central source of investment information for investors in the IPO market.\textsuperscript{129} Regulation ensures the primacy of the prospectus in a public distribution of securities by making it the primary legal sales document in any Canadian IPO. Furthermore, it compels the disclosure of extensive information about the offering itself and the issuer’s business and property.

Several authors agree to say that the prospectus fails to convey meaningful information that fosters informed, intelligent investment decisions.\textsuperscript{130} The limited relevance of information


\textsuperscript{129} See in general M.R. Gillen, supra note 5, c. 4.

contained in the prospectus decried by these authors stems from the ill-conceived willingness of regulators to make the disclosure system protect unsophisticated investors. This has lead to a focus on historical information and to a reluctance to include information of value to sophisticated investors that is thought to mislead naive investors. Thus, while the voluntary inclusion of future oriented information in the prospectus is treated with suspicion, issuers are compelled to disclose a description of the development of the business over the past five years, the occupations of directors and officers over the past five years, and the financial statements of the last five financial years.

There is reason to believe that firms incur unnecessary costs to disclose historical information. Historical information is generally of limited relevance to investors — unsophisticated or sophisticated — in assessing an investment in an enterprise. Indeed, the typical investment decision involves the determination of the probable return on a particular investment and the risk that the actual return will vary from this probable return. An investment decision is based, therefore, primarily on information about the future earnings of the firm, since this information has a direct bearing on the estimation of the return, i.e. the firm’s future sources of cash, the amounts of cash anticipated by the firm, and the timing of cash transactions, and the risk that the return will be different than expected.

To the extent that it is suggestive of future performance, historical data arguably remain relevant to these inquiries. However, for historical information to provide insight about the future, the information must be sufficient to be indicative of trends and have a certain degree of accuracy. In SMES, this will often not be the case as they generally have a very short history and lack a good track record of their past performance because of inadequate information systems. Furthermore, several commentators have questioned the ability of the standard accounting model

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131 Supra notes 9-11 and related text.
134 See however H. Kripke, supra note 130, at 298 (historical information is totally irrelevant to a current or prospective investor.)
135 Note, supra note 133, at 341-350.
to produce information useful for determining the values of securities. This will likely be even more problematic in small businesses considering their deficient accounting system.

From this it follows that given that the costs of compiling historical information can be significant, the production of this information is not cost-effective for SMES. Accordingly, the Task Force takes a sound stand in favour of a sharp reduction of historical information, including historical financial statements, in the SBPF. It proposes that the new prospectus require the inclusion of audited statements of operations, deficit or surplus and changes in financial position, for only the most recently completed financial year, if that is all that is reasonably available, instead of the last five financial years. This would codify the waiver that the Director generally grants in similar circumstances. Although issuers would still have to include in the prospectus an audited balance sheet for the most recently completed financial year, the resulting reduction in disclosure requirement would diminish the professional fees that small issuers incur, and which form the second largest direct expense after the underwriter's commission. Similarly, liberal requirements would apply to historical financial information pertaining to significant acquired businesses.

Historical information would be replaced by more detailed disclosure concerning forward-looking information such as business plans, obstacles anticipated in realising business goals and overall strategy. For example, the Task Force proposes that small issuers disclose the intended

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136 Ibid.; H. Kripke, supra note 130, at 301-305.
137 Task Force Report, supra note 2, at 74.
138 Ibid. See O.S.R., s. 53(6).
139 Issuers would also continue to have to produce audited financial statements for periods of less than a full financial year after the end of the last completed financial year. J. Higgins, supra note 87, at 5.
140 Currently, where the proceeds of an offering are used to acquire a business, the prospectus must include a balance sheet for the two most recently completed years of the acquired business, together with a balance sheet within 120 days of the day of the prospectus, and statements of operations, deficit or surplus and changes in financial position for the acquired business for each of the last three financial years of that business. O.S.R., ss. 56(1); OSC Policy No. 5.1, supra note at par. 23. The acquisition made by a small business will likely be smaller than an acquisition made by a larger company. The audited financial statements of small-acquired businesses will probably not be available and the costs of obtaining audits of such acquisitions will be disproportionately high for small businesses. R.S. Janvey, supra note 117, at 40-41.
141 Task Force Report, supra note 2, at 72-73.
use of all of their available capital rather than just the proceeds of the offering.\textsuperscript{142} To ensure that the proposed prospectus simplifies the going public process, it is suggested here that the questions raised should focus on the business plan of the issuer, and more particularly on the goals behind the offering and the steps required to reach those goals. This type of disclosures would facilitate the preparation of the prospectus and involved minimum costs as they are characteristic of the information provided to venture capital and investment banking firms in traditional private placement and venture capital financings.\textsuperscript{143} For example, the form could require management to describe those events or 'milestones' which the company must reach in order for it to become profitable. It could also require a description of how the issuer expects to achieve these milestones and the probable consequences of a delay in achieving these goals.

In addition, the Task Force proposes that issuers be given the discretion to disclose, for comparative purposes, unaudited financial statements for the immediately preceding period.\textsuperscript{144} This proposal can be criticised on the ground that unaudited financial statements will not provide useful information to investors. In the absence of third party certification, the quality of the information provided by the financial statements will be difficult and costly to verify for investors, creating thereby an adverse selection problem. Moreover, it is doubtful that the disclosure of unaudited financial statements will enhance investors' understanding of the issuers' financial situation, as argued by the Task Force. Indeed, "there is little value in comparing information prepared using different standards."\textsuperscript{145}

For this reason, it is suggested that issuers should not be given the possibility to include unaudited financial statements in the SBPF. It seems preferable to leave it open for issuers to include audited financial statements for previous years as the proposal does. This will allow issuers to balance the costs and benefits of disclosing these additional audited financial statements, and do

\textsuperscript{142} Ibid.

\textsuperscript{143} G.M. Stakias & J.E. Harris, "Simplifying Registration of Small Corporate Offerings: Form U-7 'SCORs'", (1992) 6:7 Insights 13 at 14.

\textsuperscript{144} Task Force Report, supra note 2, at 74.

\textsuperscript{145} Letter from D.M. Hyndman, supra note 124. Appendix A at 13.
so when they consider it to be beneficial, i.e. when the financial statements will convey relevant information to investors.146

Streamlining the historical information content of the prospectus will reduce the disclosure costs of SMES while having a limited impact on investor protection. Investors will not be deprived of any important information for investment decisions given the limited relevance of historical information. While, the lack of historical information may lead to an increase in promotional forward-looking information,147 adequate safeguards exist to protect investors from such abuses.148 In fact, it is ironic that the over-emphasis of investors on the past performance of issuers constitutes the basis of a leading explanation of the long run underperformance (or over-pricing) of IPOs.149 Thus, a reduction in the amount of historical financial information may help to shift the focus of retail investors to factors more likely to affect future returns and mitigate the influence of pre-IPO earnings levels on their expectations.

b) Simplifying the Presentation of Information

The Task Force proposes that the Small Business Prospectus Form use a plain English question-and-answer format similar to the ‘Small Corporate Offering Registration Form’ (SCOR) developed by the state of Washington in the 1980s, and adopted by about forty American states.150 The central

146 Letter from D.J. Low, General Director of Professional Standards, Chartered Accountants of Ontario, dated September 15, 1995, in response to request for comments at 2 (Suggesting that in many cases, audited statements for more than one year will be able). Some respondents to the proposals have urged the disclosure of audited financial statement for the last 2 to 3 years: Letter from KPMG, supra note 124, at 2; Letter from R.A. Campbell & H.G. Crawford, supra note 125, at 6.

147 Some respondents to the Task Force Proposal raise this concern. See e.g. Letter from D.M. Hyndman, supra note 124, Appendix A at 10-11.


149 Supra Chapter II, text accompanying notes 144-159.

rationales, which underlie the development of this format, are the simplification of the disclosure process and the reduction of the costs of preparing the prospectus.\(^\text{151}\)

The new prospectus would be designed to be completed by an entrepreneur armed with a basic business plan and with only limited professional assistance and other costs. It would incorporate a comprehensive and comprehensible guide to disclosure requirements that would include cross-references to and excerpts from the Securities Act, as well as examples and commentary on deficiencies routinely raised by the securities commission.\(^\text{152}\) These instructions would allow entrepreneurs, attorneys and accountants, who are not experienced securities professionals, to structure their prospectuses more closely to the finished product expected by the securities commission.

The plain English question-and-answer of the SBPF would arguably reduce the expense associated with preparing an offering.\(^\text{153}\) In the U.S., this format has helped a large number of issuers to file their SCOR registrations without the benefit of counsel.\(^\text{154}\) However, going public without the assistance of securities professionals will undoubtedly raise the burden placed on the commission’s staffs to produce a satisfactory document and increase the length of the period between the filing of the preliminary prospectus and the issuance of the receipt for the final prospectus.\(^\text{155}\) This counterproductive aspect would go against the objective of the proposal which is to reduce the regulatory review and the number of comments. For this reason, it is questionable whether small issuers should be encouraged to go public without some form of professional assistance.\(^\text{156}\) Professional fees would be nevertheless reduced if securities professionals were


\(^{152}\) Task Force Report, supra note 2, at 76-77.

\(^{153}\) Ibid. at 55

\(^{154}\) G. M. Stakias & J.E. Harris, supra note 143, at 13-14.

\(^{155}\) Ibid. at 14; Letter from D.J. Hudson, President and Chief Executive Officer, Vancouver Stock Exchange, dated September 25, 1995, in response to request for comments, at 6.

\(^{156}\) Letter from Aird & Berlis, dated October 6, 1995, in response to request for comments at 5-6. Several U.S. jurisdictions have discouraged jurisdictions have discouraged filings of SCOR registration without the help of securities professionals. G. M. Stakias & J.E. Harris, ibid.
involved as shown by the American experience. It appears that the use of the SCOR has reduced the legal and accounting fees of securities offerings, either because the work required was less burdensome or because of the realisation that offerings of this type simply cannot carry the same fee burden that is associated with traditional IPOs.\textsuperscript{157}

According to the Task Force, the Small Business Prospectus will, in corollary, foster the disclosure to SME equity investors of information that is more comprehensible and more relevant to their investment decision.\textsuperscript{158} This format, just by including questions, arguably provides information to the reader, regardless of whether the corresponding answer is affirmative or negative.\textsuperscript{159} The comprehensibility of the information will also be enhanced by the inclusion of specialised notes and warnings to assist investors in interpreting the supplied information.\textsuperscript{160} In this respect, by focusing on the business plan, the form should make it easier for the reader to analyse the strengths and weaknesses of the issuer and, thus, the potential for success.\textsuperscript{161}

The objective of making the prospectus more accessible and comprehensible for retail investors is laudable. However, it is important to keep in mind the important limits of such an objective that stems from the limited capacity of retail investors to understand the information disclosed relating to the issuer’s business, irrespective of the format used.\textsuperscript{162} Indeed, it is difficult for retail investors to comprehend the products or competitive position of SMEs in the high technology sector. Moreover, the operations of enterprises using less sophisticated technologies have hidden complexity for any reader without knowledge of the industry. Finally, since “the heart

\begin{itemize}
\item G. M. Stakias & J.E. Harris, \textit{ibid.} at 14.
\item \textit{Task Force Report}, \textit{supra} note 2, at 77.
\item G. M. Stakias & J.E. Harris, \textit{supra} note 143, at 13.
\item For example, following a series of questions on a given subject, the SCOR includes notes addressed to investors indicating how the information elicited might be used by the investor in making an analysis leading to an investment decision. These notes are also used to guard against possible misinterpretation of information elicited. H.H. Makens & J.E. Harris, \textit{supra} note 150, at 379.
\item \textit{Ibid.}
\end{itemize}
of modern disclosure is accounting”, investors can have some difficulties understanding the financial statements of issuers. \(^\text{163}\)

This does not mean that the use of plain English in the SBPF should not be encouraged. Too often, even basic information about an issuer’s business is written in a way that has been described as ‘turgid’, ‘opaque’ and ‘unreadable’. \(^\text{164}\) However, this indicates that, although the SBPF will be more accessible to retail investors, the presence of analysts and sophisticated investors will remain crucial for the assessment and dissemination of information. If the costs of preparing the proposed prospectus are to be worthwhile for SMES, this document should provide useful investment information for sophisticated investors, rather than provide an excessively simplified prospectus without value. This would reduce repetitive costs and increase the interests of institutions and analysts.

For the segment of the small firm IPO market with little institutional presence, it is doubtful that a mere change in the format of the prospectus and the provision of notes and instructions will lead to a drastic improvement of the analytical capacity of retail investors. The inclusion of these notes and instructions, which could be complemented by a ‘plain English’ glossary, should nevertheless be supported to facilitate the comprehensibility of information for retail investors. In addition, the new prospectus could be accompanied by a standard brochure produced by the securities commission that would provide warnings of risks inherent in investing in small businesses. \(^\text{165}\) The brochure would also provide practical guides to analyse the information disclosed in the form. The standardisation of the content of the brochure would reduce its costs for the securities commissions and involve no cost for issuers.

\(^{163}\) H. Kripke, ibid.

\(^{164}\) Task Force on Disclosure Simplification, supra note 117, at 21.

\(^{165}\) H.H. Makens & J.E. Harris, supra note 150, at 384. The states of Arizona and Washington require that investors be provided an investor protection brochure in addition to the SCOR. For example, the brochures admonish investors not to invest any funds that they cannot afford to lose entirely and caution investors about the risk of over-valuing emerging firms.
Finally, it is worth emphasising that the changes proposed to the prospectus form may well require a modification of the concept of materiality if it is to simplify disclosure, given the influence of this concept on the level of disclosure. Indeed, much of the difficulty and the costs of preparing a prospectus stem from the necessity to avoid misrepresentations. Issuers, underwriters and their lawyers produce defensively written documents that put a premium on legal jargon and over-inclusive disclosures. Trivial points sometimes receive as much attention as material information, and in the end may bury points significant to an investment decision. In the eyes of many, today's prospectus has become a legal document to shield against liability, rather than a useful and informative disclosure document.

This question will be examined further below.

c) The Prospectus Delivery Requirement

The Securities Act requires that a copy of the prospectus be sent to each purchaser of securities before or within two business days of the written confirmation of the sale of the securities. The delivery of the prospectus to investors is considered to be necessary or beneficial to assure that information about an issuer and the offering is widely available to investors. In addition, this requirement is employed as a prophylactic measure to minimise the adverse effects of fraudulent or misleading oral selling efforts by broker-dealers. Compliance with this obligation imposes significant costs on companies that may not be justifiable according to several commentators, including professor MacIntosh, who advocate the elimination of this requirement for small issuers. Professor MacIntosh argues that the benefits of delivering the prospectus to all buyers are

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167 Task Force on Disclosure Simplification, supra note at 21.
168 Infra notes 184-212 and related text.
169 O.S.A., s. 71(1); V.P. Alboini, Securities Law and Practice (Toronto: Carswell, loose leafs) at § 16.7.1.
171 Financing Innovative Enterprises, supra note 29, at 124-126. Professor MacIntosh cites a study by Benson that breaks down the costs of a $20 million IPO and indicates that printing cost amount to about $40,000, or 10 per cent of the proceeds raised. Ibid. at 46. Likewise, a leading Canadian underwriter estimates the printing cost (including share certificate) to amount to $75,000 to $100,000 for IPOs of $25 to $50 million: M. Weisdo, Going Public and the Public Equity Market, (Toronto: CICB – Wood Gundy, 1996) at 19.
limited since very few investors – whether institutional or retail – actually read the prospectus. In addition, he stresses that the information gathering activities of private traders and analysts ensure that information is reflected in the price of the securities prior to the filing of the prospectus.

Furthermore, MacIntosh maintains that even when the prospectus contains new information, it need not be distributed to every purchaser for the issue to be accurately priced. Indeed, "so long as there is a rump of sophisticated institutional buyers whose views are pivotal in pricing the new issue, all buyers are protected, whether or not they possess the information contained in the prospectus." From this, it follows that the Securities Act should require only that issuers make copies of the prospectus available for buyers who request a copy, or that issuers circulate only a brief summary of the prospectus to every investors.

The Task Force rejects professor MacIntosh’s proposals and contends that the existing delivery obligation is cost-effective and should be maintained, at least until the implementation of the System for Electronic Document Analysis and Retrieval (SEDAR). On the benefit side, the Task Force contends that the SBPF will enhance the utility of the prospectus and, thereby, the degree to which they are read and relied upon by investors. On the cost side, it argues that the cost generated by the delivery requirement is only marginally higher than printing a smaller number of copies to be made available to interested investors, since the bulk of the printing cost is in the set-up stages.

Both positions make the mistake of attempting to apply a one-size-fits-all approach to prospectus delivery. Instead, regulation should allow both perspectives to be addressed by focusing on the central issue: in what situations is mandated delivery of prospectus warranted?

172 Financing Innovative Enterprise, ibid. at 125.


174 See also Letter from Aird & Berlis, supra note 156, at 11.

175 L.C. Quinn, supra note 170, at 27-28.
In response to this question, there appears to be a strong case against compelling issuers to deliver the prospectus to sophisticated investors. As we saw previously, these investors have access to a wide variety of information sources prior to the delivery of the prospectus.\textsuperscript{176} Furthermore, sophisticated investors have access to soft information during road shows as well as when they are consulted by underwriters to set the market-clearing price of new issues. Accordingly, the information contained in the prospectus will generally be rather irrelevant for sophisticated investors as their assessment of the investment will already have been made.

For retail investors, the mandatory delivery of the SBPF may impose a justifiable cost on issuers. While retail investors can free ride on the activities of institutional investors in one segment of the small firm IPO market, the underpricing phenomenon indicates that significant information asymmetries subsist between retail and institutional investors. Underpricing constitutes a cost that issuers assume to compensate retail investors for their information disadvantage. Therefore, it is argued that the production and dissemination of a more informative disclosure document, such as the SBPF, to retail investors could reduce the \textit{ex ante} uncertainty surrounding issuers and diminish the extent of underpricing.\textsuperscript{177}

In the other segment of the market, the dearth of securities analysts and institutional investors reduces the extent to which all available information will be impounded into securities prices and forms the basis for some form of mandatory disclosure. Hitherto, mandatory disclosure of information has had a limited impact in improving pricing accuracy as suggested by the overpricing phenomenon. However, the improvement in the relevance of the information contained in the SBPF, coupled with its enhanced readability, may increase the reliance of investors on this document and foster thereby better informed decisions, resulting in more accurately priced securities.

\textsuperscript{176} Supra Chapter III, notes 256-262 and related text.

\textsuperscript{177} The reduction of historical information in the SBPF and the emphasis on forward-looking information will provide more informative disclosure to retail investors that may reduce the degree of underpricing.
For these reasons, it is proposed that the delivery of the prospectus be mandated only to retail investors while being made available upon request for sophisticated investors. Following this proposition, the obligation of determining whether delivery is mandated and of delivering the prospectus would fall on underwriters since they are the ones that are in contact with investors during the distribution of new issues. The concept of sophisticated investors would include the same institutions as the one recognised as exempt purchasers under the private placement exemptions. This obligation would reduce the cost born by small issuers by diminishing the number of prospectuses sent to investors. Moreover, the burden of this obligation would likely decrease over time with the extension of the institutionalisation of the market. The implementation of SEDAR will however mandate close supervision to determine at what point a sufficient number of retail investors have access to the electronic information to mandate the delivery of the prospectus only upon investor request.

d) Liability Issues Raised by the Implementation of the Small Business Prospectus Form

Following the Securities Act, the prospectus must “provide full, true and plain disclosure of all material facts relating to the securities issued or proposed to be distributed”. This obligation is reinforced by a statutory civil action provided to purchasers of securities against certain persons for a misrepresentation in a prospectus. A misrepresentation is defined in the Act as a misstatement of a material fact or an omission to state a material fact that is required to be stated or that is necessary to make a statement not misleading in light of the circumstances in which it was made. Defendants in the action are the issuer, the selling securityholders, each underwriter required to sign the certificate stating that the prospectus contains “full, true, and plain disclosure of material facts”, each of the issuer’s directors, each person or company who consented to the use of their report, opinion or statement in the prospectus, and every person who signed the prospectus, such as

178 O.S.A., s. 72(1)c).
179 O.S.A., s. 56(1).
180 O.S.A., s. 130.
officers. Alternatively, where the vendor is the issuer, a selling securityholder, or an underwriter the purchaser may elect to rescind the purchase of the securities.

The statutory civil right of action for prospectus misrepresentations is complemented by other statutory sanctions. Thus, there are penal sanctions for misleading or untrue statements in disclosure documents.\(^{181}\) The securities commission has also the power to impose administrative sanctions to reporting issuers, and their directors, officers and insiders for non-compliance with disclosure requirements. Administrative sanctions can take the form of cease trade orders, a removal of exemption, or an order to correct the misrepresentation.\(^{182}\)

Several commentators argue that the current liability provisions of the Securities Act, which enforce the full, true and plain disclosure standard, act as a powerful countervailing force to the simplification of the disclosure process contemplated by the implementation of the SBPF.\(^{183}\) In particular, they assert that issuers will have to maintain a similar level of disclosure in the SBPF as in the standard prospectus, unless the current standard of liability is modified. Small business issuers will continue to provide a level of disclosure similar to larger issuers to avoid statements that are misleading by omission. Likewise, liability concerns may lead small business issuers’ advisers to insist on disclosure beyond that required by the SBPF.

\(i)\) \textit{The Impact of Issuer Liability on the Simplification of Prospectus Disclosure}\n
The liability rule sanctioning misrepresentations plays an important role in enforcing the standard of full, true and plain disclosure enacted by the Act.\(^{184}\) It complements the market-based incentives

\(^{181}\) \textit{O.S.A.}, s. 122(1)b).

\(^{182}\) \textit{O.S.A.}, s. 127, 128.


\(^{184}\) F.H. Easterbrook & D.R. Fischel, \textit{supra} note 110, at 636-637: “The circumstances are ripe for unconditional deterrence [of fraud] in the issuance of stock.” See also L.M. LoPucki, « The Death of Liability », \textit{1996} \textit{Yale L.J.} 1 at 3 : “Liability is crucial because it is one of only two principal means by which governments enforce law.”
that work imperfectly in driving issuers to disclose full, true and plain information to the market.\textsuperscript{185} Moreover, the liability rule reduces the costs of third-party certification by making it more costly for low quality issuers to imitate high-quality issuers by making false disclosure.\textsuperscript{186} In corollary, the rule reduces the precaution costs that investors must incur to "uncover fraud so as to avoid entering into bargains they would not have concluded in an honest market."\textsuperscript{187} Thus, liability arguably reduces the expense of offering high quality securities while increasing the expenses of distributing low quality securities.\textsuperscript{188}

The liability rule however raises a significant problem when applied in the context of the SBPF whose primary purpose is to simplify disclosure. To the extent that the same liability regime, which applies to the standard prospectus, applies to the SBPF, issuers may be prevented from actually producing a simplified prospectus. In particular, since issuers will remain liable for omitted material facts, it may be feared that they will continue to provide a level of disclosure akin to that provided by other issuers under the standard prospectus.

The extent of the liability risk that will face issuers using the small prospectus form depends essentially on the scope of the materiality concept. It is only where an omission concerns a material fact that it can constitute the basis for liability. Thus, it is important to determine what constitutes a material fact.

According to the Securities Act, the expression "material fact" encompasses any fact that significantly affects, or would reasonably be expected to have a significant effect, on the market price or value of the securities of an issuer.\textsuperscript{189} This standard of materiality attempts "to establish a reasonably high threshold that enables issuers and their insiders to make reasonable business

\textsuperscript{185} R.G.D. Goulet, \textit{supra} note 3, at ¶12,000. \textit{Supra} Chapter III, notes 15-52 and related text.
\textsuperscript{186} F.H. Easterbrook \& D.R. Fischel, \textit{supra} note 21, at 677.
\textsuperscript{187} P.G. Mahoney, \textit{supra} note 109, at 630.
\textsuperscript{188} F.H. Easterbrook \& D.R. Fischel, \textit{supra} note 21, at 677.
\textsuperscript{189} \textit{O.S.A.}, s. 1(1) "material fact".
determinations, while meeting the needs of investors generally". Hence, the standard does not require issuers to disclose all information that might be considered relevant by investors. Indeed, such a duty would "simply bury the shareholders in an avalanche of trivial information — a result that is hardly conducive of informed decision-making".

A cursory examination of the materiality standard in the United States suggests that it is different from the Canadian standard. Following the seminal case of *TSC Industries Inc. v. Northway Inc.*, information is considered material in the United States where there is a substantial likelihood that a reasonable shareholder would consider it important in making an investment decision. A closer analysis reveals, however, that there are no significance differences between a standard based on the importance to investor of information in decision-making, and a standard based on the influence of information on the market price or value of an issuer’s securities. Indeed, the Canadian standard of materiality is closely linked to the investment process of the reasonable investor:

> It is clear that a perceived impact of information on share prices invariably influences and in turn is influenced by its importance to investors. Information that is significant to investors will almost always be likely to affect the market price of an issuer's securities. Indeed, it is difficult to envisage circumstances in which a fact that would not be likely to affect the market price would be material under [an investor-based] standard.

For this reason, the American case law is highly relevant for circumscribing the extent of liability for misrepresentation under the *Securities Act*.

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193 Note that the Canadian Securities Administrators have recently proposed to amend securities legislation to adopt a single standard of materiality based on the American acceptance of materiality and which would apply to investment decisions throughout Canada. The new standard would not change the current disclosure standard but would arguably facilitate its application. See «Request for Comment 51-901 Report of The Toronto Stock Exchange Committee on Corporate Disclosure and Proposed Changes to the Definitions of "Material Fact" and "Material Change"», (1997) 20 *O.S.C.B.* 5751.
In this respect, an important principle which emerges from the American case law concerns the materiality of omitted facts. In TSC Industries Inc. v. Northway Inc., the U.S. Supreme Court held that the determination of whether an omission concerns a material fact should not be made in isolation. Where examining the materiality of an omitted fact, courts should view the omission at issue in light of all other information available to investors. More particularly, courts should examine whether “the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available.” In other words, it should be established that there is a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the decision of the reasonable investor.

It is argued here that the standard developed in TSC Industries Inc. would provide little protection against liability for omissions for issuers using the proposed small business prospectus form. Indeed, unlike in TSC Industries Inc. where the court found that so much information was contained in the Securities and Exchange Commission’s forms and schedules that the omitted information could not have influenced the decision of a reasonable investor, the ‘total mix’ of information available to investors about SBPF issuers would arguably be insufficient to offer insulation from the risk of making material omissions. Less information would be available to investors because of the inherent characteristic of the SBPF. Furthermore, little alternative public information would generally exist on SBPF issuers as few securities analysts would follow the latter closely enough. In this context, there would be a great likelihood that any omission be deemed material in light of the above criterion.


195 TSC Industries Inc. v. Northway Inc., supra note 191, at 448. For a recent application of the standard see In re Apple Computer Sec. Litig., In re Apple Computer Sec. Litig., 886 F.2d 1109 (9th Cir 1989).

196 Ibid.

The risk of liability for omissions that will face issuers using the SBPF will arguably create strong incentives to continue to provide a level of disclosure similar to that provided by other issuers under the standard prospectus. This result would undoubtedly undermine the entire purpose of implementing the new prospectus form. For this reason, some form of protection against liability for omissions should be granted to issuers making an offering with the SBPF. In crafting such a protective scheme, caution is however warranted. Given the imperfections of the private information networks of the small firm IPO market highlighted previously, a liability rule remains necessary to ensure an adequate level of disclosure.

The risk of liability for omissions in the SBPF could be curtailed by avoiding imposing on issuers using the new prospectus form the general disclosure requirement that presently applies to the standard prospectus, and which creates uncertainty with respect to the materiality of the specific disclosure requirements. This catch-all provision reads: “Give particulars of any other material facts likely to affect the value or the market price of the securities proposed to be offered and not disclosed.” The use of the term “other” in the provision can be interpreted as implying that every item, which is specifically required to be disclosed, is material, which may not always be the case. If this interpretation is correct, any omission in the specific disclosure requirements will concern a material fact and will therefore constitute a misrepresentation. Removing the general requirement would leave intact the duty of issuer to provide full, true and plain disclosure which is enacted in section 56 of the Securities Act. At the same time, it would eliminate the necessity for issuers to attempt to cover every aspect of the specific disclosure requirements, irrespective of their materiality, for fear of omitting a material fact. Stated differently, it would leave to issuers the

SEC Commissioner Fleischman made a similar point in his separate statement accompanying the SEC Small Business Initiatives Release. “Separate Statement of Commissioner Fleischman on SEC Small Business Initiatives”, Securities Act Release No. 6925 (1991-1992 Transfer Binder) Fed. Sec. L. Rep. (CCH) ¶ 84,932. Commissioner Fleischman proposed that a different materiality standard should apply to omissions by small business issuers: “The term ‘material’, when used with respect to facts or information necessary in order to make other statements not misleading, shall be limited to facts or information concerning acts, events or contingencies reasonably likely to alter significantly the total mix of information made available about a small business issuer.”

S.J. Choi, “Company Registration: Toward a Status-Based Antifraud Regime”, (1997) 64 U. Chi. L. Rev. 567 at 571, 578. Liability plays an important role in helping gatekeepers bond themselves to remain faithful. See infra Chapter V, notes 154-185 and related text.

O.S.R., Form 12, item 32.

W.M.H. Grover & J.C. Baillie. supra note 18.
decision of determining which aspects of the specific disclosure requirements are material. Nevertheless, it may be argued that leaving the general full, true and plain disclosure requirement of section 56 of the Securities Act will replicate the problem. While apposite, this concern can however be addressed by specific measures limiting the risk of over-deterring negligent misstatements and omissions.

Firstly, the definition of materiality found in the Securities Act should be amended to repeal the part of the definition that qualifies as material a fact that "significantly affects" the market price of a security. Presently, the definition "allows one to determine materiality retroactively regardless of there having been no reasonable ground to expect, in advance, that the fact would have a significant effect on the market price." Repealing this part of the definition, as proposed in the Allen Report, would remove the risk of liability by hindsight, i.e. the risk that issuers will be found liable with respect to fact that significantly affected the market price of a security irrespective of whether it would reasonably have been expected to have had such an effect.

The second modification to the regulatory regime would consist in the creation of a general "safe harbour" for omissions. To enact such a safe harbour, it is important to make a distinction between two broad categories of information that are subject to omissions by issuers. The first category concerns positive information, i.e. information whose disclosure would result in an appreciation in the value or price of the securities issued. Generally, issuers will have an incentive to disclose positive information when they are making securities offerings since such information will increase the proceeds that will be generated by the offering. However, disclosure of positive information can harm issuers and investors alike because of the competitive disadvantage that may result from the dissemination of such information.

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203 Ibid.

204 A safe harbour describes a conduct of some procedures that are considered not to violate the legislation or give rise to liability.

205 Supra Chapter III, notes 2-14 and related text.

206 Supra notes 100-106 and related text.
Given the uncertainty surrounding the benefits of mandating the disclosure of competition-sensitive information underlined previously, many have argued that some level of discretion should be left to issuers to determine the opportunity of disclosing proprietary information. One approach that could be used to preserve the discretion of issuers would be the enactment of a safe harbour for omissions concerning this type of information. Such a safe harbour could provide that issuers should not be liable where they withhold information in “situations in which the company has embarked upon some strategic course of action that would be expected to enhance the value of the company, but premature disclosure would likely erode that value by signaling the company’s intentions to marketplace competitors.”

The second category of information subject to omissions encompasses negative information, i.e. information whose disclosure would result in depreciation in the price or value of the securities issued. Issuers will have strong incentives to conceal this type of information to investors when making securities offering as disclosure will lower the proceeds generated by the offering. Given the impact of negative information on investors’ wealth, securities regulation should not permit, as a general rule, omissions of such information in the prospectus. Indeed, the mere allegation of harm to the issuer of disclosing negative information is certainly not sufficient to form the basis for a right to withhold material information.

To be sure, disclosure of risks and other adverse information can be embarrassing to executives, leading to some drop in managerial morale. And bad news can also affect other constituencies – employees, suppliers, customers, etc. – leading to the possible erosion of internal corporate optimism and a threat to continued external support and resources. While these threats may be real, securities regulation has opted to subordinate subjective, reputational interests to the promotion of stock price accuracy. Mere unpleasantness should not be enough to justify the concealment of bad news, even if bad news disclosure can sometimes be something of a self-fulfilling prophecy through its spillover effects. Moreover, allowing this kind of subjective justification for nondisclosure too easily becomes a mask for self-serving inference.

Yet, concealing negative information could be justifiable from a business judgement point of view where disclosing the information would unnecessarily prejudice the best interest of the

207 J.R. Macey & G.P. Miller, supra note 103; E.W. Kitch, supra note 100, at 846-874; D.C. Langevoort, supra note 103, at 791.

208 D.C. Langevoort, ibid. at 772.

209 See e.g. In re Apple Computer Sec. Litig., supra note 195.

210 D.C. Langevoort, supra note 103, at 772-773.
issuer. Such could be the case, for instance, where an issuer is aware of a problem with the product it manufactures, but has found and is implementing corrections to the product. Disclosure of the problem would arguably harm the issuer’s competitive position, a consequence that can be devastating for a small firm seeking to enter a market, even though the problem would be corrected in a reasonable period of time.

In order to strike a balance between these two concerns, a safe harbour for omissions concerning negative information should not permit non-disclosure on the sole basis of the negative impact of the information. Rather, it should only cover situations where the information withheld concerns risks or problems in response to which the issuer has simultaneously developed a strategic response that depends on secrecy, and where disclosing the risk would inevitably compromise that response.211

The enactment of such a safe harbour would provide issuers a mechanism that allows them to balance the investor-borne cost of disclosure with its benefits. Such a mechanism has been lacking from the current regulatory framework as Edward Kitch has underlined.212 Furthermore, it would reduce some of the liability risk facing issuers using the SBPF by allowing them to select with more latitude the optimal level of disclosure.

ii) The Liability of Underwriters

Fear of liability may preclude underwriters from adapting their practices and procedures to the needs of firms using the SBPF. If this is the case, the proposed prospectus will not result in more simplified disclosure of lower underwriter compensation. We will examine thoroughly this question in the next chapter.

211 D.C. Langevoort, ibid. at 773-774.
212 E. W. Kitch, supra note 100.
iii) The Liability of Auditors

Under the Securities Act, auditors are liable for misrepresentations in the financial statements upon which they report. Plaintiff need not prove that there was a duty of care owed by auditors, that there was a reliance on the auditors' report, or that the auditors were negligent, but merely that there was a misrepresentation at the time of the purchase.

In addition, section 34 of the Regulation made under the Securities Act requires that auditors file a written consent to being named in the prospectus as having prepared their expert report. The consent must state that auditors have read the prospectus and have no reason to believe that there are any misrepresentations in the information contained in the prospectus that is derived from the financial statements upon which they reported or that is within their knowledge as a result of the audit of such financial statements. By filing the consent, auditors arguably become liable for parts of the prospectus which they did not prepare. Defendants subject to statutory liability, including auditors, are jointly and severally liable, with a right of contribution except where contribution is considered to be not just and equitable.

Auditors can escape liability if they have conducted a due diligence investigation that provided them reasonable grounds for a belief that there had been no misrepresentations with respect to their expertised part of the prospectus. Note that in contrast to the due diligence defence available to underwriters, the burden of proof is on the plaintiff to establish that the auditor did not meet the due diligence standard.

The analysis of the cost structure of audit services made previously indicates that legal liability did not appear to have a significant effect on the supply of these services to small issuers.

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214 O.S.A., s. 130(4).

215 V.P. Alboini, supra note 169, at §23.1.11.

216 Supra Chapter III, notes 192-202 and related text.
In its *Proposal for Comment*, the Task Force did not refer to the current accessibility of audit services to SMES, but expressed rather concerns with respect to the impact of the adoption of the SBPF on the cost of auditor services. The Task Force stressed that there may be a greater chance that misrepresentations would occur in the new small business prospectus, especially outside the financial statements.\(^{217}\) Auditors may therefore be exposed to greater liability risk and increase the level of their compensation.

For this reason, the Task Force had suggested initially in its proposal to limit the scope of auditors’ liability by eliminating the requirement that auditors read the prospectus and certify that they have no reason to believe that there are no misrepresentations in the information that is derived from the financial statements upon which they reported or that is within their knowledge as a result of the audit of such financial statements.\(^{218}\)

The increase in the risk of misrepresentation that spearheaded the Task Force’s proposal stemmed essentially from the elimination of underwriter liability that it proposed.\(^{219}\) If underwriter due diligence is maintained, as it will be argued below, the introduction of the SBPF is not likely to lead to an augmentation of liability risk for auditors.\(^{220}\) Indeed, auditors will continue benefiting from the gatekeeping activities of underwriters that will ensure the truthfulness of the information disclosed in the prospectus.

More importantly, it is doubtful that the changes in the format of auditors’ consent would have a significant impact of the cost of audit services. With respect to the expected loss element, note that misrepresentations in prospectuses are generally in the financial statements or the financial information derived from the financial statements.\(^{221}\) Thus, it is easy to overstate the

\(^{217}\) *Task Force Proposals*, supra note 114, at 59-60.

\(^{218}\) *Ibid.*

\(^{219}\) *Task Force Report*, supra note 2, at 85.

\(^{220}\) *Infra* Chapter V, notes 154-213 and related text.

\(^{221}\) *Task Force Proposals*, supra note 114, at 60.
extent to which the proposal would reduce auditors’ liability.\textsuperscript{222} With respect to the production element, it is unlikely that auditors’ review process would change as a result of the proposed change given that the financial information in a prospectus is stated in the context of the overall document.\textsuperscript{223}

Acknowledging some of those critics, the Task Force abandoned this proposal in its \textit{Final Report} and recommended rather the adoption of a regime of proportionate liability.\textsuperscript{224} This recommendation is a sound policy decision that should be implemented even if the Legislator were to follow the proposed suggestion to maintain underwriter liability. Indeed, the recommendation represents a moderate means of circumventing the liability of auditors.\textsuperscript{225}

Under a regime of proportionate liability, liability is determined by ascertaining the portion of responsibility of the plaintiff and of each of the defendants alleged to have cause the harm alleged by the plaintiff. The liability of a given defendant is then established by multiplying the portion of responsibility by the total damages. In other words, “[u]nder proportionate liability, less responsibility would mean less liability.”\textsuperscript{226} However, pursuant to the recommendation, proportionate liability would not be available whenever the auditor would make intentionally a misrepresentation. In such a case, the auditor would remain jointly and severally liable where a damage award is not fully satisfy.\textsuperscript{227}

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\item[\textsuperscript{222}] Letter from D.J. Hudson, \textit{supra} note 155, at 7; R.J. Steinberg \textit{et al.}, \textit{supra} note 127, at 7. The Task Force mentions that it is difficult to estimate the reduction in auditor liability that will produce the proposal. \textit{Ibid.} See also Letter from KPMG, \textit{supra} note 124, at 2; \textit{Task Force Report, supra} note 2, at 86.
\item[\textsuperscript{223}] Letter from Aird & Berlis. \textit{supra} note 156, at 10; R.J. Steinberg \textit{et al.}, \textit{ibid.} The Task Force recognised that "the proposal, if implemented, may not have had the effect of reducing auditor liability". \textit{Task Force Report, ibid.}
\item[\textsuperscript{224}] \textit{Task Force Report, ibid}
\item[\textsuperscript{227}] \textit{Task Force Report, supra} note 2. at 86.
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The introduction of a regime of proportionate liability would limit the responsibility of auditors to a level that reflects more closely the degree of their involvement in the going public process.228 Although they play a central role in the certification of financial information, the contribution of auditors to the preparation of the prospectus is by no means comparable with that of underwriters.229 Underwriters are involved in every steps of the process leading to the issuance of securities. In contrast, the intervention of auditors remains limited to the verification of the financial statements that are produced by company management. From this perspective, a regime of proportionate liability would be more in line with auditors’ role as gatekeepers of financial information.

While a regime of proportionate liability would protect auditors from liability arising out of misrepresentations in portions of the prospectus which they did not prepare, it would not shield auditors from liability. Auditors would remain liable for the damages which result from their failure to perform their function with the requisite level of due diligence.230 Differently stated, auditors would remain responsible for the quality of the services provided.

In corollary, by delimiting the scope of auditors’ liability, a regime of proportionate liability could enhance the accessibility of prestigious auditors for small and medium-sized issuers by reducing the cost of their services.231 Recall that the cost of audit services is made up of two elements: a production element and an expected loss element.232 The expected loss element, which is arguably more important than the production cost element, comprises the litigation costs as well as the potential cost of repairing reputation. By diminishing the probability for auditors of being sued, proportionate liability could lead to a reduction of the expected loss element, and thereby of overall audit costs.


229 Supra Chapter III, notes 141-178 and related text.


231 See D.C. Langevoort, supra note 225, at 1161-1162 (summarising the impact of liability risk on market intermediaries).

232 See supra Chapter III, notes 192-193 and related text.
It may be argued that the change to proportionate liability will diminish the number of the parties who can compensate victims of misrepresentations. Thus, where issuers are insolvent, it would be more difficult for plaintiffs to be compensated in full for their damages. While this concern is legitimate, it is important to stress that market intermediaries, such as auditors, should not be considered to be the insurer of investors. Indeed, the mandate of securities legislation is not to offer unconditional compensation to aggrieved investors through its system of civil liability, but rather to protect investors through an approach based on deterrence. From this perspective, it appears to be reasonable to favour a regime of liability that requires the proof of the harm caused by the defendant to trigger responsibility.

3. Modifications to the Regulation of Issuers’ Marketing Activities

The prospectus is the central information document that is to be used by firms making a public offering of their securities. To ensure the primacy of the prospectus, the Securities Act imposes restrictions to the marketing activities of issuers. Those restrictions, which hinder the free flow of information in the IPO market, are highly questionable in that they are incompatible with the goal of accuracy enhancement. Indeed, the more information that is available on issuers, the more accurately priced should be their securities. Thus, by limiting the free flow of information in the IPO market, the restrictions to the marketing activities of issuers may contribute to the mispricing of new issues by preventing issuers from taking measures to reduce information asymmetries. Accordingly, a revision of the regulation of issuers’ marketing activities seems necessary.

233 D.C. Langevoort, supra note 225, at 1171-1172; R. Mednick & J.J. Peck, supra note 228, at 914-916 (presenting and rebutting the most common critiques).


235 The goal of deterrence is reflected in the current liability regime which limits the damages that plaintiff can recover in an action for misrepresentation. See O.S.A., s. 130(7). It has been enounced more formally in the Allen Report, supra note 202, at 41-42.
a) The Inability of Firms to Test the Waters

There are no provisions in the Securities Act which deal expressly with the marketing activities of issuers in the period that precedes the filing of the preliminary prospectus (the pre-filing period). However, according to the leading view, the concept of distribution is sufficiently broad to prohibit issuers from getting involved in pre-sale activities prior to the filing of a preliminary prospectus, since these activities can be considered to be in furtherance of a trade. Thus, securities legislation prevents issuers from soliciting expressions of interest from potential investors in the pre-filing period.

Two rationales support the rule prohibiting solicitation of expressions of interest from potential investors. A first rationale for this restriction is that it is necessary to prevent pre-sale misrepresentations or pre-sale pressure tactics that can affect the confidence of investors who rely on these activities. A second rationale is that the rule ensures that all investors have equal access to the new equity offerings.

The inability for issuers to 'test the waters' by soliciting expressions of interest prior to filing their preliminary prospectus has a number of drawbacks for small firms going public. Because of this restriction, SMEs must incur the full costs of preparing a prospectus without knowledge of whether there will be any interest in their offering. If the issue fails due to lack of


239 Financing Innovative Enterprise, supra note 29, at 127-128. Professor McIntosh cites a third rationale which is to preclude investors solicited in advance of an issue from exploiting for profit their knowledge that the issuer intends to make an IPO. However, he dismisses immediately this rationale stressing that in the context of an initial public offering there is no opportunity for investors to exploit the knowledge that the firm intends to make a public issue since the firm does not yet trade in a secondary market.

investor interest, the firms must support the expenses of prospectus preparation and the adverse impact of their aborted public offering, which can constitute a significant burden for the future.

In addition, this restriction affects the effectiveness of the price discovery mechanism by reducing the period during which issuers and underwriters can assess investor demand to determine the market-clearing price of the securities.241 Permitting issuers to test the waters would also arguably give investors more time to assimilate and evaluate the information. This, in turn, would allow investors to communicate their views as to the effect of that information on the value of the security and allow thereby underwriters and issuers to price new issues more accurately.

Furthermore, this restriction probably involves higher underwriter commissions as it magnifies the uncertainty surrounding the chances of success of the issue. The inability to test the waters implies that underwriters can only truly determine whether they are associated with a bad issue that can damage their reputation after that they have incurred the efforts and expenses of assembling the preliminary prospectus. In addition, since it is more difficult to assess the level of investor interest in the context of this restriction, the proceeds from the offerings are less certain. For these reasons, underwriter commissions may incorporate a higher risk premium to compensate them for these risks.242

Acknowledging the difficulties posed, the Task Force proposes that the restriction on pre-sale activities be modified to permit issuers whose securities are not publicly traded to test the market for their securities prior to the filing of a preliminary prospectus.243

241 J.F. Daniels, “Comparing U.S. and Hong Kong Public Offering Regulation: How Cost-Effective is China's Primary Capital Market?”, (1996) 69 S. Cal. L. Rev. 1821 at 1851; Financing Innovative Enterprise, supra note 29, at 128. See also L.A. Stout, supra note 32. at 658 n. 236 (lengthening the distribution period would allow issuers to sell their IPOs at 'at-the-market' prices). According to the Task Force on Small Business Financing, "testing the waters is likely to be less advantageous in Ontario than in the United States because the smaller number of dealers and potential investors in the Canadian marketplace typically means that the issuer and its dealer will have a relatively good understanding of the demand for securities". Task Force Report, supra note 2, at 82.

242 N.D. Lobell, “Revision of the Securities Act”, (1948) 48 Col. L. Rev. 313 at 320-322; J.F. Daniels, ibid. at 1859-1860 (making a similar argument for the Hong Kong regulation in the waiting period). See also Financing Innovative Enterprise, ibid. at 128.

243 Task Force Report, supra note 2, at 82. The Securities and Exchange Commission has lifted this restriction in a segment of the exempt market, as part of its 'small business initiatives', and is currently considering allowing emerging companies intending to make an IPO to test the waters. Rule 254; 17 C.F.R. § 230.254; R.S. Janvey, supra note 117, at 23-24. See also “Solicitations of Interest Prior to an Initial Public Offering”, Securities Act Release 7188 (June 27, 1995), 60 FR 35648
Concerns may be raised that the implementation of the proposal will compromise the interest of retail investors by opening the door to selective disclosure and unequal distribution of offerings. Indeed, it seems likely that under more lenient rules issuers will preferentially approach institutional investors rather than retail investors to test the waters when a substantial portion of the issue is expected to be sold to institutions. In fact, it seems efficient that issuers preferentially canvass the primary buyers of issues, since this will reduce the underwriter’s selling cost.

This preference of issuers for institutional investors may not prejudice retail investors participating in these issues. Institutional investors are a credible source of information for underwriters in the pre-solicitation period since they repeatedly express interest in a significant number of new issues offered by underwriters. Moreover, it is probable that the sophisticated investors in the market know more about factors that affect the price of an offering. By canvassing institutions, underwriters can therefore collect indication of interest and discover information that will influence the price of the securities. Although this practice exists already in the waiting period, permitting it to start earlier may allow more information to be revealed by institutional investors leading thereby to more accurate pricing and less risk of exploitation for individual investors.

The focus of issuers on institutional investors may not only benefit investors through increased pricing accuracy. It is also possible that prolonging the pre-marketing period will diminish the information advantage of informed investors. Indeed, the knowledge possessed by

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(244) Financing Innovative Enterprise, supra note 29, at 128.


informed investors that will be revealed to issuers will have more time to leak to the market and reach uninformed investors. Thus, lifting the restriction on solicitation of expressions of interest may reduce the information asymmetry which exists among investors.  

In addition, as professor MacIntosh notes, the risk that retail investors be relegated behind institutional investors "is unlikely to be realized in the case of small firm IPOS." Because of the lack of institutional interest in smaller offerings, the presence of retail investors is frequently crucial to the success of these offerings. Accordingly, retail investors will most likely be approached by issuers testing the waters and be given the chance to express their interest.

In any case, the concerns about equal access of investors to new issues could be alleviated by requiring the disclosure to the public generally of the information used in the solicitation of expressions of interest at this stage. One form of disclosure that could be used without excessive costs would be the filing of a test-the-water document with the securities commission disclosing the substance of the information that would be provided to prospective investors. Once the document would be filed with the commission, issuers would be allowed to test the waters through any type of oral or written communications. The documents used to test the waters would however become unusable once the preliminary prospectus is filed.

Although the document would be transmitted only to the commission, it would be available to anyone who wishes to examine the commission's files. This would allow retail investors to

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248 K. Rock, supra note 246, at 189: "In general, the greater the uncertainty about the true price of the new shares, the greater the advantage of the informed investors and the deeper the discount the firm must offer to entice uninformed investors to the market."

249 Financing Innovative Enterprise, supra note 29, at 128.

250 This is proposed also in the Task Force Report, supra note 2, at 83. The document would be filed similarly as a press release and should not have to be cleared by the commission because of the cost of doing so. See Letter from D.M. Hyndman, supra note 124, Appendix A at 14. A similar approach was selected by the SEC for Regulation A, as part of its small business initiatives and is proposed by the NASAA. See Rule 254; 17 C.F.R. § 230.254; NASAA, "Proposed Statement of Policy on Solicitation of Interest (Testing the Waters)", supra note 117, at 20-27. See also E.A. Chiappinelli, supra note 237, at 492-496.

251 However, the substance of such communications would have had to be disclosed in the test-the-water document.
approach issuers on their own without having to wait to be solicited by underwriters. In addition, the general availability of the document would make it easier for small firms to determine the interest of investors in the absence of an institutional clientele. Indeed, it is very hard for underwriters to assess the interest of retail investors as they form a group of atomistic investors indistinguishable from one another because they are both numerous and distinct from issue to issue.

To maintain adequate safeguards to protect investors from abuse, regulation should continue to prohibit the conclusion of a binding agreement before the receipt for the final prospectus is obtained.\textsuperscript{252} This would ensure that investors have access to adequate information before committing themselves.

So long as the prospective investor is subject to the benefits of the current preliminary prospectus/final prospectus/rights of withdrawal provisions, there seems to be no reason to prevent an issuer from soliciting potential investors prior to the filing of a preliminary prospectus. If the offering does not go forward, there is clearly no harm. If the offering does go forward, investors have the same protection as they currently have.\textsuperscript{253}

Furthermore, as the Task Force recommends, pre-marketing materials should be explicitly prohibited from being misleading.\textsuperscript{254} Thus, although no statutory liability would attach to those materials, the Task Force, the distribution of misleading materials would be a factor considered by the Director "in the exercise of discretion pursuant to clause 61(2) as to whether to issue a receipt for a prospectus."\textsuperscript{255}

b) Advertising Restrictions during the Waiting Period

The Task Force does not address in its proposals the strict limitations imposed by the \textit{Securities Act} on selling activities during the waiting period. The provisions of the Act in this area intend to protect investors from the risk of misrepresentation in non-prospectus materials by circumscribing the form and content of any sales literature delivered or communicated to prospective investors in

\textsuperscript{252} \textit{Task Force Report, supra} note 2, at 83.

\textsuperscript{253} Letter from Borden & Elliot, \textit{supra} note 127, at 4.

\textsuperscript{254} \textit{Task Force Report, supra} note 2, at 83

\textsuperscript{255} \textit{Ibid.}
relation to a distribution of securities. These materials arguably pose a threat to investor protection as they are not reviewed by the securities commission, or subject to statutory remedy for misrepresentation.

The advertising restrictions conflict with the goal of full disclosure that forms the basis of prospectus disclosure by restricting the ordinary flow of information to prospective investors and analysts. More precisely, the restrictions impose a particularly important burden on SMES by allowing only very limited form of advertising besides the preliminary prospectus during the waiting period. Under the current regulation, the advertisement can only identify the offering, and alert investors to the availability of the prospectus, the name of the business of the issuer and the price and size of the offering.

The permitted form of advertising considerably restrict the possibility of issuers using the media to present relevant information about their offerings in salient form. This restriction makes it particularly difficult for relatively unknown small issuers coming to the market for the first time to market their offering. Indeed, it prevents these issuers from using an effective communication tool to reach the atomistic group of retail investors whose participation remains crucial for the success of most SMES offerings, and solicit indication of interest. In this respect, it is worth noting that while issuers are allowed to maintain their normal advertising and public relations activities,


258 Ontario Securities Commission, “Notice — Advertising and Use of Marketing Material During the Waiting Period”, in Canadian Securities Law Reporter, supra note 256, at §473-031: “... an issuer has an obligation to take appropriate precautions to ensure that media coverage which can reasonably be considered to be in furtherance of a trade of a distribution of securities does not occur after a decision has been made to file a preliminary prospectus or during the waiting period.”; “Media Articles Appearing during the Waiting Period”, (1988) 11 O.S.C.B. 1098 (No views should be given to the financial media by management.). See also Re Cambior, (1986) 9 O.S.C.B. 3225 at 3226: “General corporate image advertising which does not specifically identify the proposed issue may, depending on the circumstances, also be prohibited, particularly where an issue is an initial public offering.”

259 E.A. Chiappinelli. supra note 237, at 499; B.A. Mann, supra note 130, at 228. The use of greensheets which summarise the salient aspects of the offerings is however allowed if it is filed with the securities commission with the preliminary prospectus. "Use of 'Green Sheet', and Marketing Materials during the Waiting Period under the Securities Act", (1989) 12 O.S.C.B. 2641.

260 The IPO Process. supra note 3. at 17.
this exception essentially benefits larger companies with well-established communication networks with shareholders and securities analysts. For small issuers, the exception is usually not available since most of them do not have sophisticated communications activities when they come to the public equity market for the first time.261

Moreover, the restrictions preclude SMES from experiencing with alternative disclosure techniques that could reduce information costs and foster a wider distribution of information in the market.262 Advances in information technology offers vast opportunities for issuers to reduce the information acquisition costs of prospective investors and improve thereby the information environment of the IPO market.263 Likewise, technology can assist issuers in reducing their search and transaction costs by facilitating the task of locating purchasers and assessing demand for the offering.264

In addition, the restrictions may also have some adverse impact on investor confidence by contributing to the maintenance of an information grey market that leads to an unequal access of information between institutional and investors.265 The unrestricted ability to engage in oral selling efforts once the preliminary prospectus is filed leads to a reliance on oral, rather than written, sales practices during the waiting period. Thus, presentations and communications are addressed to select institutional investors to "ensure that there is a good understanding of the company, that any

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262 See generally R.J. Gilson and R.H. Kraakman, supra note 40, at 597-609.


264 D.C. Langevoort, supra note 103, at 760-761.

questions are answered and management is fully evaluated." In addition, while the preliminary prospectus is the only written material that can be distributed to potential investors during road shows, presentations and meetings with management allow institutional investors who generally assist to these events to get access to information and insights not included necessarily in the prospectus. It is certainly ironic that for investor protection purposes, it is necessary to create unequal access of investors to information.

As mentioned previously, this may not prejudice investors to the extent that institutional investors will ensure that the information revealed is impounded into the offering price. However, while lifting the restrictions to the free flow of information will not alleviate the investment advantages enjoyed by these sophisticated investors, it may nonetheless contribute to mitigating the information asymmetries among investors that is responsible for underpricing by eliminating the part of the asymmetries resulting from selective disclosure.

In fact, as Linda Quinn, former director of the SEC's Division of Corporation Finance, has remarked recently, information flows to investors can no longer be limited effectively. The regulatory requirements that impose barriers to the flow of accurate information are becoming less and less effective with the spectacular advances in electronic communications which have made corporate communications, financial, business and marketing information, analyst research reports and other formation more widely and instantaneously accessible. Thus, information outside of the mandated disclosure package is readily available to and accessible by computer-literate investors in an increasing number of new offerings. The flow of information will continue to grow as costs of gathering, storing and communicating data are lowered by technology.

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266 M.A. Weisdorf, Going Public and the Public Equity Market, (Toronto: CIBC - Wood Gundy, 1996) at 15. See also "Interim Report of the Committee on Corporate Disclosure", (1996) 19 O.S.C.B. 8 at 25 (Analysts indicate that discussion with management is a source of information when dealing with smaller companies).


268 L.C. Quinn, supra note 170, at 27. See for example Dow Jones Newswire, "SEC gives nod to Internet Road Show", The Globe and Mail, September 9, 1997 at B16.

269 Task Force on Prospectus Simplification, supra note 117, at 33-34.

270 D.C. Langevoort, supra note 103, at 757.
implementation of SEDAR that makes it possible to deliver documents electronically is a testament to the technological developments that change the circulation of information in the market and offer investors access to a wealth of information related to securities.271

Given the drawbacks and obsolescence of advertising restrictions, it seems appropriate to modify the regulation to enhance rather than restrict the flow of information during the waiting period.272 As Quinn has stressed, the focus of the regulation should be on ensuring that appropriate controls and procedures exist to ensure that information is adequate and accurate, that investors have the full opportunity to review and consider the information mandated by the Securities Act in making their decision, and that the communications are not such as to cause investors to overlook the mandated disclosures.273

It is suggested here that these objectives could be attained by allowing issuers to use alternative forms of disclosure during the waiting period provided that they are filed – or, in the case of oral communications, that the substance of the communication is filed in a written format – with the securities commission in conjunction with the preliminary prospectus and made publicly accessible. The filing of the materials would alleviate concerns with respect to selective disclosure of information. In addition, it would subject the materials to the oversight of the commission that would compare the materials with the information contained in the prospectus. In this respect, to reduce the risk that the information disclosed outside the prospectus will confuse investors and lead to inefficient pricing, the marketing documents should not include any material information that is not disclosed in the prospectus.274 To ensure the enforcement of these principles, the Commission should have the authority to intervene to prohibit its dissemination where it considers the information to be misleading or prejudicial to the public interest.275

271 Supra note. See also Task Force on Prospectus Simplification, supra note 117, at 27-28.


274 NP43, supra note 272, at para. 4.4.

275 See the proposed NP43, ibid. para. 4.1.
Additional safeguards would prevent investors from overlooking the information contained in the statutory prospectus when buying a security in an IPO. Indeed, retail investors would not be left open to the influence of sales tactics as they would continue to receive a copy of the preliminary prospectus whenever they are solicited. No securities would either be sold to them before a receipt for the final prospectus is obtained. Further, the final prospectus would still be delivered to every retail investor. Finally, the cooling-off period during which investors can withdraw from the obligation to buy the securities would be maintained.

In addition, the risk that the disclosure of such materials will lead to mispricing would be curbed by the presence of a critical mass of institutional investors ensuring that the price of the security reflects correct publicly available information more than misleading "free writings". In the segment of the IPO market dominated by retail investors, critiques may argue that the information contained in the prospectus will not cancel out the glowing statements or graphic representations in the supplemental materials: "it is unlikely that ordinary investors would understand a prospectus enough to ignore the supplemental information, and so in markets where only ordinary investors participate, misleading free writings may cause inefficient pricing." However, it is difficult to imagine how the investment decisions of these unsophisticated investors would lead to accurate pricing if the prospectus, which they arguably don’t understand, is the sole disclosure document they use in their decision-making. In any case, the implementation of the more readable and comprehensible SBPF should reduce the risk that gullible investors be overwhelmed by promotional material.

4. Removing Legal Obstacles to Greater Use of Future-Oriented Financial Information (FOFI)

For small growing firms making an initial public offering, it is critical to provide prospective investors with some form of future-oriented information. Indeed, the utility of these firms’ past

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276 E.A. Chiappinelli, supra note 237, at 510-511.
277 J.F. Daniels, supra note 241, at 1871.
278 Supra notes 141-143 and related text. On the importance of forward-oriented information see T.J. Fiflis, supra note 132, at 99-104; Note, supra note 133, at 339-343; Securities and Exchange Commission, “Safe Harbor For Forward-Looking
performance as an aid in making investment decisions is rather limited, given that they are relatively young without an established record, and bring new products to immature markets. In this respect, projections and forecasts of financial results represent a particularly important category of forward-looking information as they deal with the most significant factors influencing securities prices and investment decisions.279

Currently, issuers wishing to include future-oriented financial information (FOFI) in their disclosure documents must comply with the requirements of National Policy 48 ("NP 48").280 Briefly, the policy allows issuers to include FOFI in their offering documents in the form of financial forecasts or, where the issuer has less than 24 months of relevant operating history, softer financial projections.281 In ordinary circumstances, FOFI must not extent beyond the end of the issuer’s next financial year, i.e. 24 months. Most importantly, FOFI must conform to the Canadian Institute of Chartered Accountants (CICA) standards and be reviewed by the issuer’s auditors whose report must be included in the prospectus.282 In addition, the auditors must provide a ‘comfort letter’ stating that the assumptions underlying the FOFI are reasonable in the circumstances, and that the forecasts or projections are consistent with the assumptions made. The issuer has then the duty to update the FOFI every time financial statements are issued pursuant to continuous disclosure

279 C.W. Schneider, supra note 130, at 280.


281 NP48, ibid., Part 3. A forecast presents expected future results, it must be developed from assumptions reflecting management’s assessment of most probable future circumstances. A projection is based upon a number of alternative hypotheses which must be plausible but need not represent most likely future outcomes. N. Campbell, ibid. 350; Financing Innovative Enterprise. supra note 29, at 126.

rules and explain all significant differences between the FOFI and the results. Finally, the issuer must disclose any change in events or assumptions which has a 'material effect' on the FOFI.

Since FOFI provide particularly relevant information to investors interested in SMES, it is important that regulation does not excessively constrain the disclosure of such information by issuers. This section discusses the regulatory requirements that may impinge on the ability of SMES to include FOFI in their offering documents.

a) The Need to Have FOFI Audited

According to the OSC Task Force, forecasting is generally difficult for small issuers because of the nature of their activities and their lack of systems to budget or forecast future results. For this reason, auditing an SME's FOFI is time consuming, difficult and costly and, occasionally, impossible. Thus, although forward-looking information is more important for SMES than for larger enterprises, the Task Force argues that NP 48 imposes a relatively greater burden on SMES.

Although the Task Force refrains from proposing specific changes to the FOFI regime as it applies to SMES because of an impending reform of NP 48, it recommends that "consideration should be given to approaches to FOFI that would eliminate the requirement that FOFI be audited and impose some substituted form of discipline on unreasonable projections." This recommendation to eliminate the requirement that FOFI be audited appears to be questionable. In particular, the Task Force seems to overlook, on the one hand, the benefits that yield the

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284 Materiality is defined in accordance with the CICA Handbook, supra note 282, which uses a broader definition than the material change standards of securities regulation. NP 48, ibid., para. 3.3.

285 Task Force Report, supra note 2, at 90.

286 Task Force Report, ibid at 91. See also Financing Innovative Enterprise, supra note 29, at 127.

certification of FOFI by auditors, and, on the other hand, the drawbacks of doing away with this requirement.

The inclusion of FOFI in the prospectus can have a positive influence on the valuation of the issue.\textsuperscript{288} Empirical studies show that the inclusion of an earnings forecast in the IPO prospectus is viewed by the market as a favourable signal that reduces \textit{ex ante} uncertainty and, thereby, lowers the degree of underpricing.\textsuperscript{289} The effect of FOFI as a signal of firm value depends however on the existence of constraints that can prevent misrepresentations and convince prospective investors of the accuracy of the information disclosed. Indeed, evidence indicates that investors, aware of the risk of management manipulation of FOFI, adjust IPO valuation to compensate for expected forecast bias.\textsuperscript{290} Accordingly, it is possible to believe that the lower the level of legal and economic constraints, the higher the degree of discount that the market will apply to the valuation of offerings to adjust for the larger expected bias component of the forecast.

In this respect, auditors can perform a valuable role in the disclosure of FOFI. While auditors have not traditionally been involved in the review of forecasts and projections,\textsuperscript{290} the growing use of forward-oriented information by businesses has increased the involvement of auditors in the review of this type of information.\textsuperscript{290} Thus, auditors have progressively developed an expertise in evaluating the reliability of FOFI. The expertise of auditors is buttressed by the accounting standards issued by the Canadian Institute of Chartered Accountants establishing the recommended procedures that auditors should follow when examining forecasts or projections.

\begin{itemize}
  \item \textsuperscript{288} Firms with good news, such as information about earnings that is better than current market expectations, disclose the information when the benefits exceeds the costs associated with disclosure. Investors will therefore interpret negatively the absence of forecasts and discount the value of the firm accordingly. P.M. Clarkson \textit{et al., supra} note 148, at 623. Forecasting may also be an indication of the ability of entrepreneurs to foretell future changes in the firm's environment and adjust plans accordingly. Hence, the release of a forecast by an entrepreneur may be interpreted as a willingness to signal this ability. K. Keasy & R. Watson, \textit{Small Firm Management - Ownership, Finance and Performance}, (London: Blackwell Business, 1991) at 181 [hereinafter \textit{Small Firm Management}].
  \item \textsuperscript{289} P.M. Clarkson \textit{et al., ibid.} at 616-623; P.M. Clarkson & J. Merkley, \textit{supra} note 128, at 62. See also \textit{Small Firm Management}, \textit{ibid.} at 181-182.
  \item \textsuperscript{290} P.M. Clarkson \textit{et al., ibid.}
  \item \textsuperscript{290} See, however, J.S. Poole, "Improving the Reliability of Management Forecasts", (1989) 14 \textit{J. Corp. L.} 547 at 618-619 (Accountants had indirect experience with forward-oriented information prior to 1975.).
  \item \textsuperscript{290} \textit{Ibid.} at 633.
\end{itemize}
disclosed in securities documents. More specifically, the standards enact detailed guidelines for reviewing the forecasting process, assumptions and hypotheses, and the compilation of the forecast. In this context, the appears to be solid a priori reasons to believe that the review of FOFI by auditors enhances the reliability of this information and, thereby, reduces the discount applied to adjust for expected forecast bias.

In addition, the independent review of by auditors reduces the information costs for investors by centralising the verification process. Poole explains:

Third party review is cost effective because it provides a more extensive, thorough review by a single entity of the support for assumptions and the forecast generating process that could be conducted by individual shareholders.

While no hard data appears to be available on the cost of having FOFI audited, several factors indicate that this cost is not likely to be a burden for SMES, contrary to what is argued by the Task Force. As mentioned previously, the cost of auditor services comprises two elements: a production cost element and an expected loss element. The production cost element will not likely be significant. In most cases, auditors will already review the financial statements of the issuers as part of the going public process. The cost of having FOFI audited will therefore only include the marginal cost of reviewing the information that auditors will not have already examined in the course of their general audit.

The expected loss element, which varies with liability risk and auditor reputation, does not either render the audit of FOFI inaccessible to SMES. As seen previously, empirical research conducted by Merckley and Simunic indicate that SMES can afford the services of high quality auditors to reduce the uncertainty that surrounds their financial forecasts because the expected loss

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290 4 J.S. Poole, supra note 290.1, at 633-634.

290 5 Ibid.

291 Neither the Task Force nor Professor MacIntosh, whose work exercised a determining influence on the proposals, cites data. In addition, none of the respondents to the Task Force’s proposals presented any piece of evidence, even though respondents included many accounting firms and the Chartered Accountants of Ontario.
element increases more slowly with the level of uncertainty than the benefit.\textsuperscript{292} It must be noted that Merckley and Simunic did not examine specifically FOFI. Thus, this leaves open the possibility that the liability risk associated with the review of SMES' forward-oriented information will be higher. However, the liability risk can be curtailed effectively by the enactment of a safe harbour that protects issuers and their advisers from liability with respect to FOFI made in good faith but which turn out to be incorrect.\textsuperscript{292.1} This issue is examined more closely below.

Besides, it is worth mentioning that audit services will not represent a greater burden for small issuers when the costs of producing the forecasts themselves are added. Although the preparation of forecasts may be expensive, the marginal cost associated with preparing the forecast in accordance with \textit{NP 48} is probably not significant since most enterprises already prepare projections for their own use on a regular basis: "corporate management is constantly planning future expansion and making financial commitments on the basis of internal projections."\textsuperscript{293}

Although there exists other mechanisms to assure investors of the reliability of FOFI, none of those mechanisms can really replace the certification provided by auditing. For instance, the disclosure of ranges that indicate the minimum and maximum outcomes expected for the projections or the forecasts can complement the certification of auditors as it helps investors detect any unreasonable differences between projected and actual performance.\textsuperscript{294} It also alerts investors to the tentative nature of forward-looking information and assists them in assessing the riskiness of the information. While more frequent use of ranges should be encouraged for these reasons,\textsuperscript{295} the impact of the inclusion of ranges on the reliability of FOFI should not be overstated. Firms have

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\textsuperscript{292} P.M. Clarkson \& D.A. Simunic, "The Association Between Audit Quality, Retained Ownership, and Firm-Specific Risk in U.S. vs. Canadian IPO Market", (1994) 17 J. Acct. \& Econ. 207. One reason for this result is the low level of liability risk that face auditors. Liability risk is the primary factor affecting the expected loss component of auditor compensation which composes the most important part of the cost of audit service.

\textsuperscript{292.1} Canadian Institute of Chartered Accountants, "Report of the Special Committee to Examine the Role of the Auditor", CA Magazine, April 1978, 36 at 40.

\textsuperscript{293} B.A. Mann, \textit{supra} note 130, at 230. See also N. Campbell, \textit{supra} note 355: A.R. Rodier, \textit{supra} note 57, at 44.

\textsuperscript{294} Note \textit{supra} note 133, at 354.

\textsuperscript{295} \textit{Task Force Report, supra} note 2, at 91.
\end{flushright}
considerable latitude to use ranges to promote over-optimistic forecasts. For example, by using a simple range, they can set the forecast to be biased or misleading in a way such that the expected result is significantly more likely to be at one end of the range than the other.

From this it follows that removing the requirement that FOFI be audited will lower degree of certification of forecasts and will lead investors to apply a greater discount on IPO valuation to compensate for expected bias. Accordingly, the benefit of doing away with the audit requirement will probably be offset by the reduced value of forward-looking information. In the case of SMES, the discount applied by the market will likely be significant given the poor accuracy that have shown their FOFI in the past.

It may be argued that issuers of good quality will continue to have their FOFI audited on a voluntary basis, and that this will allow investors to distinguish firm quality. However, the information costs of investors will increase if auditing becomes optional. The review by auditors ensures that issuers follow accounting standards. These standards benefit users by increasing the uniformity of the presentation of forecasts and the comparative value of the information disclosed therein. Removing the audit requirement will therefore increase the assessment and verification costs of investors that will attempt to compare audited financial statements with unaudited ones.

Aware of the impact of reducing the reliability of FOFI, the Task Force had suggested in its Proposal for Comment the exploration of an alternative form of discipline to add credibility to unaudited FOFI. More particularly, it proposed an approach where:

SMES would not be required to have FOFI audited if existing shareholders agreed to a substantive arrangement whereby some of their shares would be returned to the SMES for no

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296 For a sceptical view of ranges see Letter from Aird & Berlis, supra note 156, at 13.

297 A simple range focuses on the end points, rather than on the median. A more appropriate measure would be a point range where a single figure is presented, accompanied by its expected deviation. Note, supra note 133, at 354 n. 89.


2981 Supra note 290.3.

consideration or additional treasury shares would be issued to public investors for no
consideration if actual results do not meet those in the disclosed FOFI.100

This imaginative proposal, which has not been included in the Final Report, had a number
of drawbacks that mitigate its value as an alternative to auditing. It provided “fertile ground for
disputes between existing and new shareholders when results do not meet those disclosed in
FOFI.”101 Given that FOFI usually exceed actual results when they are audited, it is likely that the
proposed arrangement would be often be invoked by investors.102 Undoubtedly, this constant threat
of litigation would prove to be very disruptive for the management of the issuer and generate
considerable opportunity cost.

In addition, the securities would have to be subject to escrow requirements in order for the
remedy to be effective.103 Imposing such requirements would lead to a reduction of the liquidity of
the securities, which is very important for early-stage financiers waiting for the IPO to cash out on
their investment. Thus, this remedy would have adverse consequences for SMES as venture
capitalists would demand higher return to be compensated for the reduced liquidity of their
investment.

Finally, the remedy would result “in serious market-place distortions and unequal treatment
of shareholders.”104 On the one hand, the remedy would (or should) only be available for investors
who still hold the securities, not to those that would have sold their securities before the FOFI would
be considered not to be realised.105 On the other hand, the issuance of additional securities would
penalise all previously existing shareholders, even those without any control over the FOFI or the
circumstances which give rise to the forecast not being realised.106

100 Task Force Proposal, supra note 114, at 64-65.
101 Letter from KPMG, supra note 124, at 4.
102 Letter from D.M. Hyndmann, supra note 124, Appendix A at 19. To some extent, FOFI would become a warranty under
the proposed regime. Letter from R.J. Steinberg et al., supra note 127, at 10-11.
103 Ibid.
104 Letter from D.J. Hudson, supra note 155, at 8.
105 Ibid.
In the absence of hard numbers, there appears to be good a priori reasons to believe that the cost of having FOFI audited does excessively burden SMES. More empirical research on this question would certainly bring better insights to the problem. If evidence were to indicate that audit services are not cost-effective for the forward-looking information of SMES, it would be appropriate to explore the possibility of using alternative form of auditor assurance, such as compilation, agreed-upon procedures or negative comfort letter, rather than do away completely with this certification.\textsuperscript{107}

b) Liability for Misrepresentations in FOFI

The risk of civil liability associated with the disclosure of information is an important factor which may reduce the supply of information by issuers to investors.\textsuperscript{108} Fear of liability arising out of forecasts or projections that later prove incorrect is a serious concern that raises a peculiar problem due to the very nature of FOFI.\textsuperscript{109} Although it also applies to larger issuers, liability for misrepresentations in FOFI will affect SMES more severely given that their higher risk makes their results more likely to depart from their predictions and forecasts.

In the United States, the problem that raises liability risk in the context of forward oriented information has lead to legislative,\textsuperscript{110} judicial\textsuperscript{111} and administrative\textsuperscript{112} interventions providing “safe harbours” which insulate issuers from liability for inaccurate FOFI.\textsuperscript{113} More recently in Canada, the

\begin{itemize}
\item \textsuperscript{107} Letter from D.J. Low, \textit{supra} note 146, at 2.
\item \textsuperscript{108} E.W. Kitch, \textit{supra} note 100, at 840-841.
\item \textsuperscript{109} V. Brudney, “A Note on the Materiality and Soft Information Under the Federal Securities Laws”, (1989) 75 \textit{Va. L. Rev.} 723 (suggesting that soft information should be treated differently for liability purposes than hard information”.
\item \textsuperscript{111} For a review of the case law, see J. Calderon \& R. Kowal, “Safe Harbors: Historical and Current Approaches to Future Forecasting”. (1997) 22 \textit{J. Corp. L.} 661.
\item \textsuperscript{112} \textit{E.g. Rule 175}, 17 C.F.R. § 230.175 (1992). See also \textit{Safe Harbor For Forward-Looking Statements, supra} note 278.
\item \textsuperscript{113} A safe harbor can be defined as “a description of conduct or procedures that will be considered not to violate the legislation or give rise to liability.” See \textit{Allen Report, supra} note 202, at 17.
\end{itemize}
enactment of such a safe harbour was recommended in the Report of the Toronto Stock Exchange Committee on Corporate Disclosure (the *Allen Report*) with respect to forward-looking information provided by issuers in the secondary market. Following the proposal, no liability would attach to a misrepresentation in forward-oriented information where: (1) such forward-oriented information was accompanied by “reasonable cautionary language and, where reasonably practicable, an analysis indicating the sensitivity of such information to variations in the material factors or assumptions that were made in reaching a stated conclusion”; and (2) there was a reasonable basis for the conclusion or forecast. It is suggested here that the *Securities Act* should be amended to enact such a safe harbour for forward-looking information disclosed either in the primary or in the secondary market. The two requirements that issuers and their advisers must meet to benefit from the safe harbour would arguably maintain an adequate standard of investor protection. At the same time, the requirements would shield issuers and their advisers from unfounded liability risk.

The first requirement of the proposed safe harbour, the inclusion of reasonable cautionary language, is a codification of the “bespeaks caution” doctrine elaborated by American courts. The bespeaks caution doctrine has been explained in these words by the Third Circuit in *In re Donald Trump Casinos Sec. Litig.*:

...when an offering document’s forecasts, opinions or projections are accompanied by meaningful cautionary statements, the forward-looking statements will not form the basis for a securities fraud claim if those statements did not affect the total mix of information the document provided investors. In other words, cautionary language, if sufficient, renders the alleged omissions or misrepresentations immaterial as a matter of law.

The central element of the doctrine is the inclusion by the issuer of meaningful cautionary language that sufficiently dilutes the significance of disclosure so as to render the forward-looking

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314 *Allen Report*, ibid. at 58.

315 Ibid. at 67-68.

316 The legislation implementing the safe harbour advocated by the *Allen Report* would not extend the safe harbour to forward-looking information disclosed in the prospectus.


318 *In re Donald Trump Casinos Sec. Litig.*, 7 F.3d 357 at 371 (3d Cir. 1993), cert. denied, 114 S. Ct. 1219 (1994).
information immaterial, or to make it unreasonable for investors to rely upon it.\footnote{319} Although the standard developed by courts to assess the cautionary language tends to vary, courts agree that general cautionary language such as a bold generic disclaimer is not sufficient to satisfy the first requirement of the safe harbour.\footnote{320} Thus, in \textit{In re World of Wonders}, the Ninth Circuit, applying the bespeaks caution doctrine, held that to be meaningful the cautionary language must be conspicuous, specific and disclose adequately the assumptions upon which the forward-oriented information was based.\footnote{321} Likewise, the court in \textit{Trump} held that “the cautionary language must be substantive and tailored to the specific future projections, estimates or opinions in the prospectus which the plaintiffs challenge.”\footnote{322}

The bespeaks caution doctrine rests on the assumption that where the forward-looking information is counterbalanced by specific cautionary language, investors will not be misled by overly optimistic forward-oriented financial information. Professor Donald Langevoort challenges this assumption by arguing that even the more sophisticated and rational segment of the investor population can be misled by caution-laden forward-oriented information.\footnote{323} While Langevoort aptly underlines that qualified forward-looking information will continue to exercise a significant influence on investors, he respectfully omits to consider the limitations of the bespeaks caution doctrine that can prevent investors from being unduly misled by such information.

Indeed, courts have recognised a number of limitations to the bespeaks caution doctrine. A first limitation is that the doctrine does not apply to existing facts. As one court held: “Fraud is still fraud, and all the cautionary language in the world will not replace a true material omission or
misstatement of a fact which would matter to a reasonable investor.  

For this reason, it is likely that issuers and their advisers will continue to maintain a high level of due diligence when preparing forward-looking statements.

Secondly, the bespeaks caution doctrine applies only to cases in which there was an affirmative disclosure of forward-looking information. Thus, it does not extend to situations where there was a failure to disclose such information.

Finally, the most important limitation to the doctrine is codified into the second requirement of the proposed safe harbour which requires that the disclosure of information be made by issuers on a reasonable basis. This limitation purports to ensure that issuers are not afforded protection where they make statements designed to mislead investors. The rationale for this limitation is that even though forward-oriented information is contingent by nature, the disclosure of this type of information conveys to investors the implicit representation by issuers that there is a reasonable basis for the statement.

What constitutes a reasonable basis constitutes a question that courts will have to resort to in light of the facts of each case. Amongst the guidelines that courts should follow in their assessment of the facts, it is suggested that reasonableness of basis should be construed as meaning reasonableness under the circumstances. In this respect, courts should give consideration to the

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324 In re Integrated Resources Real Estate Ltd. Partnership Sec. Litig., 815 F.Supp. 620 at 674 (S.D.N.Y. 1993). See also In re World of Wonders, supra note 321, at 858.


326 In re World of Wonders, supra note 321, at 858.

327 In the United States, there exists a concurrent safe harbour according to which the actionability of forward-looking statements depends on one of the following assertions being inaccurate: (1) the statement is genuinely believed; (2) there is a reasonable basis for that belief; or (3) the speaker is not aware of any undisclosed facts tending to undermine the accuracy of the statement. This test was set forth in In re Apple Computer Sec. Litig., supra note 326. For a review of earlier cases recognising such a safe harbour see T.J. Fiflis, supra note 132, at 114-127.

328 J. Calderon & R. Kowal, supra note 311, at 675.

329 Roots Partnership v. Land's End, Inc., 965 F.2d 1411 at 1417 (7th Cir. 1992); J. Calderon & R. Kowal, ibid. at 675; R.A. Rosen, supra note 317, at 36-37.
good faith demonstrated by the issuers and their advisers in disclosing the information at issue.\textsuperscript{330} More specifically, courts should examine both the reasonableness of the method and of the underlying data used by issuers to prepare the forward-oriented information.\textsuperscript{331}

In sum, the enactment of the proposed safe harbour would recognise that the very nature of forward-oriented information makes it likely to turn out to be incorrect. Thus, liability would not attach to incorrect forward-oriented information where issuers take reasonable steps to disclose accurate information and caution investor of the specific risks. At the same time, it would provide investors with adequate protection by preventing issuers from escaping liability with respect to forward-oriented information that is misleading or prepared by issuers with an intent to deceive.

c) The Duty to Update FOFI

Following \textit{NP48}, issuers have a duty to report changes in the events or in the assumptions used to prepare such information that have a "material affect" on the FOFI.\textsuperscript{332} Such changes are reported in the same manner as ordinary material changes. In addition, issuers must update the FOFI to account for the changes. The updated FOFI will then accompany the issuers' annual or interim financial statements required to be filed immediately following the occurrence of the changes.

The duty to update FOFI arguably departs from the general requirement to provide full, true and accurate disclosure of all material facts as shown by the American experience.\textsuperscript{333} In the United States, courts recognise that full, true and accurate disclosure compels issuers to correct statements which they discover are not accurate or are misleading based upon the facts and circumstances that

\textsuperscript{330} The good faith requirement exists under the American safe harbour. Although it is not stated explicitly in the safe harbour proposed by the \textit{Allen Report}, the good faith requirement is arguably an implicit obligation that flows from the duty to provide full, true and plain disclosure.

\textsuperscript{331} \textit{Eisenberg v. Gagnon}, 766 F.2d 770 at 776.

\textsuperscript{332} \textit{NP48}, supra note 280, para. 7.1 to 7.3.

existed at the time the statements were made. In contrast, there is considerable controversy in the case law on whether such a duty to correct requires issuers to update prior statements which were accurate when made.

The soundness of the duty to update is fragile from a policy perspective. In its support, the duty to update may contribute to enhancing the accuracy of securities prices by ensuring that the “markets promptly receive material information that is necessary to prevent statements by issuers that are or have become misleading from distorting the price of the issuers’ securities.” However, the imposition of such a duty may prevent issuers from disclosing voluntarily forward-oriented information to avoid the cost of updating previously issued statements and of assuming the potential liability arising from breach of the duty.

The costs generated by the duty to update are likely to be substantial. The duty requires that, in addition to continuous disclosure obligations, issuers assess on a permanent basis whether changes in the events or assumptions used to prepare their FOI have a material affect on the latter. This task is complex and surrounded by “immense indeterminacy.”

In particular, the duty to update refers to a different concept of materiality, defined in accordance with the Canadian Institute of Chartered Accountant (CICA) Handbook which “is broader than the definition of ‘material change’ contained in the Securities Legislation”. Materiality is determined in the context of the overall financial position of issuers, taking into account:

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335 For decisions recognising a duty to update in certain circumstances, see Backman v. Polaroid Corp., ibid.; In re Time Warner Inc. Sec. Litig., 794 F.Supp. 1252 (S.D.N.Y. 1992). For decisions refusing to recognise such a duty, see Wielgos v. Commonwealth Edison Co., 892 F.2d 509 (7th Cir. 1989); Stransky v. Cummins Engine Co., 51 F.3d 1329 (7th Cir. 1995).


337 Ibid. at 315.


339 D.C. Langevoort, supra note 103, at 767.

340 NP48, supra note 280, at s. 3.3.
account both qualitative and quantitative factors. An item is considered material "if it is probable that its omission from the financial information would influence or change a decision." While the use of a broader materiality standard is beneficial to investors, it creates unnecessary confusion among issuers and their advisers with respect to the meaning of the materiality concept.

Moreover, the process of determining whether changes have a material affect requires issuers to determine whether the FOFI is still material. Indeed, the general disclosure philosophy underlying the Securities Act suggests that issuers should not have to update forward-looking information that has ceased to reasonably be expected to affect the market price or value of the security. Otherwise, the duty to update would cover information which is no longer relevant for investors for making investment decisions. Thus, the process of updating forces issuers to find out if the forward-looking statement can still be considered current or 'alive'.

Given the costs and uncertainty surrounding the duty to update FOFI, it is suggested that NP48 issuers should be amended to repeal the duty to update forward-oriented information. Repealing the duty to update would reduce the cost of providing forward-looking information and increase thereby the incentive of issuers to do so. At the same time, it would not affect significantly the information available to investors since issuers would have to disclose material changes as currently required by the continuous disclosure obligations.

341 NP48, ibid. at s. 3.3.
342 N. Campbell, supra note at 357.
343 See in this respect R.H. Rosenblum. supra note 336, at 319-321; Safe Harbor For Forward-Looking Statements, supra note 278, at 17-18. For an attempt to solve this question see In re Time Warner Inc. Sec. Litig, supra note 335.
344 The duty to update FOFI will be maintained in the new regulation. See NISL-101, supra note 280, Part. 6.
345 Financing Innovating Enterprise, supra note 29, at 126-127; F.G. Withers, supra note 280, at 146 (noting a general reluctance of issuers to update FOFI and lenient enforcement of the requirement).
5. **Toward More Simplified Escrow Requirements**

Issuers filing their first prospectus in Ontario must comply with the escrow requirements required by the *Securities Act* and **OSC Policy 5.9** in order to receive the receipt for their final prospectus. These requirements have laudable objectives. They are imposed to ensure that promoters and major shareholders retain an interest in the issuer and share the risk of the venture with public investors for a significant period of time following the offering. Furthermore, they intend to prevent insiders from issuing cheap securities prior to the IPO and selling them to the public at inflated priced. In sum, escrow requirements “attempt to balance in a fair manner the reward and opportunities of the IPO purchasers with those of the pre-IPO shareholders.”

The escrow requirements apply to securities owned or controlled by promoters of the issuer, directors and/or officers holding more than 5 per cent of any class of securities, and shareholders holding more than 10 per cent of any of securities. These ‘Related Security Holders’ must escrow their shares with the exception of a certain number of “free shares”. Once escrowed, the shares cannot be sold, assigned, pledged, transferred or otherwise dealt with in any manner without the written consent of the securities commission’s director. Release of the escrowed securities takes place progressively nine months after the receipt for the final prospectus.

According to the Task Force, the application of the present escrow requirements to SMEs must be reviewed because of the problems that they raise for small issuers. The Task Force stresses

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346 *O.S.A.*, ss. 61(2)(f); “Policy 5.9 Escrow Guidelines — Industrial Issuers”, in *Canadian Securities Law Reporter, supra* note 256, at ¶471-509 [hereinafter **OSC Policy 5.9**]


349 **OSC Policy 5.9, supra** note 346, at par. II(1)(k), III-A.


351 **OSC Policy 5.9, ibid.** at par. VII.

firstly that the provisions governing escrows in general, and particularly the provisions regarding the calculation of the number of shares subject to escrow, are extremely complex. More importantly, one of the factors used to determine the number of securities not subject to escrow, the number of net tangible assets per share, excessively burden SMES, particularly high technology SMES. Indeed, high technology issuers typically lack significant net tangible assets. Therefore, owner-managers and major investors of these issuers receive fewer 'free' shares than the principals of other issuers.

In this perspective, the Task Force recommends that the credit for net tangible assets be eliminated from the calculation of the number of shares subject to escrow requirements. Instead, the regulation would provide that one third of the securities are free from escrow. This proposal would simplify the calculation of the escrow requirements as well as bring enterprises with little or no net tangible assets to a level playing field with the other enterprises.

Secondly, the Task Force questioned the rational basis for some of the distinctions which determine the escrow release schedule. Under the current regulatory regime, ten per cent of the securities subject to escrow are released nine months after the receipt for the final prospectus. After this initial release, securities are released from escrow according to a schedule which varies in accordance with the nature of the security and on the number of securities escrowed. The Task Force stressed more particularly the irrelevance of the 'legal for life' status of the securities (which has been replaced in most federal and provincial legislation as the appropriate investment standard) which "only indirectly relate[s] to the object of the escrow requirements themselves." Accordingly, the Task Force initially proposed to standardise the escrow release for all issuers by releasing progressively the two-thirds of the securities escrowed over a period of one year: one

353 Task Force Report, supra note 2, at 96.
354 Ibid. See also Financing Innovative Enterprise, supra note 29, at 114.
355 Task Force Report, ibid. at 97.
356 Task Force Proposals, ibid. at 68-69; OSC Policy 5.9, supra note 346.
357 Task Force Proposals, ibid. at 69.
third of the securities would be released six months after the closing date of the offering, and the remaining one third would be released on the first anniversary of the closing date.

This proposal considerably shortened the escrow period and raised some concerns that insiders will reap most of the benefit at the public investors’ expense. Thus, many commentators cautioned that the proposal would open the door to manipulation by allowing promoters and issuers to issue themselves an unlimited number of shares at prices significantly below the price at which the shares are sold to the public, then promote the issuer and sell the shares within one year at inflated prices. Further, they contended that the one-year period would be detrimental for the issuers’ future financial performance since it would not provide any incentive for management to support their firms beyond one year. Accordingly, critics, as well as the Task Force, maintained that an escrow period of 18-24 months would be more appropriate “on the basis that that length of time would permit the marketplace to become familiar with the issuer ... and because the longer period would ensure that audited financial statements would be provided.”

While the majority of the members of the Task Force acknowledged these concerns, it contended that a one year period would be sufficient since “it is apparent after the passage of 12 months from the date of the closing of the offering whether or not the business concept described in the prospectus can be achieved.” In other words, the profits that the founders and major shareholders could realise by selling their cheap securities quickly after the offering would remain rather limited because the price of the offering would adjust rapidly during this period to reflect the prospect of the issuer.

Empirical evidence supports the position of the majority of the Task Force. The results of a study by Vijay Jog indicate that the poor performance of IPOs becomes generally apparent at the

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359 Task Force Proposals, supra note 114, at 69-70. See also Letter from R.A. Campbell & H.G. Crawford, supra note 125, at 7-8; Letter from D.J. Hudson, supra note 155, at 8.

360 Task Force Proposals, ibid. at 70.
end of the first anniversary of the closing date. Performance indicators such as return on assets, sales to total assets, and profit margin, decline significantly during the first year.\textsuperscript{361} Moreover, the evidence marshalled by Jog shows that the stock market performance of new offerings starts to decline approximately ten months after the offering, suggesting thereby that the market responds to this decline in operating performance.\textsuperscript{362} Thus, the marketplace appears to be able to readily assess the success of a venture at the end of the first year after an initial public offering.

These results are also important given that the poor performance of IPOs is concentrated among non venture-capital-backed firms which are generally held by retail investors. They imply that even though this segment of the market is characterised by a lower degree of information efficiency, retail investors have nevertheless access to performance-related information that allows them to reassess their evaluation of these firms.\textsuperscript{363} In particular, the results mean that investors need not receive a set of audited financial statements before they can determine the success or failure of an SME.\textsuperscript{364}

Despite the existence of relatively solid foundations for the Task Force’s proposal, the release schedule was modified in the \textit{Final Report} in response to the many commentators who considered the proposed escrow period too liberal.\textsuperscript{365} Thus, the Task Force now recommends that one third of the shares be free from escrow. One third of the shares would be released nine months after the closing date. The remaining one third of the shares would be released at the later of 18 months after the closing date and one week after the filing of the first issuer’s first post-offering audited annual financial statements.


\textsuperscript{362} See \textit{supra} Chapter II, notes 137-139 and related text.

\textsuperscript{363} Letter from R.J. Steinberg \textit{et al.}, \textit{supra} note 127, at 12.

\textsuperscript{364} \textit{Task Force Proposals. supra} note 114, at 70.

\textsuperscript{365} \textit{Task Force Report, supra} note 2, at 97.
Finally, the Task Force proposed that escrow requirements should apply to Related Security Holders individually. 366 Currently, the regulation does not require that the latter participate in the escrow arrangements to the same extent. It allows therefore a Related Security Holder to negotiate to have all or a larger portion of his/her/its securities free from escrow. Following the proposal, two-thirds of each related security holder’s shares would be escrowed without any possibility of one related security holder agreeing to escrow more or less. The proposal aimed primarily at preventing venture capitalists from bargaining for less onerous escrow requirements. According to the Task Force, this should benefit issuers and public investors by ensuring that venture capital investors do not leave the newly publicly traded enterprise too quickly and deprive it from their expertise. 367

In its Final Report, the Task Force abandoned this proposal and recommended that disproportionate sharing of escrow requirements continue to be permitted. This is sound a sound policy decision. Indeed, the Task Force arguably overstated the risk that venture capitalists leave their new publicly traded investee firms on their own rapidly after the offering. While initial public offerings do constitute an important exit mechanism for venture capitalists, empirical evidence from the United States where escrow requirements are more lenient indicate that these investors maintain a significant portion of their holdings after the IPO. 368 Likewise, indirect Canadian data indicate that venture capitalists remain involved with their investee firms after they have gone public even though they can presently negotiate to have all of their securities free from escrow. 369

366 Ibid.
367 Ibid.
369 A recent survey of the Business Development Bank of Canada reports that at the end of 1995, 19 per cent of firms benefiting from venture capital were publicly traded. Further, the shares of investee firms that are public has risen from 12 per cent in 1993 to 19 per cent in 1995. Business Development Bank of Canada, Economic Impact of Venture Capital, (Montreal: BDBC, 1996) at 11.
In this perspective, by imposing a uniform level of liquidity for securities of all firms going public, the proposal would have created an unnecessary constraint on the investment contract negotiated between enterprises and venture capitalists. This constraint would have had the effect of preventing firms and investors from modulating the participation in escrow requirements to assign different liquidity level to securities as part of the compensation package. Thus, the proposal could have introduced an additional impediment for an issuer looking for a venture capitalist or angel investor who may need the extra incentive that the current rules permit.\(^{170}\)

**SECTION D: SUMMARY**

The *Securities Act* enacts a complex regulatory framework governing initial public offerings. The regulation purports to protect investors and enhance market efficiency. Mandatory disclosure is the principal regulatory instrument used to achieve these goals.

Investor protection provides a rather fragile justification for the regulation of IPOs from a costs-benefits perspective. The costs of regulatory provision attempting to protect investors can be substantial, especially for smaller enterprises. At the same time, empirical research casts doubt on the effectiveness of regulation in reducing incidence of investor exploitation. Furthermore, several market-based mechanisms exist to protect investors from fraud and other form of exploitation. Thus, investor protection is at best a controversial justification for the regulation of IPOs.

The goal of market efficiency is a more defensible justification for regulating securities offerings. Regulation can play a role in eliminating market imperfections that compromise efficiency. In doing so, regulatory intervention will enhance pricing accuracy and reduce the risk of investor exploitation. While the soundness of the goal of market efficiency is indisputable, its implementation in the *Securities Act* is more debatable. Indeed, it has been argued that the

Legislature has put too much emphasis on one aspect of efficiency, namely informational efficiency, and has failed to give consideration to operational efficiency.

The lack of consideration for operational efficiency in the Securities Act has important consequences for SMEs seeking to access public equity financing. It translates into regulatory requirements that are not adapted for SMEs and that impose compliance costs which are disproportionately high for smaller issuers. Thus, this Chapter explored the reforms that can be made to the regulation of smaller IPOs in order to have a more cost-effective regulatory regime, using the Report of the OSC Task Force on Small Business Financing as a starting point.

This Chapter has also examined the regulatory framework in the perspective of enhancing informational efficiency and pricing accuracy. It identified the provisions which act as barriers to the free flow of information in the IPO market and which appear to be incompatible with the goal of accuracy enhancement. It proposed modifications which would eliminate the unnecessary restrictions to the free flow of information in the market.
CHAPTER V

INCREASING COMPETITION IN THE INVESTMENT DEALER INDUSTRY

Investment dealers play a central role in the going public process. They can advise issuers on their financial situation and provide information on the various alternatives to raise capital and the ways to structure the transactions. They also assist issuers in the distribution of their securities offerings by locating investors and conducting transactions with them. In addition, they perform a risk-bearing function when they execute firm commitment underwritings by purchasing the issues they distribute. Moreover, the participation of underwriters in IPOs can provide a 'seal of approval' on offerings that will convey information on firm value to prospective investors.

Unfortunately, the first section of this Chapter suggests that small and medium-sized enterprises are not well serviced by investment dealers. The Canadian investment dealer industry is dominated by large investment dealer firms which tend not to be interested in SME financings. Furthermore, economic and regulatory barriers hinder the entry of new firms that could service the financing needs of SMEs. In addition to making it more difficult for SMEs to find a dealer to underwrite their IPOs, the dearth of investment dealers servicing SMEs increases the costs of going public by reducing the degree of competition. Indeed, competition arguably affects the level of underpricing and underwriter compensation. In this context, it appears crucial that there be a more vibrant investment dealer market to service small and medium-sized enterprises considering making an initial public offering. Thus, the second and third sections of this chapter explore regulatory changes that could be made to increase the supply of investment dealer services to SMEs. More particularly, the second section examines the possibility of removing regulatory barriers to entry into the investment dealer industry that unnecessarily stifle competition in the small firm segment of the market. The third section discusses whether SMEs should use an alternative selling mechanism, competitive bidding, to overcome the adverse consequences of the low level of investment dealer competition.
SECTION A: THE PARTICIPATION OF INVESTMENT DEALERS IN SMALL AND MEDIUM-SIZED ENTERPRISE FINANCINGS

Investment dealers play a critical role in assisting firms going public. Unfortunately, it appears that SMES are not well serviced by investment dealers in Canada. This section purports to identify the salient factors which can explain the under-provision of investment dealing services for SMES. It describes firstly the structure of the investment dealer industry, emphasizing that the high degree of market and ownership concentration that characterizes this market may be responsible, at least in part, for the disinterest of investment dealers in servicing SME financing needs. Secondly, this section explores the economic and regulatory barriers that may impede the entry of new firms into the market for SMEs investment dealer services.

1. The Structure of the Investment Dealer Industry

The Canadian investment dealer industry is highly concentrated,1 both at the production and at the distribution level, in which the major firms generate considerable economic momentum.2 At the production level, in 1985, 65 per cent of new issues underwriting accrued to four securities firms,

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1 Market concentration is generally used to measure the level of actual competition in a market. Rather than being concerned with the number of firms in a particular industry, market concentration "refers to the share of an industry's total output that is accounted for by a small number of firms." W.K. Viscusi et al., Economics of Regulation and Antitrust, 2nd Ed. (Cambridge, The MIT Press, 1995) at 145-149; Economic Council of Canada, A Framework for Financial Regulation (Ottawa: Supply and Services, 1987) at 27 [hereinafter A Framework for Financial Regulation]. The task of determining the actual size of the securities industry is a difficult one. Securities firms can be members of one of the five Canadian stock exchanges or of the Investment Dealers' Association of Canada (IDA). However, it is also possible for a firm to be active in the securities industry without belonging to one of those self-regulatory organizations (SROS). In 1995, there were 160 firms in the securities industry which were members of the IDA. Investment dealers involved in underwriting are generally member of the IDA. There are about 90 firms who are members of the Toronto Stock Exchange. See generally, A.M. Andrews, The Canadian Securities Industry: A Decade of Transition (Ottawa: The Conference Board, 1991); The Canadian Institute, The Canadian Institute Securities Course (Toronto: Canadian Securities Institute, 1996) at 1-39, 1-40 [hereinafter Securities Course]; P. Dey & S. Makuch, "Government Supervision of Self-Regulatory Organizations in the Canadian Securities Industry", in Proposals for a Securities Market Laws for Canada (Ottawa: Supply and Services, 1979) 1399; R. Sorell, "Supervision of Self-Regulatory Organizations in Ontario's Securities Market", in Securities Regulation - Issues and Perspective (Kingston: Carswell, Queen's Annual Business Law Symposium, 1994) 165.

and eight securities firms accounted for 80 per cent of that market. While these figures are now dated, a more recent study by the Conference Board of Canada indicates that the industry remains highly concentrated at the production level. According to this study, the Canadian securities industry consists of a few large full-service broker-dealers, accounting for almost 65 per cent of the revenue of the industry, a number of large firms targeting specific markets, and about 100 niche players serving a variety of specialized or regional markets.

The large investment dealer firms are typically not interested in small business financings for at least three reasons. Firstly, they tend to avoid smaller issuers, which are inherently more risky, to protect their investment in reputational capital. Secondly, since smaller issues yield lower underwriting commissions on a dollar basis, “the larger firms have an incentive to participate in only the larger issues because of the overhead associated with maintaining their position as prestigious firm.” Finally, large investment dealers may not be interested in SME IPOs because the low level of trading in the securities of these firms may not generate sufficient brokerage commissions to allow them to recoup the costs of providing research services in the after-market.

Although it is not a recent trend, the concentration of the industry at the production level has been fostered by the reform of financial institutions, both at the provincial and federal level, which has considerably eroded the distinction between the four pillar of the financial system, i.e. banking, trust, insurance, and securities dealing. Since 1987, financial institutions - banks, trust and

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5. *Supra* Chapter III, notes 150-157 and related text.


insurance companies - are now allowed to own up to 100 per cent of securities firms. The demise of the pillar system, which contributed to the concentration of ownership in the securities industry, also affects the concentration of production. Indeed, most Canadian banks used the opportunity offered by the elimination of ownership barriers to enter the securities industry by acquiring and merging most of the major full-service investment dealers (Table I).

The concentration of the production of investment dealer services amongst relatively few bank-owned securities firms further impacts on the level of services provided to small and medium-sized enterprises. Banks are progressively eliminating minority interest held by managers of the securities firms they have acquired and are thereby removing the incentives of equity ownership for managers. Unless special compensation adapted to the industry is adopted, this will have a dampening effect on the entrepreneurial spirit of members of bank-owned securities firms and affect the nature of their business. Secondly, bank-owned dealers may have become more risk averse to reflect the culture of banks.

The objectives of commercial bankers is to make well-secured loans to entities that pay interest on time and repay the loan principal on schedule. The emphasis is on risk avoidance or minimization. Investment bankers, on the other hand, consciously and continuously assume risk in seeking out opportunities to make profits. If this is the case then these investment dealers will tend to be more wary of getting involved in small business financing.

Moreover, the institutionalization of the market and the globalization of financial markets are intensifying competition in the large deals segment of the market thereby further mitigating the interest of bank-owned full-service investment dealers in small firm financing. Foreign firms constitute a strong competitive force for Canadian investment dealers on both the international and

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8 A.M. Andrews, supra note 1, at 2.
9 Financing Innovative Enterprise, supra note 6, at 140.
11 Ibid.
the domestic markets. Canadian dealers compete with foreign securities firms on international markets for the lucrative bond underwriting business. Debt issues tend to be more international than equity issues and provide therefore an opportunity for foreign-owned firms to sell their expertise to Canadian issuers. Bank-owned dealers will likely continue to focus in this area where they have a competitive advantage over independent dealers, especially in swaps-driven global bond underwriting and trading. Accordingly, "[m]ost of the large national Canadian underwriters do not want to spend much time on relatively small capitalization initial public offerings when they can be doing large debt or equity issues for established companies or the government."

It is important to note that independent investment dealers have not been totally eclipsed by major bank-owned dealers and remain a source of competition at the production level. Independent dealers are moving towards a greater specialization in areas where they have a natural strength, such as "equity underwriting and distribution, cross-border merger and acquisition advisory services, institutional equity research, sales and trading, both domestically and internationally, and services to retail clients." Still, although the number of dealers has risen over the last years, it is unclear whether independent dealers are providing adequate services to SMES in

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12 A Framework for Financial Regulation, supra note 1, at 6-7; A.M. Andrews, supra note 1, at 14-18; J. McFarland, "U.S. dealers invading", Fin. Post, Jan. 17, 1995 at 1. Canadian dealers are losing ground progressively in domestic financing to foreign firms. In 1995, of the top ten investment dealers raising money for Canadian firms through the issue of stock, bonds and other instruments, four firms were American and one was Swiss. The competition brought by the entrance of foreign investment dealers in the Canadian market is particularly concentrated in the institutional segment of the market. Foreign dealers generally lack a domestic retail clientele and focus therefore on large corporate finance transactions. While the full-service Canadian investment dealers, with their network of retail brokers, remain in a better position to place new issues with retail investors, the institutionalization of the market increases the competition in the new issue market as this competitive advantage of Canadian firms decline. M. Den Tandt, "Brokers urged to merge for survival". The Globe and Mail, October 18, 1996 at B15. A.M. Andrews, ibid., at 1, 17; International Monetary Fund, International Capital Markets, (Washington: IMF, World Economic and Financial Surveys, 1990) at 6-7.


14 Competing in the New Global Economy, supra note 4, at 177-178.

15 According to one investment dealer, further mergers may be necessary for the Canadian industry to compete with foreign rivals operating in Canada. M. Den Tandt, supra note 12, at B15.

16 D.K. Johnston, supra note 10, at 65.
regional markets. Indeed, much of this increase in the number of dealers appears to be attributed to the boom in discount brokerage business and ‘introducers’, i.e. small brokers aligning themselves with a large broker that does all the back office functions, rather than to an increase in the number of underwriters.

Furthermore, an examination of the market structure at the delivery level suggests that the branches of investment dealers tend to be concentrated in Ontario and Québec, and to a lesser extent in British Columbia. The dearth of regional investment dealers contributes to the creation of an environment that disadvantages SMES which are located outside major cities. The lack of regional dealers is particularly worrisome given the importance of geographic proximity for coping with uncertainty and reducing risk. Moreover, it increases the costs for SMES of dealing with dealers, in the form of time, money, and the inconvenience costs of travel.


A. Corelli, supra note 4, at B21.

A Framework for Financial Regulation, supra note 1, at 69.

Financing Innovative Enterprise, supra note 6, at 140-141; Conseil Économique du Canada, Intervention et efficacité (Ottawa: Approvisionnements et services, 1982) at 30.

Infra notes 30-33 and related text.
### Table I

**Canadian Banks in the Securities Industry**

<table>
<thead>
<tr>
<th>Bank</th>
<th>Full-service broker</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank of Montreal</td>
<td>Nesbitt Burns (Nesbitt Thomson &amp; Burns Fry)</td>
</tr>
<tr>
<td>Bank of Nova Scotia</td>
<td>Scotia McLeod (McLeod, Young &amp; Weir)</td>
</tr>
<tr>
<td>CIBC</td>
<td>Wood Gundy</td>
</tr>
<tr>
<td>Desjardins</td>
<td>Desjardins Securities</td>
</tr>
<tr>
<td>Laurentian Bank</td>
<td>BLC Securities (Select Securities)</td>
</tr>
<tr>
<td>National Bank</td>
<td>Lévesque Beaubien</td>
</tr>
<tr>
<td>Royal Bank</td>
<td>RBC Dominion Securities (Dominion Securities &amp; McNeil Mantha)</td>
</tr>
<tr>
<td>Toronto-Dominion</td>
<td>Evergreeen Investment</td>
</tr>
</tbody>
</table>

2. **Entry Conditions into the Investment Dealer Market**

Small and medium-sized enterprises are not well serviced in a concentrated market characterised by the domination of few large investment dealers. However, to the extent that SMES do have financing needs which remain unsatisfied, new investment dealer firms should enter the market to provide services to smaller issuers. This section explores the economic and regulatory barriers that may impede the entry of new firms in the market to assist SMES going public. A barrier to entry is said to exist when there is a cost of producing at some or every rate of output which must be borne by firms which seek to enter an industry, but is not borne by firms already in the industry. Stated differently, there are differential long-run costs between existing firms and new entrants.

a) **Economic Barriers**

Economic barriers exist when new competitors must bear exploitation costs which are higher than existing firms for reasons other than regulation. The principal economic barrier to entry relates to the ability of entrants to serve the market demand in similar conditions as incumbent firms. This requires that entrants face no disadvantage vis-à-vis existing firms because of differences in production technology, input prices, products, or information about market demand.

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22 Entry into an industry refers to the ability of a firm to undertake the production and sale of a product. Entry conditions are important determinants of the degree of competition of an industry. Firstly, they determine the number of active firms in the market which is, to some extent, an indicator of the degree of concentration of an industry. Secondly, the costs and difficulty of entry also affect the effectiveness of potential competition that induces active firms to compete vigorously. Competition can exist in concentrated markets if firms are compelled to behave in a competitive fashion. However, for competitive behaviour to exist where there are few market participants, the market must be contestable, i.e. there must be freedom of entry and exit. W.K. Viscusi et al., *supra* note 1, at 155: *A Framework for Financial Regulation, supra* note 1, at 32. On contestable markets see W.J. Baumol et al., *Contestable Markets and the Theory of Industry Structure*, Rev. Ed. (New York: Harcourt Brace Jovanovich, Publishers, 1988) [hereinafter *Contestable Markets*].

23 *Contestable Markets, ibid* at 282. For a review of the various definitions W.K. Viscusi et al., *ibid.* at 158-162.


25 *Contestable Markets, supra* note 22, at 5.
An important potential disadvantage that is often used to explain the concentration of industries is scale economies. More precisely, it is the magnitude of economies of scale relative to total market demand which affect entry into the market. In other words, the larger the fraction of the market’s output that is necessary for a firm to achieve minimum long-run average costs, the more difficult it is for the firm to enter the market. While earlier studies suggested that there were no significant economies of scale in the securities industry, more recent research tends to demonstrate the existence of scale economies.

In any case, according to Stigler, scale economies may be just a red herring for the real barrier to entry into an industry: brand loyalty. This barrier stems from the inherent complexity of professional services that makes them difficult for consumers to assess. Because of this complexity, customers tend to rely on reputation when selecting a professional. New firms with no reputation face a barrier to entry in that they must incur costs to build their reputation an overcome brand loyalty, i.e. costs to get consumers familiar with their services and build public confidence. Coleman aptly summarizes the role of reputation as a barrier to entry into the securities industry:

Those wishing to invest money depended on investment dealers to provide them with advice on new issues. Gradually, a relationship of trust builds up between a dealer and an investor, making the latter reluctant to change firms. On the side of the issuers, again the corporation involved would rely heavily on the dealer for advice in designing the securities and establishing their amount, characteristics, and price. Consequently, a close relationship will grow between dealer and company somewhat similar to the professional relationship between a lawyer and his client, and the dealer may on occasion be represented on the corporation’s board of directors. These kinds of relationships made it rather difficult for a firm to enter the industry, and achieve success quickly.

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26 W.K. Viscusi et al., supra note 1, at 152-155. There is however a controversy among economists as to whether scale economies represent a barrier to entry. Id. at 160-162.


Furthermore, the particularities of the Canadian market may hinder the emergence of regional investment dealers. The involvement of investment dealers in small firm financing involves the gathering and the assessment of considerable information to determine the value of the venture. In this respect, the geographic proximity of investment dealers to the firms contemplating a security offering plays an important function in reducing uncertainty, compensating for ambiguous information and minimizing risk.\(^3\) Even with the development of sophisticated communication networks, exchange of information still requires a face-to-face contact in some instances because of the need for trust.

Certainly, messages can be transmitted from person-to-person with remarkable speed, but they contribute very imperfectly to the nature of the emotional (and behavioral) adjustment of the individuals concerned ... Distance is still a barrier to overcome.\(^4\)

In particular, geographic proximity gives investment dealers a better knowledge of the venture capitalists and early stage financiers, who tend to operate on a regional basis, associated with the firm and whose reputation are crucial in the evaluation of the venture. Moreover, proximity reduces the operational costs of preparing the firms to go public, including the cost of meetings with the members of the going public team and the cost of visiting the firms' premises to "kick the tires" and get a more realistic view of its operations.

While financial intermediaries will generally prefer to move closer to the source of the information,\(^5\) this is warranted only where the source of the information is not only remote but also clustered. When there is a low degree of localization of investment opportunities, such as in a small regional market, sources of business opportunities are widely dispersed and the incentive of financial intermediaries to shift to a regional market is lessened. Given the small size of Canadian

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\(^4\) W.R. Code, ibid. at 114.

\(^5\) See J. Lerner, "Venture Capitalists and the Oversight of Private Firms", (1995) 50 J. Fin.301 (geographic proximity is an important determinant of venture board membership); Conseil économique du Canada, supra note 20, at 30.
regional markets, it may not be surprising that there is a very limited number of regional investment dealers.\(^33\)

b) The Regulation of Investment Dealers

Securities legislation regulates the three major functions of the securities industry, namely, acting as a dealer, adviser or underwriter.\(^34\) An underwriter designates the person or company who agrees to purchase securities with a view to distributing them, or who offers for sale or sells securities in connection with a distribution.\(^35\) A dealer refers to the person or the firm who acts as agent (or broker) in the buying and selling of securities, or trade in securities for its own account.\(^36\) Generally, securities firms act both as principal and agent in the market, buying and selling securities on their own behalf and on behalf of others. Finally, securities legislation governs the adviser who is defined as "a person or company engaging in or holding himself or itself out as engaging in the business of advising others as to the investing in or the buying or selling of securities".\(^37\)

The *Securities Act* regulates these various actors by requiring them to register. Thus, the Act prohibits anyone from trading in securities, underwriting issues of securities or giving advice with respect to investments in securities unless registered.\(^38\) Note that a person or firm can be registered

\(^33\) *Financing Innovative Enterprise*, *supra* note 6, at 141. The relation of the mass of information to the return per unit of that information affects the spatial distribution of financial intermediaries. Where the value of information is low in comparison to the return on the venture, such as when investment dealer undertake many new offerings for small enterprises, it is preferable to have geographic proximity because of the cost of moving the information to a financial centre. Conversely, the undertaking of large new issues of enterprises may justify the transfer of information to a financial centre. While this may suggests that investment dealers have a strong regional presence to serve small businesses, the small size of the Canadian regional markets noted above will act as counterbalancing force. See W.R. Code, *supra* note 30.


\(^35\) *Ontario Securities Act*, R.S.O., c. S-5, s. 1(1) [hereinafter *O.S.A.*]. The definition of underwriter excludes a person or company who is a member of a selling group and who sells a portion of an issue of shares on a customary commission basis. See M.R. Gillen, *ibid.* at 360 n. 5.

\(^36\) *O.S.A.*, s. 1(1).

\(^37\) *Ibid.* There are at least three subcategories of advisers: investment counsel, portfolio manager, and securities advisers.

\(^38\) *O.S.A.*, s. 25.
as an underwriter without becoming registered as a dealer, while a broker, an investment dealer or securities dealer, referred to as 'fully registered dealer', is deemed to be registered as an underwriter. Furthermore, unlike underwriters, dealers and advisers are broken down into several sub-categories which relate to the type of functions performed in the industry and the membership in a recognized self-regulatory organization (SRO).

While the legislation uses the word registration to define this form of regulation, it is more accurate to speak of a form of licensing. Registration is considered to be a weak form of regulation of entry into an occupation as it usually does not attempt to prevent entry into the occupation, but is rather used as a device for gathering information. However, under the Securities Act, registrants must comply with regulation which sets and enforces standards of financial responsibility, honesty and competence. Thus, the registration process bears more resemblance with that of licensing which regulates more stringently entry into an occupation by granting licenses to individuals satisfying stipulated admission standards.

Before examining specifically some of the admission requirements established by securities regulation, it is worth pointing out that the authority that has the power under the Securities Act to grant registration has broad discretion. Indeed, the Securities Act provides that registration shall be granted "where in the opinion of the Director the applicant is suitable for registration and the proposed registration ... is not objectionable." The use of vague terms such as 'suitable' and 'not objectionable' gives considerable discretion to the Director and creates uncertainty for individuals seeking registration. For example, Alboini reports that, in the past, the Director has exercised this

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39 Ontario Securities Regulation., s. 100(1) [hereinafter O.S.R.].
41 M.Q. Connelly, "The Licensing of Securities Market Actors", in Proposals for a Securities Market Law for Canada, supra note 28, at 1273.
42 T.R. Muzondo & B. Pazderka, supra note 40. at 3.
43 O.S.A., s. 26.
discretion in assessing applicants' moral character, their past conduct in the securities field or in any field considered relevant, their knowledge of the securities industry and their general competence.\textsuperscript{44}

While there are no reported instances where the Director has directly used this broad power to quash undue competition or set undue barriers to entry, as an association might do,\textsuperscript{45} it should not be assumed that regulators are well-intentioned individuals who always seek the public interest when exercising their powers.\textsuperscript{46} Thus, it is not impossible that the Director could use its broad power to restrict entry into the securities industry to serve the interest of professional associations and, as a result, secure the support of the latter.\textsuperscript{47}

For example, in \textit{Re Larrimore Securities Ltd.},\textsuperscript{48} the Ontario Securities Commission refused to grant registration to an applicant because the Broker-Dealer's Association had refused to admit the latter as a member.\textsuperscript{49} The OSC did not substitute its discretion for that of the Association, even though membership in the Association was not a prerequisite for registration. The Commission's decision was criticized by the Court of Appeal for having been unduly influenced by the Association's opinion. The Court of Appeal aptly underlined that "to give effect to [the}

\begin{itemize}
\item \textsuperscript{44}V.P. Alboini, \textit{Securities Law and Practice} (Toronto: Carswell, loose leafs) at § 11.2.1 [d].
\item \textsuperscript{45}The OSC has recently used its power to cancel the registration of salespeople and a dealer corporation concurrently regulated by the TSE. \textit{O.S.A.}, s. 127: \textit{Re Chappell and Midland Doherty Ltd.}, (1987) 10 \textit{O.S.C.B.} 3996; \textit{Re Oster Inc.} (1991) 15 \textit{O.S.C.B.} 5307. See also R. Sorell, \textit{supra} note 1, at 182-183.
\item \textsuperscript{46}This phrase is borrowed from J.G. Maclntosh, "Securities Regulation and the Public Interest: Of Politics, Procedures, and Policy Statements — Part I", (1994-95) 24 \textit{Can. Bus. L.J.} 77 at 100.
\item \textsuperscript{48}[1956] O.W.N. 501 (C.A.).
\item \textsuperscript{49}See also \textit{Dolford Trading Ltd.}, (1951) 1 \textit{O.S.C.B.} 1.
Association's opinion] as a determining factor would be, in effect, to create a virtual monopoly in the members of the Association which ... the statute never intended."\(^50\)

With these thoughts in mind, I will review the salient admission requirements established by securities and professional regulation that can constitute barriers to entry into the securities industry. These requirements arguably raise the cost of entry by imposing a cost on entrants above what they would have be in their absence and can therefore be likened to an entrance fee which imposes a burden on new entrants.\(^51\)

\textit{i) Financial Responsibility}

Securities regulation requires market intermediaries to meet certain capital requirements to ensure that they have sufficient funds to meet their financial obligations to their clients when they engage in acting on behalf of the latter.\(^52\) The capital requirements are an important feature of a viable securities market as they ensure that investors have a high degree of confidence in the ability of market participants to perform their contractual obligations.\(^53\) More particularly, capital requirements are necessary because of information asymmetries which impede the assessment of the solvency of financial intermediaries by investors.

Capital requirements economize on information costs; one agency monitors an important determinant of creditworthiness: capitalization. This reduces (but does not eliminate) search and evaluation by private parties. Moreover, the imposition of universal requirements reduces the importance of the daisy chain problem, as capital requirements provide some assurance that a particular firm's other counterparties are viable and/or solvent, thereby reducing the necessity of evaluating the creditworthiness of these other firms.\(^54\)

\(^{50}\) Re Larrimore Securities Ltd. supra note at 504. See also Liberty Securities Ltd., (1966) O.S.C.B. 4.

\(^{51}\) T.G. Moore. "The Purpose of Licensing", (1961) 4 J. Law & Econ. 93 at 111. Note however that the real cost of entry is diminished by the additional income that entrants derive from their admission in the occupation.

\(^{52}\) M.R. Gillen. supra note 34. at 379-380.


\(^{54}\) S.C. Pirrong, ibid. at 469.
Accordingly, capital requirement regulation serves the purpose of reducing the costs of enforcing contractual performance and improves thereby market efficiency.

Specifically, to meet the capital requirements, dealers must have and maintain minimum free capital in an amount which represents the maximum deductible amount under the bonding or insurance policy required,\(^5\) plus the greater of $25,000 of net free capital and a varying percentage of adjusted liabilities.\(^6\) In addition, they must contribute to a compensation fund that is intended to protect investors in the case of a business failure.\(^7\) The applicant who seeks registration in the capacity of underwriter only must maintain a minimum free capital of the maximum amount deductible under the bonding or insurance policy required,\(^8\) plus $10,000 of net free capital.\(^9\) Finally, advisers must maintain a minimum free capital of the maximum amount deductible under the bonding or insurance policy required,\(^10\) plus $5000 of working capital.\(^11\)

While in theory the rationale for capital requirements is sound, these requirements may not perform the function of reducing the costs of trading. Capital requirements are more burdensome for small start-up firms because of their regressive features.\(^2\) This is particularly the case for the proportion of net liquid capital required from dealers to cover adjusted liabilities, i.e. the varying percentage of adjusted liabilities, which exhibits a strong tendency to decrease as adjusted liabilities

\(^{55}\) Every broker, investment dealer and securities dealer must post a bond or maintain insurance in a minimum amount of $200,000. O.S.R., s. 108(1).

\(^{56}\) O.S.R., s. 107(1).

\(^{57}\) O.S.R., s. 110.

\(^{58}\) Applicants who intend to act only as underwriters must post a bond or maintain insurance in a minimum amount of $10,000. O.S.R., s. 108(3).

\(^{59}\) O.S.R., s. 107(5).

\(^{60}\) Applicants who intend to act only as advisers must post a bond or maintain insurance in a minimum amount of $10,000. O.S.R., s. 108(3).

\(^{61}\) O.S.R., s. 107(3).

rise. The amount of net liquid capital is determined on a declining scale by reference to adjusted liabilities, the amount being equal to ten per cent for the first $2,500,000 of adjusted liabilities, plus six per cent of the next $2,500,000, and five per cent of adjusted liabilities in excess of $10,000,000. Recently, the Quebec Securities Regulation was amended to make the coverage rate of adjusted liabilities by net free capital uniform, irrespective of such adjusted liabilities. It is proposed that the other securities commissions should give careful consideration to making a similar modification.

In addition to being inequitable on the grounds that it is too onerous for smaller firms, the capital requirements tend to make it more difficult for new firms to enter the market. They influence directly the cost of market access by determining the amount of capital that new firms must hold. This is particularly disquieting given that the impact of the capital requirements on entry is more profound in regions where there are already few investment dealers. It will be argued below that a special category of securities dealers, involved only in the distribution of IPOs, should be exempted from the capital requirements.

ii) Educational Requirements

Entrants must meet certain educational requirements to register as a broker-dealer, underwriter or adviser. They must successfully complete the courses provided by institutions such as the

64 Quebec Securities Regulation. (1983) 115 G.O. 2, 1269, s. 207 (as amended).
66 R. Pozen, “Competition and Regulation in the Stock Markets”, (1974) 73 Mich. L. Rev. 315 at 352 (Net capital rules impose a legal barrier to entry for some potential brokers but the impact of the barrier depends on the number of brokerage firms in a city or region.).
67 M.R. Gillen, supra note 34, at 388-389.
Canadian Securities Institute or the Institute of Chartered Financial Analysts.\(^{68}\) In addition, they must complete the required minimum apprenticeship periods.

The purpose of these requirements is to prevent losses suffered by investors who are unable to fully assess the competence of the individuals from whom they purchase securities services such as underwriting, advising or brokerage.\(^{69}\) Stated differently, the requirements ensure a minimum acceptable quality of services in the industry.\(^{70}\) However, the need to complete the compelled education and apprenticeship requirements involves direct costs for entrants in the form of expenditure on books and tuition.\(^{71}\) In addition, it imposes opportunity costs on entrants to the extent that they have to spend more time in school and longer in apprenticeship than they would in the absence of regulation. In this respect, it appears that this opportunity cost is likely to be significant. Gillen observes:

> For instance, to become a registered dealer one needs to (i) complete the Canadian Securities Course, (ii) complete the Canadian Investment Finance Course, (iii) complete the first year of the Canadian Financial Analysts Course, and (iv) have done financial analysis for at least five years with three of those years under the supervision of an advisor responsible for the administration of investment portfolios having an aggregate value of at least $1M.\(^{72}\)

While the purpose of such requirements is laudable, the extensive preparation required to become a registered dealer undoubtedly stifles the supply of the service at the source. More flexible educational requirements are clearly warranted.\(^{73}\)

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\(^{68}\) O.S.R., s. 124.


\(^{71}\) T.G. Moore, *supra* note 51, at 111.

\(^{72}\) M.R. Gillen, *supra* note 34, at 389.

\(^{73}\) P. Slayton, *supra* note 69, at 118. Note that the Director may exempt a person or a company from the educational requirements, *O.S.R.*, s. 126.
iii) Membership Requirements

The Securities Act establishes several sub-categories of dealers. The most important sub-categories for our purpose are the broker, which requires membership in a recognized stock exchange, the investment dealer, which requires membership in the Investment Dealers’ Association of Canada (IDA), and the securities dealer, which is a residual sub-category that does not require membership in a self-regulatory organization (SRO). Although in principle, a dealer does not have to be member of an SRO to be granted registration, the presence of such organizations may nevertheless have a negative impact on the entry of new dealers into the market because of the risk of anti-competitive conduct.

The IDA is the Canadian securities industry’s national trade association. It represents about 160 members and acts, at the same time, as a self-regulatory organization. The IDA’s mission is “to foster efficient capital markets by encouraging participation in the savings and investment process, and by ensuring the integrity of the marketplace.” To achieve these objectives, the association regulates the market practices of its members in both the primary and secondary markets. Since 1997, the regulation of the Toronto Stock Exchange’s (TSE) 100 members’ business affairs and dealings with customers is also the responsibility of the Investment Dealers Association of Canada. The TSE’s regulatory functions now focus on regulation of its markets and listed companies.

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74 O.S.R. s. 98.
75 For a history of the IDA see W.D. Coleman, supra note 29; R. Sorell, supra note 1, at 173-176.
76 Securities Course, supra note 1, at 1-51.
77 Ibid.
Arguments supporting self-regulation in the securities industry are well known.\textsuperscript{79} Self-regulatory organisations are said to be more expert than bureaucratic agencies at establishing and enforcing high standards of conduct. Self regulation is also considered less costly than government regulation since it is performed by an industry-financed organisation which is more likely to be obeyed by its members. In this respect, compliance with self-regulation is fostered by the fact that losses resulting from insolvency from a member are absorbed by an industry-sponsored fund that is not subsidised by the government. In addition, by assuming the burdensome ‘prosaic functions’, SROs allow securities commissions to concentrate on their more pressing policy-making activities.

On the other hand, self-regulation can have some anti-competitive effects. Firstly, the involvement of SROs in the disciplinary process may create a two-tier disciplining process where members of self-regulatory organisations are subject to more lenient application of the standards of conduct, while other market participants are closely scrutinised by the securities commission. The tendency of SROs not to enforce standards of conduct against its own members as rigorously as an independent regulator has been noted by several commentators.\textsuperscript{80} Sorell notes:

That such a danger is real and not merely theoretical has been borne out in Ontario by the number of disciplinary proceedings initiated by the Ontario Securities Commission where an SRO could have acted against a member but either declined to do so or did not impose penalties as severe as the Commission staff thought appropriate or where the OSC simply elected to bypass the SRO and take matters into its own hands.\textsuperscript{81}

Secondly, SROs may restrict competition by using their powers intentionally or unintentionally to set membership standards too high to unduly restrict membership entry.\textsuperscript{82} In this


\textsuperscript{80} R. Sorell, \textit{ibid.} at 182-183 citing decisions where the OSC has used its power to discipline registrants in cases where the SRO has failed to do so. See also R.S. Karmel, “Is the Shingle Theory Dead?”, (1995) 52 Wash. & Lee L. Rev. 1271 at 1302-1303.

\textsuperscript{81} R. Sorell, \textit{ibid.} at 178.

respect, note that the difficulty of getting membership in a self-regulatory organization may have important consequences for new entrants who may be seeking in this way to overcome their lack of reputation. This risk is exacerbated by the vagueness of SROs standards applicable to membership applications which leave considerable discretion to reject an application. For example, applicants to the IDA must be considered to be complying with vague concepts such as ‘high standards of ethics’, ‘public interest’, and ‘character and business repute’.

Furthermore, an SRO may restrict competition by attempting to disadvantage non-members that seek to do business with its members by prohibiting trades with any member of similar organisations. Likewise, it may establish rules that limit the activities that their members can undertake, such as trading listed securities away from the stock exchange.

The advantages and disadvantages of self-regulation highlight the inherent conflicts that can arise from the dual role of an SRO as a regulatory body, and as protector and promoter of the private interests of its members. The potential for such conflicts call for an adequate supervision of SRO activities by the Ontario Securities Commission to ensure that the latter role of SROs does not supersede the former.

IDA involves application, entrance, and annual fees. In addition each member of the association must pay a levy with respect to each public offerings with which the member has acted as the responsible dealer as well as to the portion of securities underwritten and distributed by him.


TSE General By-law, in Canadian Securities Law Reporter, ibid., s. 16.32.

TSE General By-law, ibid., s. 11.01.

Sorell remarks that "the idea that an SRO exists exclusively for investor protection and the advancement of the public interest is novel both as statutory concept and as comprehensive description of what SROs do in Canada today." R. Sorell, supra note 1, at 189. See also S.A. Romano, supra note 82, at 4827-4828.

J.D. Cox et al., supra note 82, at 1192-1193; R. Sorell, ibid. at 190. See also generally P. Dey & S. Makuch, supra note 1.
While the Ontario Securities Commission possesses adequate powers to supervise the decision-making and disciplining functions of the TSE, the commission’s supervisory power over new policies and initiatives remains limited.\textsuperscript{89} The OSC exercises supervision over TSE rules through an informal non-disapproval process which has its foundation in its public interest jurisdiction.\textsuperscript{90} However, the breadth of this supervisory power is restricted by the commission’s own experience and expertise that may preclude it from adequately evaluating those policies and initiatives.\textsuperscript{91}

With respect to the Investment Dealers’ Association, the problem seems even more acute. Indeed, it appears that the OSC has only very limited oversight power over the IDA’s activities:

The power currently enjoyed by the Commission over the IDA falls short of the power exerted over the TSE. Unlike stock exchanges which cannot carry on business in Ontario unless recognized by the Commission, no like prohibitions exists for other SROS. Unless a self-regulatory organization elects to seek recognition, it would appear that the Commission’s power over such a body is quite limited—perhaps more limited than intended.\textsuperscript{92}

Accordingly, the limits of the OSC’s oversight capacity over membership requirements prevent the commission from acting as a check on the SROS’ inclination to adopt rules promoting their members’ interests and that have the effect of reducing competition.

\textbf{SECTION B: TOWARD A REDEFINITION OF THE REGISTRATION REQUIREMENT}

The study of the investment dealer industry indicates that SMEs are not well serviced by investment dealers. The industry is dominated by a relatively low number of large investment dealers which do not find it economical to service smaller issuers. The fact that there may not be a sufficient number

\textsuperscript{89} O.S.A., s. 23(3) (appeals), 127 (disciplinary power). See R. Sorrell, \textit{supra} note at 180-184.

\textsuperscript{90} The OSC has the power, where it appears in the public interest, to make any decision with respect to any by-law, rule, regulation, policy, procedure, interpretation or practice of the TSE. \textit{O.S.A.}, s. 21(5)(d). R. Sorrell, \textit{ibid.}, at 184-189.

\textsuperscript{91} \textit{Ibid.} at 191. See also W.D. Coleman, \textit{supra} note 29, at 522.

\textsuperscript{92} R. Sorell, \textit{supra} note at 180.
of investment dealers to service SMES suggests however that there may be barriers which restrict the entry of new firms in the market.

As we saw in the previous section, barriers to entry may arise from economic or regulatory sources. While it is beyond the scope of this dissertation to examine whether subsidies could be used to foster entry of new dealer firms to service smaller issuers, it appears appropriate to examine whether changes to the regulatory framework could be enacted to facilitate entry. Entry by new firms in the market could undoubtedly help fill the gap in investment dealing that currently disadvantage SMES. Moreover, facilitating entry would stimulate competition and thereby improve the condition at which are serviced by existing investment dealer firms.

The reform of the regulatory framework should be undertaken with caution. Indeed, the registration of investment dealers, which forms the pinnacle of the regulatory framework, rests on sound policy rationales. Thus, even though it may constitute a barrier to entry, the regulation of investment dealers cannot be entirely eliminated without compromising the public interest. Still, it is important to assess whether those requirements are cost-effective.

This section presents an overview of the potential benefits of increased competition in the investment dealer market. It then examines the various functions performed by investment dealers in order to determine the extent to which regulatory barriers to entry can be lifted to enhance competition.

1. **The Benefits of Increased Competition**

The reduction of regulatory barriers to entry could increase competition in the investment dealer industry and yield significant benefits for SMES seeking to access the public equity market.
a) **The Supply of Investment Dealer Services**

By establishing a threshold for the quality of services, investment dealer regulation leads to the exclusion of sellers of lower quality services which cannot meet the registration requirements. While the exclusion of the low-quality suppliers purports to protect market participants by increasing the average quality of the services provided, at the same time it reduces the range of service quality available on the market and thereby diminishes the possibility for issuers or investors to choose services that best meet their needs. It is important to emphasise that some market participants will have tastes for lower quality, lower-priced services. However, this preference for lower quality services, which is as legitimate as any other, is not satisfied when regulation eliminates the supply of such services. Accordingly, market participants with a preference for inferior-quality services are "forced to reallocate resources away from some other area of preferred consumption, with an unclear but probably negative impact on their general welfare." 

Increasing competition in the securities industry by facilitating entry would widen the range of the quality of services available. This greater choice would enable issuers wishing to maximize the value of their IPO to select the form and level of certification that is the most suited to their particular needs. In particular circumstances, small firms going public may not find it appropriate to invest in a high quality underwriter. While these firms have the choice between reputable and less reputable underwriters under the current regime, relaxing entry requirements would increase the choices available and ensure that small firms can select the level of underwriter certification that would maximize firm value. The existence of a wide range of quality would be consistent with the goal of implementing a regulatory framework complementing, rather than replacing, voluntary disclosure.

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95 A.D. Wolfson et al., *supra* note 32, at 208.
In addition, this increase in the number of regional dealers would place pressure on established dealers to service firms in their region and become themselves more accessible. Presently, the inadequate access of firms to investment dealers in their region creates geographic barriers in the form of excessively high time, money, and inconvenience costs of travel to these professionals. As Evans aptly points out, "[u]niversal access, as a public objective, cannot be separated from the need to influence the supply side of the professional marketplace."

Increasing the regional accessibility of investment dealers may be beneficial for SMEs by facilitating the accessibility of public equity financing for these enterprises. Indeed, it is primarily regional dealers who get involved in the IPOs of small local firms.

b) The Costs of Underwriter Services

Underwriter compensation is the largest single expense incurred by firms going public, representing more than half of total IPO expenses. As Table 2 shows, compensation ranges, on average, between 5 per cent of total proceeds of the offerings for larger offerings to 10 per cent for smaller offerings. While these results support the view that there are scale economies in the production of large offerings, they may also indicate that there is a low degree of competition for smaller offerings.

The low degree of competition for smaller IPOs could be explained on the demand side by the fact that small firm owner-managers are not familiar with the underwriting process and do not know the number of potential underwriters. Thus, underwriters are able to extract supra-competitive

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96 R.G. Evans. "Universal Access: the Trojan Horse", in P. Slaton & M.J. Trebilcock, (Eds.), The Professions and Public Policy (Toronto: University of Toronto Press, 1978) 191 at 206: "a more competitive professional services market could help lower non-price barriers as well by placing more pressure on professionals to move to where user are and to make themselves more accessible”.

97 R.G. Evans. ibid. at 193.


99 M. Andrews, supra note 1, at 11.
fees from small issuers. On the supply side, there may not be a high number of investment dealers that are willing to take public smaller and more speculative offerings. This explanation finds support in our previous discussion which highlighted the disinterest of individual dealers toward smaller IPOs.

The competitive process creates a strong incentive for a firm to offer a more attractive product than its competitors in terms of the price charged for a given level of quality. Accordingly, enhancing competition in the investment dealer market could lead to a reduction of underwriter compensation. A recent empirical study shows that the degree of actual or potential competition between underwriters is negatively related to the commission charged by investment dealers for their services.\(^{100}\) This can be explained by classic price competition. Competition between dealers on the compensation they are willing to accept leads to a level of commission that reflects the cost of supplying underwriting services.\(^{100}\) While this study suggests that increasing the level of competition in the investment dealer industry could lead to a reduction of underwriter compensation, it must be emphasised that, given the fixed-costs components of underwriting, it is likely that the size of the offerings will remain negatively related to underwriter compensation, even in competitive underwriting markets.

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\(^{100}\) K. Garbade, Securities Markets (New York: McGraw-Hill, 1982) at 478. See also infra note 372 and related text.
Table 2

<table>
<thead>
<tr>
<th>Size of Offering (U.S. $ millions)</th>
<th>Number of IPOs</th>
<th>Underwriter Compensation (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.1 – 0.9</td>
<td>47</td>
<td>10.22</td>
</tr>
<tr>
<td>1-9.9</td>
<td>9</td>
<td>7.89</td>
</tr>
<tr>
<td>10-24.9</td>
<td>8</td>
<td>6.01</td>
</tr>
<tr>
<td>25-49.9</td>
<td>2</td>
<td>5.82</td>
</tr>
<tr>
<td>50-99.9</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>100-199.9</td>
<td>2</td>
<td>5</td>
</tr>
<tr>
<td>200 plus</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Average</td>
<td></td>
<td>9.56</td>
</tr>
</tbody>
</table>

Source: The Conference Board of Canada

c) The Degree of Underpricing

An increase in the level of competition among underwriters in the new issue market could also reduce the cost of capital for SMES by reducing the degree of IPO underpricing. A recent study by Chishty et al. yields some support to the view that the presence of a large number of knowledgeable underwriters is likely to force IPO returns closer to their long run equilibrium level.101 Chishty et al. found significant evidence "that the competition in the market among underwriters is negatively related to the price run-ups in the post issue trading."102 In other words, competition appears to affect the degree of IPO underpricing in the same way as underwriter reputation.

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101 Recall that underpricing is a short-run phenomenon.
102 M.R.K. Chishty et al., supra note 100, at 912.
The evidence marshalled by Chishty et al. can be interpreted as an indication of the role market incentives play in shaping gatekeepers’ conduct.\textsuperscript{103} Competition creates incentives for firms to improve their products, to the extent that improvement is cost-effective.\textsuperscript{104} Indeed, a firm which does not improve its methods to enhance quality will likely suffer a decline in sales and operations. Thus, it is possible that "in a competitive environment underwriters research an issue’s value more thoroughly, and that this information is reflected in the price the issuer receives."\textsuperscript{105}

More importantly, the results suggest that competition is instrumental in enforcing the reputational sanction that is crucial for the effectiveness of underwriter gatekeeping.\textsuperscript{106} In a competitive market, information about the prices charged, the level of service provided and performance produced tend to be more visible.\textsuperscript{107} Furthermore, there are more alternatives against which to compare the services and products offered. Thus, if mispricing increases a firm’s cost of capital, a competing firm should be available to publicise this and solicit the underwriter’s unsatisfied customers. In other words, competition magnifies the reputational sanction that an underwriter suffers for mispricing: the greater the level of competition, the greater will be the impact of the loss of reputation for a given underwriter. This is particularly important given that the

\begin{itemize}
\item \textsuperscript{104} J.D.Todd, supra note 2, at 29.
\item \textsuperscript{106} Some commentators argue that greater competition in the underwriting market would reduce the level of underpricing by limiting the impact of the principal-agent problem between issuers and underwriters. See e.g. L.A. Stout, "The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation", (1988) 87 Mich. L. Rev. 613 at 659: "If the underwriting business were a competitive one, corporations presumably would choose the underwriting syndicate willing to pay the highest possible price for a new issue." However, as we saw previously in Chapter II, notes 59-61 and related text, the principal-agent problem is not a satisfactory explanation for the persistent underpricing of IPOs.
\item \textsuperscript{107} R.A. Schotland, “Conclusions and Recommendations”, in Twentieth Century Fund, Abuse on Wall Street: Conflicts of Interest in the Securities Markets (Westport: Quorum Books, 1980) 565 at 568 [hereinafter Abuse on Wall Street].
\end{itemize}
ability to earn a return on the non-salvegeable capital reputation must drop if the underwriter cheats too much.\textsuperscript{108}

2. The Need to Clarify the Scope of the Advisory Function

The investment dealer plays an important role in the early stage of a firm’s financing decision by providing helpful advice regarding the firm's financial problems and opportunities.\textsuperscript{109} More precisely, dealers first assist firms in making an assessment of their funding needs. Then, they inform firms on the respective costs and benefits of the various alternatives for raising funds. For each of the financing vehicles considered, they discuss market conditions and timing considerations in order to ultimately propose a funding mechanism and structure that is considered to be the most appropriate in the circumstances. If an equity offering is considered to meet a firm’s need, for example, the investment dealer will provide information “regarding the potential reactions of the market to the proposed offering, and an estimate of the appropriate price and number of shares that can be sold at that time.”\textsuperscript{110} It will also guide the issuer through the maze of the going public process and perform a valuable administrative function.\textsuperscript{111}

Under the \textit{Securities Act}, no person may act as an “adviser” unless the person or company is registered as an adviser. The Act further defines “adviser” to mean a person or company engaging in or holding himself, herself or itself out as engaging in the business of advising others as to the investing in or the buying or selling of securities.

Considerable uncertainty surrounds the definition of “adviser” because of the dearth of reported decisions dealing with what constitutes a person as an adviser. The dominant interpretation

\begin{itemize}
\item \textsuperscript{110} R.C. Perez, \textit{ibid}.
\item \textsuperscript{111} A.M. Santomero & D.F. Babbel, \textit{supra} note 109, at 485-486.
\end{itemize}
given of the definition limits the scope of definition to investment advice. Support for this interpretation is found in the description of the categories of registration available to an adviser (investment counselling, market commentaries, and portfolio management) that essentially encompasses advising activities offered to a party making a portfolio investment. In one of the few decisions available on the subject, the Ontario Securities Commission seems to have adopted this interpretation when citing a decision of the British Columbia Securities Commission stressing that:

A person who recommends an investment in an issuer or the purchase or sale of an issuer's securities, or who distributes or offers an opinion on the investment merits of an issuer's securities, is advising in securities.

Indeed, this citation makes no reference to advice given to issuers with respect to their corporate finance activities, and seems to apply to portfolio investments only. Accordingly, this statement of the B.C. Securities Commission supports the view that the word "others" in the definition of adviser does not include issuers and, therefore, that advice given to issuers does not come within the scope of the legislation.

The issue nevertheless remains unsettled. While individuals offering merger and acquisition advice have never been required by the OSC to register, the Task Force on Small Business Financing recently suggested that counselling services such as the giving of advice regarding the

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113 O.S.R., s. 87.


116 J.D. Scarlett, supra note 112, at 175.
formulation of a business plan, could constitute acting as an adviser.\textsuperscript{117} This interpretation is open to criticism. Even though there is arguably an element of portfolio investment in such an activity, allowing the interpretation of adviser to cover counselling services in corporate financing would extend the scope of application of the registration requirement to activities beyond the realm of securities regulation.\textsuperscript{118}

The uncertainty surrounding the definition of adviser unduly limits the ability of unregistered business adviser to assist small issuers in many circumstances. The task of determining who is an “adviser” places an additional burden on those firms and individuals who would otherwise render financial advice to companies seeking financing and may thereby hinder competition. Hence, the OSC should issue an interpretation notice clarifying the definition of adviser and exempting from registration individuals and firms providing advisory services to issuers. Allowing for greater competition with respect to this function would appear to be in line with the adoption of the Small Business Prospectus Form (SBPF) which would considerably simplify the going public process and allow for new breed of advisers to emerge.

3. Preserving the Gatekeeping Function of Underwriters Through Registration

a) The Need for Underwriter Registration

The \textit{Securities Act} enacts that a person or company who agrees to purchase securities with a view to distributing them, or who offers for sale or sells securities in connection with a distribution, must be registered as an underwriter. This section presents the rationales for the registration requirement.


\textsuperscript{118} This would be the case if merger and acquisition advice was covered by the definition of adviser. J.D. Scarlett, \textit{supra} note 112, at 176.
The registration requirement can be justified firstly on the ground that it is necessary to provide information about the quality of underwriter services to issuers and investors. The complex nature of these services makes them difficult to be evaluated properly by market participants. Moreover, there is a considerable dispersion in the quality of services supplied because of the heterogeneity of abilities, qualities, talents, training and general competence. Thus, it may be difficult for market participants to assess the quality of investment dealer services unless they try the services or obtain information from a third party. Furthermore, it is argued that imperfect information precludes market participants from measuring accurately the risks of being harmed by a particular professional service.

In the context of the agency relationship that exists between market participants and investment dealers, imperfect information about the quality of professional services generates an adverse selection problem that can threaten the viability of the market. Gillen explains:

The less financially responsible, less honest, and less competent securities market actors (who can operate at lower cost) may drive more financially responsible, more honest and more competent securities market actors out of the securities industry. The risk of substantial loss from dealings with less financially responsible, less honest and less competent securities market actors may, in the long-run, cause investors to discount the value of the services provided by industry members or the value of the securities members themselves. In short, investors will "lose confidence" in securities markets.

In addition, when market participants are unable to assess the value of their services, investment dealers may use imperfect information to promote their own self-interest at the expense of issuers.

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119 J.H. Beales, "The Economics of Regulating the Professions", in R.D. Blair & S. Rubin, supra note 93. at 127.

120 This is the "society knows best" argument. M.R. Gillen, supra note 34, at 363; T.R. Muzondo & B. Pazderka, supra note 40, at 4-5; T.G. Moore, supra note 51. at 106-109.

121 M.R. Gillen, ibid. at 363. See also J.H. Beales, supra note 119, at128.

122 M.R. Gillen, supra note 34. at 363. See also J.H. Beales, supra note 119, at128.

ii) **Conflicts of Interest in Underwriting**

A conflict of interest can be defined as a situation where two or more interests are legitimately present and competing or conflicting.\(^{124}\) In such a situation, the decision-maker having the power to affect those interests may have a larger stake in one side than the other but is required to serve each side regardless of his or her own interest. Conflicts of interest can take two forms:

- A conflict between the decision maker's duty to another party and the decision-maker's own interest ("a self-interest conflict"); or

- A conflict between the duties owned by the decision-maker to two or more other persons ("a divided duty conflict").\(^{125}\)

The underwriting function, as any financial intermediary function, provides fertile ground for "divided duty" conflicts of interest as it confronts the underwriter with the interests of the providers of capital and the users.\(^{126}\) Indeed, the underwriter typically performs its gatekeeping role for the benefit of issuers and investors. The underwriter prepares the prospectuses and distributes the issues in the best interests of corporate issuers. In addition, under the existing securities laws, the underwriter has a competing duty to act in the interest of investors who will use the disclosure documents and who can be considered to be the underwriter's clients as well.\(^{127}\) Thus, since there are two second parties to the underwriting function,\(^{128}\) the underwriter is generally placed between its duty to the buying public and its obligations to corporate issuers.

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127 *Infra* notes 264-268 and related text.

Concurrently, the self-interest of underwriters can taint the underwriting function and conflict with the issuers' and/or investors' interests. On the one hand, the interest of underwriters to minimize the risks and costs of underwriting may conflict with the issuer's interest by leading to the underpricing of an offering. On the other hand, existing ties between the underwriter and the issuer arising from past business relationships, interlocking directorships, equity ownership, or personal and social associations, may give the underwriter an incentive not to undertake a complete due diligence review of an issuer or make less than full disclosure during the distribution of the issuer's securities.

Two potential sources for this latter type of self-interest conflicts are noteworthy. The first relates to the deregulation of the ownership rules which has increased the potential for self-interest conflicts by expanding the scope of the underwriter's interest. Under the new ownership rules, the self-interest of the underwriter must be construed as including the interest of its parent corporation. Among the potential conflicts created by the new rules is the possibility that investment dealers owned by financial institutions be pressured by their parent company to favour issuers in their due diligence activities and pricing decisions in order to maintain business relationships, or to ensure repayment of loans.

The second source stems from the use of innovative techniques used by investment dealers involved in SME financing. Investment dealers, particularly regionally-based firms knowledgeable

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129 Supra Chapter II notes 62-66 and related text.

130 Regulation of Conflicts of Interest, supra note 125, at 5260; R.C. Perez, supra note 109, at 41; N. Wolfson, supra note 126, at 374.

131 To address the increased opportunities for conflicts of interest brought by the elimination of barriers to non-industry ownership in the securities market the Government of Ontario introduced Part XIII of the Ontario Securities Regulation consisting of sections 219-233. Regulation of Conflicts of Interest, ibid. at 5260-5264; Conflicts of Interest in Underwriting, supra note 126, at 3163. See also R. Balfour, “Regulation of Conflicts of Interest after the Abolition of Ownership Rules” in 1989 Law Society of Upper Canada Special Lectures: Securities Laws, supra note 112, at 199.

132 The abolition of ownership rules raise complex and vast issues that are beyond the scope of this dissertation. For a good overview see in general N.S. Poser, “Chinese Walls or Emperor’s New Clothes?”, (1989) 9 Company Law. 119; Regulation of Conflicts of Interest, ibid.; Conflicts of Interest in Underwriting, ibid.

133 Regulation of Conflicts of Interest, ibid. at 5260; Conflicts of Interest in Underwriting, ibid. at 3173-3174.
about local business and local investors, get involved as early stage investors in the financing of emerging enterprises. The involvement of regional dealers in early stage financing, which leads to direct participation by the dealers in the financing of emerging enterprises, raises conflicts with the dealers’ clients who seek advice, research analysis, underwriting services and trading execution. The Joint Securities Industry Committee on Conflicts of Interest writes:

the [investment dealer] firm itself has a potential conflict when it holds significant investments in emerging companies and then engages in underwriting and trading for clients in the shares of these companies. The perception is that the objectivity of the firm is compromised when it carries out underwriting, trading and research on emerging companies when the [investment dealer] firm, and/or its brokers, have a material financial interest in the emerging company.

This type of self-interest conflicts is particularly worrisome in the context of new equity issues of SMEs given the limited value of historical information concerning these enterprises, and the importance of the expert judgement of underwriters. Indeed, if uncontrolled, these conflicts of interest will considerably mitigate the value of the certification provided by underwriters and increase the information asymmetries in the market. In the small firm IPO market, the structure of financing deals and of underwriter firms mitigate the incentive of underwriters to act as gatekeepers. The heightened information asymmetries will negatively affect the degree of underpricing and thus will contribute to increasing the cost of capital for emerging enterprises.

iii) The Limits of Reputational Sanctions

The reputation built by an investment dealer provides a substantial economic incentive to take adequate care even in the absence of legal sanctions. Reputation is acquired and maintained by

134 Strengthening Emerging Company Markets. supra note 17, at 5. 8.
135 Supra notes 96-98 and corresponding text.
136 N. Wolfson, supra note 126, at 367-368.
137 Strengthening Emerging Company Markets. supra note 134, at 5.
138 The cost of capital will increase directly through underpricing, as well as indirectly through the higher return required by investment dealers to offset the underpricing of the IPO.
investments in high quality services with the expectation that the value of the services will be recognised by customers willing to pay a premium for them. In the context of the IPO market, underwriter reputation reduces informational problems to the extent that both investors and issuers rationally believe that underwriters would not risk damaging their reputation by mispricing new issues.

Reputation mitigates *ex ante* information asymmetries by enabling issuers to distinguish underwriter quality. More importantly, the loss of reputation, or reputation sanction, is an effective mechanism to control moral hazard. A reputation for poor quality services makes market participants less willing to deal with the investment dealer and leads thereby to losses in valuable business opportunities. Indeed, as we saw previously, underwriters that systematically misprice offerings tend to lose market share. Thus, reputation sanctions compel investment dealers to pay indirectly for losses arising from the poor quality of its services.

Reputation can also be effective in controlling externalities. An investment dealer who offers poor quality services damages his reputation with his client and third parties and cannot charge as much for those services in the future. In a recent study, Nanda and Yun find that overpricing leads to loss in underwriter market value, consistent with significant damage to its reputation capital.

While reputation undoubtedly sends valuable signal to market participants and constrains opportunistic behavior, it is less certain that it would be effective absent registration, particularly for less reputable underwriters. Less reputable underwriters have lower investments in specific assets whose value will be sacrificed if they are excluded from the market. In addition, by removing

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140 R.H. Kraakman, *supra* note 103. at 96-97.
142 V.P. Goldberg. *supra* note 128, at 303.
barriers to entry into the securities industry, the abolition of registration considerably diminishes the level of investment required of investment dealers. Accordingly, they "have less to lose from gambling with their reputation, and as a result may voluntarily choose to ignore signs of fraud."\(^{144}\)

From this it follows that it is uncertain whether reputational sanctions would provide less reputable underwriters with sufficient private incentives to ensure that they would execute faithfully their certification duties, in the absence of registration. Furthermore, legal liability would also be an insufficient safeguard protecting third parties from opportunistic behaviors in the absence of registration. According to Kraakman, gatekeepers with little capital at stake are more likely to accept corrupt offers that are large enough to offset the legal cost of corruption.

Whenever entry into a gatekeeping market requires significant capital, including investment in specific human capital or reputation, simple legal penalties such as civil damages ... can be powerful deterrents. One suspects, for example, that professionals -- accountants, lawyers, and doctors -- make attractive legal gatekeepers in part because they have large and vulnerable investments in licenses and reputations; they stand to lose too much if their corruption is detected ... Valuable licenses, whatever their primary purpose, are always convenient devices for assuring that wayward gatekeepers risk a substantial penalty for corruption.\(^{145}\)

Thus, it is probable that very few issuers would choose to undertake an offering with an uncertified dealer.\(^{146}\) The market undoubtedly would react negatively to such an association, and the issuer would bear the cost of going public using an uncertified investment dealer. Assuming that the majority of issuers are seeking to maximize firm value, those issuers would seek to use the services of certified dealers and this would cause the decline and eventually the collapse of the uncertified dealer market.

\(^{144}\) S.J. Choi, "Company Registration: Toward a Status-Based Antifraud Regime", (1997) 64 U. Chi. L. Rev. 567 at 587.

\(^{145}\) R.H. Kraakman, supra note 103. at 70.

b) The Central Role of Underwriter Liability

The Securities Act imposes liability upon the underwriter for any misrepresentation in the prospectus.\(^\text{147}\) Two defences that underwriters can claim are noteworthy. For the expertised part of the prospectus, underwriters must show that they had no reasonable ground for believing that there was a misrepresentation. For the non-expertised part of the prospectus, underwriters can avoid liability by showing that after a reasonable investigation, they had reasonable grounds for believing that there was no misrepresentation.\(^\text{148}\) This defence, known as due diligence, creates an affirmative duty for the underwriter to verify the accuracy of disclosures relating to the securities offered.\(^\text{149}\) Thus, underwriters usually undertake extensive investigation and inquiries during the preparation of the prospectus to ensure that the latter satisfies the full, true and plain disclosure standard and does not contain any misrepresentations.

The responsibility assigned to the underwriter stems from the unique relationship that exists with the issuer and "which is both semi-adverse, and not without clout".\(^\text{150}\) In addition, the underwriter possesses the control of the distribution process to pressure the issuer to disclose adequate and truthful information.\(^\text{151}\) If it does not agree with the information contained in the

\(^{147}\) O.S.A., s. 130.

\(^{148}\) O.S.A., s. 130 (4), (5). See V.P. Alboini, supra note 44, at § 23.1.4-23.1.12; M.R. Gillen, supra note 34, at 131-139; G.R.D. Goulet, Public Share Offerings and Stock Exchange Listings in Canada (North York: CCH, 1994) at 231-241.

\(^{149}\) D.C. Langevoort, "Information Technology and the Structure of Securities Regulation", (1985) 98 Harv. L. Rev. 747 at 769; G.R.D. Goulet, ibid. at 238; J.F. Seegal, "Due Diligence Procedures in Initial Public Offerings", (1996) 939 P.L/I/Corp. 335. Goulet defines due diligence as: "...conducting an appropriate and reasonable investigation of all material facts and matters relating to an issuer and its securities to be rationally satisfied in one's own mind that the prospectus contains no misrepresentation and that the certificate in the prospectus is accurate, i.e., that the prospectus constitutes full, true and plain disclosure of all material facts, without omission, relating to the offered securities. Due diligence procedure are intended to ascertain risk factors and to ferret out in advance and deal with potential problems, and to cause appropriate disclosure in this and other material respects to be made." ibid. at 232.


prospectus, the underwriter can refuse to proceed with the offering by refusing to sign the certificate in the prospectus and effectively thereby eliminate the offering's chances of success. In this respect, the underwriter has the capacity and experience needed to undertake the investigation and verification of the facts concerning an issuer as well as to provide valuable insights as to what information will be considered material by the market.152

The Task Force on Small Business Financing recommends to eliminate the liability of underwriters for misrepresentations in an SME prospectus by removing the requirement that they sign a certificate in a prospectus stating that to the best of their knowledge, information and belief, such prospectus contains no misrepresentation.153 This bold proposal rests on the premise that due diligence is not cost-effective for SMEs and presents an important cost in the going public process. In order to assess the merit of this proposal, it is necessary to unpack the different costs and benefits resulting from the due diligence requirements.

i) The Importance of Underwriter Liability in Reputation Building

A first potential benefit of the due diligence requirement accrues to investors through a reduction in the probability of abuses resulting from material misstatements or omissions in the prospectus.154 Thus, the provision by regulation of a check on the accuracy of disclosure is justified on the ground that investors want "not only information relevant to determining the value of a security, but also assurance that the information is correct".155 In this respect, it is argued that an efficient market does


155 D.C. Langevoort, supra note 149. at 769-770.
not afford sufficient protection for investors because fraudulent information can be processed just as efficiently as accurate information and reflected in the price of the security.\textsuperscript{156}

This justification for due diligence rests on the conception that the private mechanisms of market efficiency cannot assess information and detect misrepresentations. However, this position overlooks the role of sophisticated investors and information intermediaries in ensuring the accuracy of the information disclosed, irrespective of the existence of liability. Indeed, as we saw previously, there are good reasons to believe that the presence of sophisticated market participants offers some level of protection against fraud and misrepresentation for unsophisticated investors and that the role of regulation remains limited.

The protective role of due diligence is also mitigated by portfolio diversification which offers some protection to investors from misrepresentation. By constructing diversified portfolios across other securities issues and other securities and assets, investors can eliminate all company-specific risk, such as the risk of misrepresentations.\textsuperscript{157} When company-specific risk for the portfolio has been reduced to zero, any potential for fraud or misrepresentation has no effect on the portfolio as a whole.

Because of the dearth of institutional investments in the small firm IPO market, investors cannot rely on the presence of sophisticated market participants to limit the possibility of misrepresentations. Furthermore, the extent of the protection afforded by diversification to investors remains limited in a market that has a low level of information efficiency such as the small firm IPO market: "Implicit within the dichotomy between systematic and nonsystematic risk is that, initially, markets properly value risk: markets must be efficient."\textsuperscript{158} When the market is unable to evaluate meaningfully new firms coming to the market with relatively unknown managers and products,

\begin{itemize}
  \item \textsuperscript{157} B.A. Banoff, \textit{ibid}.
\end{itemize}
investors may not succeed in constructing efficient portfolios and diversifying away the risk of misrepresentations.\textsuperscript{159}

Besides, some commentators question whether fraudulent misrepresentation constitutes a company-specific risk which can be diversified:

\textquote{[T]he assumption that the market evaluates the risk of [fraud] on a firm specific basis needs re-examination. Much more likely is that the market makes this judgment not on a firm-by-firm bias but generically across a range of similarly situated stocks. Only those firms (notably few, I believe) that can credibly distinguish themselves from the herd through signalling, monitoring, or bonding will be separately and individually 'priced'... In short, there will be external effects, because bad managers will raise the cost of capital to good managers, unless the latter can credibly signal their higher virtue.\textsuperscript{160}

While market mechanisms do not completely eliminate the risk of misrepresentations, they do reduce it and thereby the benefit that yield the due diligence requirements. Accordingly, it is necessary to consider the contribution of these mechanisms when determining whether it is the public interest to use due diligence to protect investors and at what cost is this protection afforded.

The second benefit attributed to due diligence rests on the broader role that plays the stock market in allocating resources in the economy.\textsuperscript{161} Viewed from this perspective, due diligence is important because it forces the disclosure of more truthful information that improves pricing accuracy and "influences the decision of corporate management in ways that increase the efficiency


\textsuperscript{160} J.C. Coffee, "No Exit?: Opting Out, the Contractual Theory of the Corporation, and the Special Case of Remedies", (1988) 53 Brooklyn L. Rev. 919 at 945-946. The diversification of misrepresentation may also prove difficult for investors to the extent that all issuers are naturally inclined to overstate the value of their offerings. D.C. Langevoort, supra note 149, at 769-770 n. 96.

with which scarce resources are allocated." 162 The real function of underwriters is thus to act as a gatekeeper of the integrity of the offering rather than as a risk-bearer.163

A recent empirical study by Ramsay and Sidhu examined the role played by due diligence in capital allocation by testing the hypothesis that due diligence requirements, by reducing the uncertainty characteristic of companies making an IPO, are associated with less underpricing of IPOs.164 The results failed to support the hypothesis and did not show that higher due diligence, proxied by the costs of due diligence, was associated with lower underpricing. As the authors of the research conclude, "[i]f due diligence costs do not result in more accurate pricing of IPOs then an important issue is raised regarding the value of these costs."165

The results of the study may be explained by the fact that the purpose of due diligence is to decrease the information search and analysis cost of market participants.166 Thus, the savings in information costs increase net returns to investors and are only reflected in security returns, i.e. in gross returns, in cases where "the information required to be disclosed was unavailable or available only at great cost".167 This suggests that due diligence is less important to the extent that the market is efficient, i.e. that investors have low search and verification costs in obtaining information on an issuer.168

162 M.B. Fox, ibid. at 1010. See also S.P. Ferris et al., "An Analysis and Recommandation for Prestigious Underwriter Participation in IPOs". (1992) 17 J. Corp. L. 581 at 585.


165 Ibid. at 199.


167 M.J. Whincop, ibid. at 445.

168 B.A. Banoff, supra note 156, at 184; D.C. Langevoort, supra note 149, at 773-778.
However, given the higher degree of uncertainty surrounding issuers in the IPO market, the reduction of information costs brought about by due diligence should be significant enough to move the market towards a greater level of efficiency and, therefore, lead to an observable lower level of underpricing.\textsuperscript{169} In other words, if due diligence were valuable, greater expenditures in due diligence should improve the information environment of firms going public and lead to an observable reduction of underpricing. Although the study of Ramsay and Sidhu indicates that this is not the case, the study should not be interpreted as implying that the information intermediary role of underwriters, including their due diligence function, is without value.\textsuperscript{170} Rather, it highlights the centrality of the reputation of underwriters — for diligence and honesty — as the primary determinant of the value of the monitoring services provided by underwriters.\textsuperscript{171}

The centrality of underwriter reputation stems from the fact that underwriter liability, \textit{i.e.} legally-induced due diligence, covers only a fraction of the underwriter’s role as an information intermediary.\textsuperscript{172} Underwriters verify the information disclosed by issuers but also acquire and process all available information in establishing the issue price. Accordingly, liability "cannot ensure ... important element of quality performance, such as the underwriter’s skill in appraising business prospects and ferreting out hidden risks."\textsuperscript{173} In this context, reputation becomes an important factor which investors consider when determining the ability of an underwriter to certify the quality of the information about an offering and increase the quantity of information.

\textsuperscript{169} R.J. Gilson & R.H. Kraakman, \textit{supra} note 166 at 597: "If, as we argue, capital market efficiency is a function of information costs, then economizing on information costs pushes the capital market in the direction of greater efficiency."

\textsuperscript{170} Ramsay and Sidhu argue that the due diligence requirements may serve purposes other than more accurate pricing of IPOs. I.M. Ramsay & B.K. Sidhu, \textit{supra} note 164, at 199. See also M.J. Whicop, \textit{supra} note 159, at 444-445 (arguing that the proxy for due diligence costs may not capture the full extent of due diligence examination costs and may not be measuring the variable of interest).

\textsuperscript{171} R.J. Gilson & R.H. Kraakman, \textit{supra} note 166, at 613-621.


\textsuperscript{173} R.H. Kraakman, \textit{ibid.}
Furthermore, investors need to consider the reputation of underwriters because liability is not a sufficient warranty for the quality of due diligence. The explanation of Ferris et al. is apposite. It may also be argued that prestigious underwriters are better able to handle the required due diligence investigations than are lesser underwriters. A material omission in a registration statement or false or misleading information in the prospectus can subject both the issuing firm and the underwriter to a lawsuit for violation of due diligence requirements. But because the standards of due diligence are vague, and the issuing firm's management is typically unfamiliar with the process, the attraction of using an established underwriter increases.\textsuperscript{174}

The importance of underwriter reputation receives wide support in the empirical literature. As we saw previously, empirical evidence indicates that IPOs sold by prestigious underwriters tend to be less underpriced than those sold by fringe underwriters.\textsuperscript{175} For this reason, investors are more concerned with the reputation of underwriters than with discreet measures of the level of investigation they may conduct. In this respect Ramsay and Sidhu's study may show that due diligence is meaningless for investors when the reputation of the underwriters performing is not considered. Further research analysing the influence of underwriter reputation could certainly shed more light on this question.

Although reputational concerns are instrumental for the monitoring efforts of underwriters, there may nevertheless be a need for liability. According to professor Reinier Kraakman, the imposition of liability on underwriters remains necessary because reputation is a noisy signal.\textsuperscript{176} Investors observe only indirectly the underwriters' efforts through the price performance of the issues brought to the market.\textsuperscript{177} Thus, investors may attribute the same reputational effect to issues which fail for different reasons such as fraud, bad luck, or mispricing. Likewise, the risk that particular underwriters decide to milk their reputation over time, by lowering quality while continuing to charge premium prices, limits the refinement of reputation over time. In this context,

\textsuperscript{174} S.P. Ferris et al., supra note 162, at 587-588.
\textsuperscript{175} Supra Chapter III notes 148-149 and related text.
\textsuperscript{176} R.H. Kraakman, supra note 103, at 96-97.
\textsuperscript{177} Ibid. See also S.P. Ferris et al., supra note 162, at 586-587 n. 54.
"investors will 'buy', and underwriters will 'sell', less monitoring effort in aggregate than they would in a more informed market."178

For professor Kraakman, these shortcomings highlight the positive contribution of liability: "[liability] can single out the most basic element of quality underwriting - simple honesty and a reasonable procedure for verifying issuer representations - and give it a much firmer guarantee than reputation alone can provide."179 Differently stated, imposing liability on underwriters warrants the elements of underwriter performance which are not subject to reputational control. Viewed from this perspective, the primary benefit of legal liability is to foster the creation of an industry standard for the quality and value of underwriter monitoring, as well as the review of the underwriter’s role in the event of the failure of an issuer.180

Several difficulties would make such a standard difficult to mimic by contract in the absence of liability. Among others, the presence of free-riders would preclude the development of a uniform community practice of due diligence and create significant uncertainty as to the value and limits of the warranty established contractually.181 In addition, Kraakman notes that "it is by no means certain that the courts would definitely establish the scope of such an amorphous warranty against the backdrop of common law fraud action."182 The difficulty in establishing the scope of the contractual warranty would likely raise the cost of underwriting. Given that predictability plays a

178 R.H. Kraakman, ibid. at 98.
179 Ibid.
180 J.N. Gordon & L.A. Kornhauser, "Efficient Markets, Costly Information, and Securities Research", (1985) 60 NYU L. Rev. 761 at 814-815 n. 138; Letter from D. Hyndmann, Chair, British Columbia Securities Commission, dated September 26, 1995, in response to request for comments, Appendix A at 23 (The threat of litigation provides an incentive to underwriters to follow industry standards in performing their gatekeeper function and in conducting due diligence.).
important part in the assessment of liability risk, higher costs would probably be assigned to risks which are perceived to be not only substantial but indeterminate.\(^{183}\)

In addition, to be effective, the creation of a due diligence standard would require the cooperation of the other market participants involved in the prospectus process, namely lawyers and accountants. Given the difficulty of collective action, this would create tremendous coordination problems that would substantially raise the cost of the warranty.

Furthermore, the actual standard imposed by liability is enforced by the direct compensation of investors rather than by reputational injury only. To the extent that the penalty imposed by liability exceeds the reputational losses that would accompany issue failures, it ties "the underwriter's incentives directly to investor losses in precisely the circumstances in which issues are most likely to have failed as a result of gross incompetence or collusion between underwriters and fraudulent issuers."\(^{184}\)

While the presence of a uniform industry-wide standard benefits investors, it also contributes to the stabilization of the underwriting market by curtailing the negative spill-over effects of free-riders.\(^{185}\) Opportunistic or careless underwriters will bear most of the risk of the losses they impose by having to compensate directly investors. Moreover, the lawsuits launched against these low-quality underwriters will help define the reputational penalty by contrasting the quality of their services with industry standards. Thus, low-quality underwriters will not be able to free-ride on the reputation of high quality underwriters and neither pass on them the reputational penalty associated with their failures.

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\(^{183}\) M.P. Dooley, *supra* note 150, at 801.


\(^{185}\) *Ibid.*
ii) Limiting the Costs of Underwriter Liability

The costs imposed on underwriters by the liability regime consists of two elements. The first is the operational cost of discharging the prescribed level of monitoring needed to improve information. The second element is the residual legal risk of liability assumed by underwriters in the event the information presented is not legally adequate, and the cost of the strategies to limit this risk. Both of these costs are reflected to a certain extent in underwriter compensation and affect the level of investments by raising the cost of capital of issuers. However, a portion of the monitoring and risk-bearing costs are not passed to issuers because of competition among investment vehicles which requires that securities maintain rates of return equivalent to other investments of comparable risk. When these costs are large, as is the case for SMES, underwriters will tend to avoid riskier issuers by refusing to deal with them.

An optimal liability regime should encourage underwriters to prevent issuer misconduct in connection with IPOs without precluding a substantial number of firms from making public offerings. According to the Task Force, the current liability regime fails to strike this balance by imposing costs on issuers that are not justified in regard to the benefits yielded by underwriter gatekeeping.

Undoubtedly, underwriter compensation is a significant burden for small issuers going public. It represents the largest single direct expense of any IPO and appears to have a substantial fixed-cost component. However, the Task Force does not unbundle underwriting costs to

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186 M.P. Dooley, supra note 150, at 840; R.H. Kraakman, ibid. at 75-78.
187 M.P. Dooley, ibid. at 841. The impact of the costs generated by liability on underwriter compensation is limited by the competition which exists between investment vehicles.
188 Ibid.; R.H. Kraakman, supra note 103, at 77.
189 M.P. Dooley, ibid. 798. See also D.C. Langevoort, supra note 149, at 770.
190 M. Andrews, supra note 1, at 11; Financing Innovative Enterprise, supra note 6, at 50.
demonstrate the importance which the liability regime represents in underwriting expenses. Such an analysis of the components of underwriting costs is clearly warranted.

While there does not appear to be empirical evidence regarding the cost-effectiveness of underwriter due diligence, several factors indicate that the cost imposed by the liability regime should not be overstated. First, it is important to emphasise the dearth of securities litigation in Canada. This considerably reduces the risk of costly litigation for underwriters. Indeed, while billions of dollars are raised annually through IPOs, Chapman remarks that "as far as can be ascertained from the law reports, no cases have ever come before any Canadian court for trial claiming statutory damages for misrepresentations contained in a prospectus." J.J. Chapman, "Class Actions for Prospectus Misrepresentation", (1994) 73 Can. Bar. Rev. 492 at 494. This is not to say that there is no risk of liability for underwriters; securities actions can be settled before proceeding to trial and leave no trace in law reports. However, the dearth of securities litigation in Canada does suggest that the level of liability risk is rather low and the cost generated by this risk should not be overwhelming, even for underwriters involved in small offerings.

In addition, the existence of persistent over-pricing in the small firm IPO market should not be perceived as increasing the risk of lawsuits. As Janet Cooper Alexander remarks, "securities acts are disclosure statutes, not substantive regulations of the value or price of investments." J.Cooper Alexander, "The Lawsuit Avoidance Theory of Why Initial Public Offerings Are Underpriced", (1993) 41 UCLA L. Rev. 17 at 35. Any action for damages necessitates the existence of a misrepresentation in the prospectus at the time of purchase of the securities offered. Thus, there is no legal basis for a lawsuit because a security was priced too high: "It is the misrepresentation or omissions, not the overpricing, that violates the law." J.J. Chapman, "Class Actions for Prospectus Misrepresentation", (1994) 73 Can. Bar. Rev. 492 at 494.


Ibid. at 35-36. However, strike suits, which professor Cooper Alexander researched, are generally triggered by price drops.
More importantly, the Task Force fails in its analysis to consider that the liability regime has the capacity to allow the underwriting industry to evolve toward the provision of more limited, less costly services and thereby reflect the changes that the small business prospectus form will introduce. The current liability standard does not provide specific duties because of the complexity of the misconduct targeted. Instead, it enacts a rather broad duty of investigation to define the scope of the underwriter's monitoring role. As mentioned, underwriters can escape liability by establishing that they have conducted a "reasonable investigation" of the issuer's representations.

This high standard of conduct leaves it to underwriters to shape the monitoring duties that satisfy the due diligence requirements, subject to ex post review by the courts. The standard of reasonableness used to determine what constitutes a reasonable investigation is "that required of a prudent person in the circumstances of the particular case." The qualification given to the prudent person test suggests that courts will give consideration to the fact that underwriters are professionals expected to a higher standard than that of the ordinarily prudent lay person, since they hold themselves out as possessing special skills and experience. Therefore, it is likely that the standard of reasonableness must be interpreted in relation to the professional standards of the service offered. However, since self-regulatory organisations have not established standards of professional responsibility for underwriters, it is the widely shared business experience of the latter that sets

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197 O.S.A., s. 132.


199 A policy statement issued by the National Association of Securities Dealers dealing with due diligence requirements was briefly in force in 1976-1977. However, one commentator argues that it is unclear whether courts would defer to standards formulated by underwriter self-regulatory organizations as they do for accountants, since they are not considered to be experts E.F. Greene, supra note 152, at 804-806.
the basis of what reasonable monitoring means as well as suggests useful limits on the kinds of misconduct for which they may be held liable.\footnote{200}

The use of established business practices to establish the boundaries of underwriters' monitoring duties tends to limit the costs generated by the liability regime.\footnote{201} The well-understood and predefined character of the liability rule reduces the learning cost of underwriters, including the cost of legal advice.\footnote{202} In addition, underwriters need only provide roughly the same amount of monitoring as they would otherwise do to protect their reputational capital, even though they have "an additional interest at stake (preventing targeted misconduct) and an additional reason to perform carefully (expanded liability for breach)."\footnote{203}

Furthermore, the deference of courts to industry practices implies that if the small business prospectus form is adopted, the liability regime should not constitute a barrier to the reduction of underwriter compensation that will result from changes introduced to the services provided to small issuers, to the extent that such changes gain industry-wide acceptance. For example, the liability regime will not prevent underwriters from undertaking a more limited review of historical financial statements under the SBPF. Likewise, it will not preclude underwriters from adapting their practices and procedures to the needs of firms using the SBPF as these will become the new industry standards


\footnote{201}{R.H. Kraakman, \textit{ibid.} at 79-81; J.R.S. Prichard, "Professional Civil Liability and Continuing Competence", in P. Slayton \& M.J. Trebilcock, \textit{supra} note 96, at 308: "To the extent that the courts adopt the customary practices of the profession as the standard of care, professionals are a privileged group in civil liability actions." Note that following industry practices does not entirely shield professionals from liability if they nevertheless breach a duty of care or if the practices are not reasonable. See \textit{Roberge v. Bolduc,} [1991] 1 S.C.R. 374 at 432-440; \textit{Kripps v. Touche Ross \& Co.}, [1997] 6 W.W.R. 421 (B.C.C.A). In Kripps, auditors had actual knowledge that simple application of general applicable accounting practices would omit material information in financial statements and lead to a misrepresentation. Thus, in this case, the standards put out by professional bodies could not supplant the degree of care called for by law.}


\footnote{203}{R.H. Kraakman, \textit{supra} note 103, at 80.}
for this type of offering. In this respect, note that the proposed safe harbours for omissions and forward-looking information would also allow underwriters to adapt their procedures without fear of excessive liability.

Additional support for the adaptability of the liability regime is found in the standard of reasonableness used to qualify the investigation which the underwriters must undertake. Recall that the extent of the due diligence requirements varies with the circumstances, as illustrates the landmark American decision of *Feit v. Leasco Data Processing Equipment Corp.*

Dealer-managers cannot, of course, be expected to possess the intimate knowledge of corporate affairs of inside directors, and their duty to investigate should be considered in light of their more limited access. Nevertheless they are expected to exercise a high degree of care in investigation and independent verification of the company's representations. Tacit reliance on management assertions is unacceptable; the underwriters must play the devil's advocate. [Emphasis added.]

This case has been interpreted as implying a variable standard of due diligence for underwriters depending on "a variety of other circumstances [that] may deprive the underwriter of access to information essential to establishing that he conducted a reasonable investigation".

Thus, the standard of reasonableness is flexible and permits the modulation of the due diligence requirements to reflect the relationship that will exist between underwriters and issuers under the new small business prospectus. The circumstances that can compel underwriters to narrow their investigation of the information disclosed in the prospectus, and affect the reasonableness of their conduct, include the size and nature of the issuer, the type of underwriting

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204 The adoption of Rule 176 by the Securities and Exchange Commission, which deals with due diligence in the context of the integrated disclosure system, is a testament to the adaptability of the liability regime. Rule 176 sets forth a list of circumstances which the SEC believes bear upon the reasonableness of the investigation and "embraces the judicially developed sliding-scale standard for Section 11 culpability". *Reasonable Investigation and Reasonable Grounds for Belief Under Section 11*, Securities Act Release No. 6335, 23 SEC Docket (CCH) 401 (Aug. 6, 1981); J.D. Cox et al., *supra* note 82, at 644.


206 *Ibid.* at 582. In this case, dealer-managers were assimilated to underwriters for liability purposes.


208 V.P. Alboini. *supra* note 44, at § 23.3.1.
arrangement, the role of the underwriter, its degree of involvement and its expertise. Since the SBPF will reduce the degree of involvement of underwriters in new security offerings, it is therefore reasonable to think that the due diligence requirements will be relaxed to reflect the more limited access of underwriters to information. In turn, the diminution of the due diligence expected of underwriters taking SMES to the market should reduce the residual risk born by underwriters by curtailing the risk of liability for misrepresentations that are costly or impossible to detect.

There is however a caveat. While the liability risk of underwriters will be reduced because of the SBPF, the industry standard will not necessarily decline since it does not depend solely on liability risk but also on the necessity to protect reputation. Accordingly, underwriters with reputational capital will continue to wish to avoid failing firms and will therefore continue to conduct thorough investigations. From this it follows that the reduction in the liability risk may not translate in a drastic diminution of underwriter compensation. Thus, although prestigious underwriters may become more accessible for smaller issuers, the latter will continue to have to rely on alternative modes of certification. Likewise, the elimination of underwriter liability would not have a significant impact on the compensation of reputable underwriters who can provide valuable certification to small issuers.

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209 Federal Securities Code, supra note at s. 1704(g). According to Alboini the standard or reasonableness of the Ontario Securities Act is closely aligned to that of the American Law Institute. V.P. Alboini, ibid. See also G.R.D. Goulet, supra note 148, at 236.

210 V.P. Alboini, ibid.; G.R.D. Goulet, ibid. A similar point is made by many commentators about the use of shelf registration. See, e.g., D.M. Green, supra note at 821. However, the Canadian Securities Authorities have taken a more restrictive approach with respect to the prompt offering prospectus (POP) system. National Policy No. 47 clearly states that "nothing in this policy statement shall be construed to provide relief from liability under the provisions of the Securities Legislation". See V.P. Alboini, ibid. at § 23.1.13.

211 The poor information record of SMES increases the difficulty and cost of detecting misrepresentations.

212 Contra M.B. Fox, supra note 159, at 1030-1032.

c) Reforming Conflicts of Interest Rules

Upon completion of an ongoing reform on the regulation of conflicts of interest, potential conflicts of interest between investment dealers and their clients (issuers or investors) will be regulated by Part XIII of the Ontario Securities Regulation\(^{214}\) and by the new Multi-Jurisdictional Instrument 33-105 on Underwriting Conflicts.\(^{215}\) The new conflicts of interest rules address those conflicts arising from the multiple roles performed by investment dealers, and from the existence of relationships between the latter and their clients. They purport to cover also the conflicts related to the abolition of ownership rules.\(^{216}\) The detailed regulation of conflicts of interest is completed by a general duty imposed on underwriters to deal fairly, honestly and in good faith with their customers and clients.\(^{217}\) This general duty, which codifies the "shingle theory" elaborated by the Securities and Exchange Commission,\(^{218}\) gives residual power to the Commission where the rules do not provide adequate protection from conflicts of interest in particular circumstances.\(^{219}\)

As a general principle, the Regulation requires every underwriter intending to deal in the securities of non-arm's length issuers to file with the Commission and provide to its clients a self-dealing policy regarding those transactions.\(^{220}\) The self-dealing policy must also contain an up-to-date list of all non-arm's length issuers of the underwriter and summarize the relationship between

\(^{214}\) O.S.R., s. 219-233. For a useful overview see V.P. Alboini, supra note 44, at § 13.1


\(^{216}\) Conflicts of Interest in Underwriting, supra note 126. at 3163.

\(^{217}\) O.S.R., s. 221, 222. Note however that O.S.R. s. 222 which imposes the shingle theory to every officer, partner and salesperson of a registrant has been held to be ultra vires and is therefore ineffectual. See R. v. Haldenby, [1994] O.J. (QL) No. 1865 (Prov. Ct.).

\(^{218}\) Charles Hughes & Co. v. S.E.C., 139 F.2d 434 (2d Cir. 1943); L. Loss & J. Seligman, supra note 115, at 3772-3798. See also R.S. Karmel, supra note 80.

\(^{219}\) R. Balfour, supra note 131. at 215.

\(^{220}\) O.S.R., s. 223.
the latter and the issuers listed. Thereafter, no underwriting activities involving the securities of non-arm’s length parties should take place unless in accordance with the specific conditions set out in the new regulatory framework governing conflicts of interest.

The scope of the regulatory framework rests on the definition of who is a non-arm’s length party, since that definition determines which relationships and transactions come within the ambit of the regime. Two concepts are relevant in this respect: “related issuer” and “connected issuer”. These concepts attempt to cover relationships “that could have a significant adverse impact on the underwriter’s performance of its due diligence, disclosure and pricing duties in the course of a distribution.”

For our purpose, a “related issuer” of an underwriter is any issuer that influences the underwriter or that is influenced by the underwriter. More precisely, a “related issuer” relationship results primarily from cross-ownership between an issuer and the investment dealer that can give rise to concerns over conflicts of interest. The concept of “connected issuer” refers to some other relationship between the issuer and the investment dealer “that would cause a reasonable prospective purchaser of the securities being offered to question if the registrant and the issuer or selling securityholder are independent of each other for the distribution.”

The regulatory scheme imposes two conditions on underwriters involved in offerings of a related issuer or a connected issuer. Firstly, the distribution must be made by a prospectus which contains comprehensive disclosure of the relationship between the related issuer or connected issuer

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221 Conflicts of Interest in Underwriting, supra note 126, at 3171.
222 MJI 33-105, supra note 215, s. 1.1 (“related issuer”), 1.2(2).
223 Policy 33-105CP, supra note 215, s. 2.1(1)c).
224 MJI 33-105, supra note 215, s. 1.1 (“connected issuer”).
and the underwriter.\(^{225}\) More precisely, the prospectus must indicate the nature of the existing relationship between the issuer and the underwriter, the involvement of the underwriter in the decision to distribute the securities offered, including the terms of distribution, and the effect of the issue on the registrant.\(^{226}\) This obligation is complemented by the general obligation of issuers to disclose the holdings of any promoter\(^{227}\) or any person or firm that beneficially owns 10 per cent or more of any class of its securities.\(^{228}\)

Secondly, an independent underwriter, who is not related or connected to the issuer, must underwrite a portion of the issue that is at least as great as that underwritten by the non-arm’s length underwriter.\(^{229}\) The rationale justifying the independent underwriter requirement is to ensure that full and true disclosure is made and that the terms and conditions of the offering are fair to investors.\(^{230}\) While this objective is laudable, it must be kept in mind that “[t]he question is whether the institutional arrangements enlarge or diminish the uninvited harm done by such conflicts, and whether the costs of changing the arrangements exceed the benefits to be derived.”\(^{231}\)

Prior to the recent reform, the conflicts of interest rules also required that an independent underwriter “underwrites” a portion of the offering. However, they did not compel the arm’s length underwriter to perform a particular role in the transaction and did not provide a specific definition

\(^{225}\) O.S.R., s. 224(1a); MJI 33-105, *ibid.* s. 2.1(a).

\(^{226}\) V.P. Alboini, supra note 44, at § 13.1. A summary of the relationship between the issuer and the registrant must also be disclosed in bold face on the first page of the prospectus.

\(^{227}\) Promoter is defined as any person involved in the founding, organizing, or subsequent reorganizing of their business, or who receives in connection with such activities 10 per cent or more of any class of their securities. The promoters are required to certify the accuracy of the information disclosed in the prospectus and assume, thereby, liability for misrepresentations in the prospectus.

\(^{228}\) O.S.R. Form 12, item 15, 26.

\(^{229}\) O.S.R., s. 224(1b); MJI 33-105, *supra* note s. 2.1b). See also *Conflicts of Interest in Underwriting*, *supra* note 215, at 3177-3178; *Regulation of Conflicts of Interest*, *supra* note 125, at 5268-5269.

\(^{230}\) *Conflicts of Interest in Underwriting*, *ibid.* at 3165.

\(^{231}\) M. Mayer, “Broker-Dealer” in Twentieth Century Fund, *supra* note 107, at 435. On the cost-effectiveness goal of conflict of interest rules, see R.A. Schotland, *supra* note 107, at 15-16. The Canadian Securities Administrators Committee on conflicts of interest recognized that the level of regulatory protection should be the lowest amount consistent with a reasonable degree of investor protection. *Conflicts of Interest in Underwriting*, *ibid.* 3168-3169.
of underwriting. In the absence of a clear indication, the independent underwriter followed industry practice and relied on the due diligence, disclosure and pricing decisions made by the issuer and the lead underwriter. Thus, the Canadian Securities Administrators Committee on Conflicts of Interest remarked that “[t]he participation of the independents has not in fact afforded the market any significant additional protection from conflicts of interest.” In such a setting, it was doubtful that the requirement for independent underwriter participation was cost-effective for any issuers.

As an attempt to deal with the variable involvement of independent underwriters in the IPO process, the new conflicts of interest rules now require that the independent underwriter be identified in the prospectus. Moreover, the prospectus must disclose the role of the independent underwriter in the structuring, pricing and due diligence activities of the distribution. Even if the role of the independent underwriter becomes more precisely defined, it is contended that the cost of the independent underwriter involvement would nevertheless outweigh its benefits for small issuers. Indeed, the requirement would burden excessively smaller issuers by imposing the obligation to bear the cost of a second underwriter. Unlike larger issuers, it is not typical for small issuers to have more than one underwriter since the size of their offerings does not generally warrant the formation of underwriting syndicates.

Fortunately, the drafters of the new regulatory regime appear to have taken into account this concern. The rules will now provide for a non-discretionary exemption from the requirement to involve an independent underwriter where certain conditions are met. More specifically, an investment dealer will be allowed to act as underwriter of a distribution by a connected issuer where the issuer is not a “specified party” or where the only relationship between the issuer and the

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232 *Conflicts of Interest in Underwriting*, ibid. at 3176.

233 Ibid. (the Committee recognizes that by failing to impose a measure of objectivity to the underwriting process the independent underwriter does not add value).

234 MJII 33-105, *supra* note 215, s. 2.1(c).

235 R.A. Schotland, *supra* note 107, at 16, notes that solutions to conflicts of interest problems “that do not take variations in firm size into account may overburden small firms.”

236 MJII 33-105, *supra* note 215, s. 3.2.
investment dealer is a “minor debt relationship”. Pursuant to the new rules, a “specified party” is a person or company that is under some financial stress. A relationship is a “minor debt relationship” where the aggregate debt owed to the investment dealer, plus the preferred shares of the issuer and their related issuers, owned by the investment dealer is less than 10 per cent of the value of the issuer’s equity.

This new exemption from the independent underwriter requirement should not lead to greater risk of investor exploitation. Conflicts of interest arising from a relationship between an underwriter and an issuer can be effectively controlled through the disclosure requirements. Disclosure allows investors to make their own assessment of the relevance of a given relationship between an underwriter and an issuer, and of its impact on the securities offered. Mayer colourfully remarks:

Customer skepticism remains the best protection against abuse of conflict of interest in any trade or profession. Neither court nor bureaucracy can protect a fool from his folly or a hog from his greed.

For disclosure to provide adequate protection, investors must however have the necessary information to review the transaction and be able to give informed consent. This is ensured by the requirement that the non-arm’s length relationship of underwriters be disclosed in the prospectus.

However, it must be acknowledged that in certain circumstances, underwriters may have incentives to hold information about specific relationships confidential. Nevertheless, there are a

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237 MJI 33-105, ibid. s. 1.1 (“specified party”).

238 MJI 33-105, ibid. s. 1.1 (“minor debt relationship”).

239 In its recommendations, the Joint Securities Industry Committee on Conflicts of Interests recommended that the rules be amended to cover situations in which the holdings of dealers, or employees or securities dealers, may be small when taken individually but are significant when taken in aggregate. It remarked that it was not in the best interests of investors or the marketplace in general for such a situation to exist without being disclosed. Strengthening Emerging Company Markets, supra note 17, at 21.

240 M. Mayer, supra note 231, at 435.

241 Regulation of Conflicts of Interest, supra note 125, at 5282-5284; R.A. Schotland, supra note 107, at 577.

242 Conflicts of Interest in Underwriting, supra note 126, at 3166 (noting that underwriters are interpreting the rules in a very conservative manner to address any relationship between them and their issuers that might possibly be viewed as giving rise to a connected issuer or related issuer relationship).
number of parties in every underwriting with different interests and duties that play an important role in ensuring that the information disclosed in the prospectus is accurate and complete.\textsuperscript{244} Although counsel is not directly liable for prospectus misrepresentations under the \textit{Securities Act}, except for any parts that they may have expertised,\textsuperscript{245} he/she can be liable to their clients for negligent advice in the preparation of the prospectus if the client is found liable for a misrepresentation in the prospectus.\textsuperscript{246} In addition, the lawyers arguably have a professional obligation to assist their clients in meeting the required disclosure standard and to discourage them from producing a misleading prospectus.\textsuperscript{247} Moreover, auditors impose a measure of objectivity on the underwriting process by certifying the accuracy of the financial information disclosed in the prospectus.\textsuperscript{248} Accordingly, the presence of lawyers and auditors “reduces the risk that a relationship between the issuer and the underwriter would negatively affect the underwriter’s performance of its due diligence duties.”\textsuperscript{249}

Critics who question the ability of investors to assess the risks of conflict of interest transactions also argue that disclosure will have an undesirable effect by encouraging investors to believe in the integrity of the underwriter and, thereby, to reduce their natural caution.\textsuperscript{250} These critiques should not be overstated. Regulators recognize that “there is little hard evidence that

\textsuperscript{244} \textit{Regulation of Conflict of Interest, supra} note 125, at 5284.

\textsuperscript{245} \textit{Conflicts of Interest in Underwriting, supra} note 126, at 3169.

\textsuperscript{246} \textit{O.S.A.}, s. 130.


\textsuperscript{248} V.P. Alboini, \textit{ibid.} at 253-255; M.R. Gillen, \textit{ibid.}; G.R.D. Goulet, \textit{ibid.}

\textsuperscript{249} \textit{Conflicts of Interest in Underwriting, supra} note 126, at 3169.

opportunities for conflicts are routinely exploited in a manner that results in actual abuse."251 This proposition is consistent with evidence showing that underwriters that systematically misprice their offerings damage their reputation and lose market share. Furthermore, there is empirical evidence indicating that the market reacts to conflicts of interest resulting from the presence of non-arm’s length underwriters by discounting the securities offered.252

In sum, the new regime governing conflicts of interest appears to strike a sound balance between the need to control conflicts of interest through regulation, and the interests of smaller issuers that may not be able to afford the costs of regulatory requirements.

4. **The Distribution of Initial Public Offerings**

   a) An Alternative to the Registration of Sales Representatives

   A central role of the investment dealer during an initial public offering is to act as an intermediary between the issuer and investors. Usually, the dealer will contact potential investors, give them information about the securities offered, and solicit offers to purchase. This reduces issuers’ search and transaction costs by allowing them to benefit from the dealer's distribution network.253

   The marketing of small firm IPOs is generally undertaken by a single investment dealer firm. The small size of these offerings does not warrant the formation of a selling group and therefore there is only one dealer designated as the exclusive agent to offer the securities for sale to the public.254 Similarly, the nature of best efforts offerings makes it unnecessary to form an

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251 Regulation of Conflicts of Interest. supra note 125, at 5259.


253 R.C. Perez, supra note 109, at 58.

Recall that in best efforts agreements, investment dealers do not purchase the issuer's securities but rather act as a placement agent and receive a commission for the sales completed. Thus, dealers are under no obligation to sell the entire issue and do not bear an underwriting risk if the offering is unsuccessful.

The presence of a sole investment dealer in small IPOs has an important drawback. It limits the scope of the distribution network for the offering. This is particularly worrisome given that national dealers do not have access to a pool of retail investors deep enough to form the basis for a distribution network for small IPOs. Indeed, as mentioned, the bulk of the business of national dealers is generated by large issues marketed primarily to institutional investors. However, new issues by SMEs are often too small to be distributed through the same methods investment dealers use for larger issuers. The dearth of regional dealers in Canada limits the assistance that can be provided to national underwriters distributing SME IPOs and this contributes to their disinterest in that type of offerings.

Acknowledging these difficulties, the Task Force on Small Business Financing had suggested in its Proposal for Comment to eliminate the requirement that a registrant must be involved in a public offering in its professional sales role. However, the Task Force abandoned this proposal in its Final Report, arguing that dealer involvement would be dictated by the demand side:

For that reason, because as a practical matter most investors in an SME public offering will invest through a dealer, and because of the benefits of the involvement of a professional

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255 One reason cited to form a syndicate of underwriters is to have more than one analyst following the security. M. Andrews, supra note 1, at 8.

256 In the U.S. national underwriters use underwriting syndicates with substantial geographic diversity to distribute new issues. The syndicates typically include high-grade regional investment bankers to ensure widespread national distribution of the issues. R.C. Perez, supra note 109, at 62. See also Competing in the New Global Economy, supra note 4, at 177.

257 See Strengthening Emerging Company Markets, supra note 17, at 8.

sales representative [...] the Task Force is now of the view that the requirement to involve registered sales representative should be retained.259

This decision of the Task Force is unfortunate. Indeed, unregistered sales representatives could play an important and valuable role in the distribution process. Far from replacing registered dealers in the distribution function, unregistered salespeople could assist underwriters in providing a more widespread distribution of smaller offerings.260 For example, the investment dealer acting as underwriter could form a selling group comprised of unregistered sales representatives with "grass roots" strength to which it could leave a portion of the offering for sale to retail investors. Alternatively, the underwriter — or the issuer — could rely on emerging internet matching systems to enhance the distribution of the offering.261 Internet matching systems offer vast potential for the marketing of new issues with retail investors as remarks Choi: "Because of the breadth of the internet, investors may obtain information on particular companies and securities, whether located domestically or abroad, at low expense and almost instantaneously."262

In order for the proposal to realize this promise, adequate safeguards would have to exist to ensure an acceptable level of investor protection and foster confidence in unregistered salespeople. The Task Force had not however addressed in its proposal what safeguards would ensure investors protection from abuses of unregistered sales representatives. Undoubtedly, this may have influenced the decision of the Task Force to abandon the proposal in its Final Report.

As a starting point, it is proposed here that the actual licensing of sales representative, i.e. the registration requirement, should be replaced by a requirement that the latter register their names with the securities commission. Unlike the actual licensing of sales representatives, this form of

259 Task Force Report, supra note at 153. at 101.

260 M. Andrews, supra note 1. at 8. In the eight growth firm IPOs surveyed, in at least one case, a specific underwriter was added to the syndicate to ensure broad retail distribution of the issue.


262 S.J. Choi, ibid. at 10.
registration would not purport to prevent anyone from entering into this activity but would only be used as a device for gathering information and, if necessary, collect reasonable fees for administration. Thus, while the licensing requirement would be removed for sales representatives involved in SBPF IPOS, salespeople would remain nevertheless bound by the same legal requirements as registered securities dealers. As we will see, this approach should guarantee an acceptable level of investor protection while considerably reducing the burden for individuals or firms interested in acting as sales representatives.

b) Regulatory Mechanisms Protecting Investors: A Focus on Output Quality

Dealers hired to distribute new issues are in a classic agency relationship with issuers which can lead to adverse selection and moral hazard problems in the context of imperfect information. While issuers may have some difficulty detecting the quality of dealers ex ante, the risk of ex post opportunism is considerably reduced by the use of commissions to compensate dealers. When dealers are compensated on a commission basis, their economic interest, which is to generate the maximum amount of sales so that they can earn the maximum compensation, is in line with the interest of the issuers' which is to have their offerings distributed successfully among investors. In this respect, the saying “New issues are sold, not bought” emphasizes the energy that is devoted by members of the IPO team to the promotion and distribution of the securities offered.

If the interests of dealers are aligned with those of issuers by the use of commissions, the same cannot be said, however, for the relationship between dealers and potential investors.

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263 The usual argument against removing registration requirement is that market participants would become unregulated. See D.C. Langevoort, supra note 115, at 21: J.D. Scarlett, supra note 112, at 152-153. The proposal purports to address this criticism by maintaining the current regulatory framework.

264 While the level of the commission varies with the nature of the issue, it is generally correlated to the expected difficulty of selling the security, which depends on the security’s level of risk.


266 In theory dealers can be said to be in a three-way conflict of interest. However, since the interest of dealers is aligned with those of issuers, it is more appropriate to qualify the conflict of dealers as a self-interest conflict.
Investors are in a similar position towards dealers marketing new issues as they are with dealers acting as gatekeepers. Although investors are not in a contractual relationship with dealers marketing IPOs, and do not select the latter either, they cannot be assimilated to classic third parties. Indeed, dealers selling securities generally seek to cultivate investors' trust and therefore build close relationships with the latter. Thus, investors are also second parties to the distribution function. However, the incentive structure of distribution contracts skews the dealers' interest in favour of issuers and can lead to potential abuses of investors. The existence of ownership stake held by dealers in issuers will magnify the risk of abuses. Those abuses form the main rationale for mandating the registration of dealers hired to sell new issues in the market.

In their classification of policy options for professional regulation, Wolfson et al. make a distinction between output regulation, which focuses on the quality of the service produced, and input regulation, which focuses on the producers of the services. Input regulation is generally achieved through the enactment of entry requirements in a particular market attempting to set a minimum quality standard. On the other hand, output regulation establishes a minimum level of quality by concentrating on transactions without attempting to regulate entry into the market per se.

The current regulatory framework relating to sales representatives approaches the problem of quality through the control of input as well as output quality. It is argued that one layer of regulation, namely input monitoring, could be removed without compromising investor protection to facilitate entry of new participants in this segment of the securities industry. With respect to the sale of new issues, the registration of sales representatives protects investors only in so far as it establishes the applicability of regulatory requirements. As we will see, the bulk of existing rules

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267 The case of the underwriter is analogous to that of auditors. M.J. Trebilcok et al., Professional Regulation, (Toronto: Queen's Printer, 1979) at 38. See however V.P. Goldberg, supra note 128, at 301.


269 A.D. Wolfson et al., supra note 32, at 197-212.
protecting investors from abuses in the distribution of IPOs set standards for output quality and are sufficient to enforce sanctions against incompetent or unacceptable performance.

i) Protection from Pressure Selling

Sales representatives are paid a commission on the securities sold during the distribution, profiting from sales regardless of whether investors profit from buying the securities. They therefore have economic incentives to persuade investors to buy the securities issued in the IPO. Sales representatives can generate demand for a new security by passing on accurate information to prospective investors about it. They can provide investors with accessible and customized information about the set of investment options available in the market, and more particularly the security issued.270 In doing so, they can also assist investors in identifying their investment needs and objectives, and assess whether a particular security is consistent with them.

Assuming the accuracy and truthfulness of the information provided by the dealers, a first source of concerns nevertheless arises with respect to the dealers’ competence in advising investors about their portfolios. In the presence of information asymmetries, investors may not be able to assess the value of the dealers’ competence, nor of their recommendations, because of the dispersion in the quality of services supplied and the heterogeneity of abilities, qualities, talents, training and general competence. Thus, investors may be lead into bad investment decisions by less competent dealers.

A second source of concern arises from the compensation structure which makes sales representatives “as much a salesperson as a transmitter of information.”271 While the latter’s objective may be to transmit accurate information about a security, their first and foremost objective is to maximize profits by stimulating sales. Demand generation can be achieved by persuasion. A sales

270 Note that under the current regime a registered dealer need not be registered as an adviser. O.S.A. s. 34(c).

representative can generate demand for a particular security by instilling in investors an increased willingness to take investment risk. This will generally take the form of a modification of investors’ risk aversion through promises of a higher desired return and then the suggestion of specific investments recommendations.

Sales can also be stimulated through the use of misrepresentations or omissions about the securities creating perceived opportunities for profits. Sales representative may, among other things: conceal relevant information to induce investors to purchase the securities; misrepresent the availability of the security; misrepresent that the issue is oversubscribed; misrepresent that they have themselves bought the security; misrepresent that others have purchased the security.272 Likewise, they may make recommendations to purchase a security without having a reasonable basis for their recommendations, e.g. without having essential information about the issuer, or without disclosing the lack of essential information.273 For example, sales representatives may make unfounded claims about new issues which are difficult for investors to verify such as promises of extraordinary returns which never materialize. They may also make such unenforceable guarantees as that "the security will be repurchased at a given price, that the purchase price of a security will be refunded, that the price will increase to or not fall below a certain amount, or that the future marketability of the security is guaranteed".274

Several techniques have been developed by the securities industry to stimulate demand for a particular security by imparting biased and incomplete information to investors. These techniques are well-known and have been discussed extensively elsewhere.275 They often involve the crude


274 M.R. Gillen, supra note 34, at 367.

pressure selling tactics of boiler rooms, cold calls, and outright misrepresentations. The primary goal of pressure selling is to overcome customer suspicion and build trust so that the representations made are believed, and the recommendations acted upon. The selling techniques typically "involve predicting or discovering the needs and objectives that the customer brings to the interaction, building a sales pitch around them, countering objections and getting a prompt close."

The extent of pressure selling in the context of small firm financing is difficult to estimate in the absence of empirical evidence. Contrary to the opinion of one author, "boiler rooms" have not been effectively closed down in Canada. Indeed, anecdotal evidence indicates that pressure selling continues to be the prevalent modus operandi in the penny stock market. Moreover, the OSC Task Force on Small Business Financing notes that most dealers getting involved in the marketing of small firm IPOs have concentrated on "high pressure" marketing, rather than investor assistance.

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277 Sales staff making cold calls usually work from scripts which are designed to "take advantage of potential investors' lack of sophistication in financial matters and play on basic human emotions such as shame, fear, and, above all, greed." Using the scripts, they make three or more calls to potential investors where they will play more on emotions and psychological factors than argue the merits of the investment. J.I. Goldstein et al., supra note 275, at 788-789.

278 D.C. Langevoort. supra note 268, at 651.

279 M.R. Gillen. supra note 34, at 367.


281 Task Force Proposal, supra note 258, at 74 n. 94.
Because of the risk of abuses raised by high-pressure selling techniques, the Securities Act imposes several constraints on selling activities prior to the issuance of the receipt for the final prospectus to protect investors. Presently, firms considering the opportunity to make an IPO are prohibited from testing the waters prior to the filing of a preliminary prospectus.\(^{282}\) Once the preliminary prospectus is filed, selling efforts are constrained during the waiting period. Sales representatives can only identify the security, its price, and where it can be purchased, distribute the preliminary prospectus, and solicit expressions of interest in the purchase of the security. The purpose of these restrictions is to prevent issuers, underwriters and brokers from making misrepresentations about the securities in order to persuade investors to buy the securities.

Secondly, investors who purchase a security are granted a right of withdrawal from a purchase within two days of receiving the final prospectus.\(^{283}\) The withdrawal right allows the investor some time to calmly review the opportunity of the investment decision, in light of the information contained in the prospectus. It reduces therefore the risk of unsound decisions made hastily under the pressure of sales representatives.

Thirdly, the Securities Act prohibits certain types of trading representations that may be used to entice prospective investors into making investments they would not otherwise make. Thus, sales representatives are enjoined from making any representations concerning a repurchase, resale or refunding of the purchase price of the security, unless the security carries an obligation of the issuer to redeem or purchase, or a right of the shareholder to require redemption or purchase.\(^{284}\) The Act also forbids undertakings concerning the future value or price of a security, including guarantees, estimates, conjectures, and other statements related to the future value or price of a

\(^{282}\) It has been argued previously in this dissertation that allowing firms to test the waters would not lead to abuses. Supra Chapter IV, notes 236-255 and related text.

\(^{283}\) O.S.A., s. 71.

\(^{284}\) O.S.A., s. 38(1).
Finally, no representation can be made that a security will be listed on a stock exchange or that application has been or will be made for such listing.  

It is worth pointing out that registered dealers can visit any residence in Ontario or telephone from Ontario to any residence within or outside Ontario for the purpose of trading in securities. Door-to-door and telephone sales techniques, typical of boiler-rooms operations, often involve pressure selling and were prohibited in the former Securities Act. While these techniques are now allowed under the current legislation, the Commission retains authority to revoke or restrict the ability to make visits or telephone calls with respect to any person or any security. Thus, the Commission possesses the ability to regulate any abuses in the direct marketing of securities.

ii) The Regulation of Investment Advice

There is an element of advising which is incidental to any trading activity. However, since the advising activity is an integral part of the trading activity, dealers have been traditionally exempted from the obligation to register as advisors. Thus, dealers can give advice incidentally to their trading function, without having to comply with the proficiency requirements imposed on investment advisors.

285 O.S.A., s. 38(2). Construed narrowly, undertakings would cover only guarantees. See D.L. Johnston, supra note 34, at 353. However, Alboini, reviewing certain decisions of the OSC, concludes that a broader meaning can be given to undertakings so that it covers, estimates and forecasts. V.P. Alboini, supra note 44, at § 13.3.1.

286 O.S.A., s. 38(3). “OSC Policy Statement 5.1: Prospectuses – General Guidelines”, in Canadian Securities Law Reporter, supra note 82, ¶471-501, s. 7, permits the inclusion in the prospectus that a stock exchange has conditionally approved the listing of the issuer’s securities.

287 O.S.A. s. 37.

288 V.P. Alboini. supra note 44, at § 13.2.1.

289 O.S.A. s. 37(2).

290 D.C. Langevoort, supra note 268, at 680; M. Mayer, supra note 231, at 433; Report on the Requirements and Sources of Capital, supra note 62, at 21; J.D. Scarlett, supra note 112, at 177.

291 O.S.A., s. 34(b).
This does not imply that the advisory activities of dealers are left unregulated. Investors, especially unsophisticated investors, are often dependent on their dealers’ investment advice and arguably need some protection from abuses. Thus, the Regulation imposes on registered dealers the obligation to make investment recommendations suitable for their clients. Dealers must “know their clients” by learning the essential facts related to their clients’ financial position, investment objectives and needs. In light of the information gathered, they must make investment recommendations suitable for their customers. Suitability refers to the dealers’ prudence and diligence in matching their recommendations to their clients. A suitable recommendation is one that matches the client’s needs and objectives to the appropriate securities. When dealers conclude that a security is unsuitable for their clients’ capacity, they must convey this information to their client in clear and understandable terms.

The suitability rule rests on the assumption that disclosure requirements do not adequately protect investors from pressure selling techniques. These techniques can lead investors to overlook disclosure documents and make hasty investment decisions that are not consistent with their financial situation and needs. By enacting this rule, regulators purport to ensure that investment recommendations provided to investors will be appropriate in light of their particular financial capacity.

292 O.S.R., s. 114(4).

293 The “know your client” rule is not only important for the suitability doctrine. The rule intends to minimize dealers’ risk of financial losses. Gillen explains: “The idea is that since brokers and dealers are often in the position of extending credit to clients they ought to be careful about the credit risks that they accept.” M.R. Gillen, supra note 34, at 381.

294 O.S.R., s. 114(4).


The suitability rule would undoubtedly apply to unregistered sales representatives involved in the distribution of SME offerings. Indeed, the extent of the rule is far reaching. A dealer cannot avoid its application by failing to inform himself on his client’s situation since the essence of the rule is to impose a duty to know the client.\textsuperscript{297} Although some authorities suggest that the dealer should be relieved from the suitability duty when his relationship with the customer is that of an order clerk, e.g. where the customer is looking solely for trading execution and disregards any investment advice offered, or where the dealer offers only matching services, a reading of section 114(4)b) of the Regulation, which imposes a suitability duty, indicates that this view is untenable.\textsuperscript{298} The section encompasses more than recommendations as it requires that a dealer ensures the suitability of “a proposed purchase or sale” for the client. Accordingly, the suitability rule extends well beyond recommendations made by the dealers and on which customers rely, to encompass almost any sale of securities to customers, even where the latter do not rely on the special skill and knowledge of the dealers.\textsuperscript{299}

One important consequence of the suitability rule is to shift the responsibility for making inappropriate investment decisions from the investors to the sales representatives.\textsuperscript{300} This is arguably necessary because of the reliance investors place upon the superior competence of dealers in investment decisions: “[t]he principles of [the suitability] rule place the burden of guarding against inappropriate investment decisions on those who claim to, and in most cases do, have superior skill.”\textsuperscript{301} However, because of the interpretation given to the concept of suitability, the

\textsuperscript{297} M.Q. Connelly, supra note 41.

\textsuperscript{298} R.H. Deacon & Co. Ltd. v. Varga (1972) 30 D.L.R. (3d) 654 (Ont.C.A.); conf. (1973) 41 D.L.R. (3d) 767 (S.C.C.). The decision is criticized by M.Q. Connelly, ibid.; D.L. Johnston, supra note 34, at 111. Contra Zagha v. Kingwest Securities Ltd. (1981) 13 B.L.R. 129 (Ont.S.C.) (Broker found liable for the client’s losses resulting from trading in options, even though trading was made in accordance with the directions given by a friend of the investor.).


\textsuperscript{300} R.H. Mundheim, ibid.

application of the suitability rule to unregistered sales representatives could considerably dampen their interest in SBPF offerings by imposing too high a level of risk on their activities.

The dominant approach to suitability rests on the legal conception of risk which focuses on the risk of capital loss associated with particular securities rather than with the portfolio as a whole. Thus, when regulators assess the suitability of a recommendation, they examine the risk levels of individual securities in light of the investors' objectives, without any consideration to the impact of the securities on the total risk of these investors' portfolios, as suggested by modern portfolio theory. Stated differently, the current approach to suitability analyzes a particular security's risk vis-à-vis the level of risk the investor is willing to bear, as implied from his investment objectives, and does not consider whether the security's risk is one which the investor has the capacity or ability to bear given the actual risk level of his portfolio. Accordingly, a recommendation to buy a high risk security will be judged to be unsuitable for a low-risk customer even if the total risk of the customer's portfolio remain below his risk preference.

Furthermore, the interpretation of suitability does not acknowledge that return as well as risk must be evaluated when deciding if an investment is suitable. The analysis of suitability does not take into account the expected returns of investments even though "many times an investor will be more concerned with returns and less so about risk and, therefore, would be willing to make riskier investment with a higher probability of return." For this reason, a dealer cannot justify a

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303 Note, supra note 296, at 1085-1086. See e.g. In the Matter of Frederick Elliot Rosen, (1991) 14 O.S.C.B. 1091 at 1106 (Any individual trade did not result from an unsuitable recommendation since any one of those trades, when viewed in isolation, could be said to be encompassed by the relatively aggressive and speculative objectives that the investors appeared to have adopted over time.); In the Matter of Aatra Resources Ltd. et al., supra note 295, at 5128 (know your client rule was breached in that clients invested large position in speculative securities despite their inexperience); In the Matter of Trend Capital Services Inc., supra note 301, at 1769-1770 (know your client rule was breached as the majority of clients were from a lower income bracket and had little business and market experience).

304 R.H. Munheim, supra note 299, at 474 (suggesting that suitability should refer to each customer's risk threshold as determined by the customer's willingness and ability to bear risk).

305 J.E. Kerr, supra note 295, at 821.
risky recommendation to a risk-averse customer on the ground that the returns were large enough to offset the high risk.

The application of the suitability rule to unregistered sales representatives would impose considerable risk of loss on the latter given that the bulk of dealer-customer litigation involves unsuitability claims. Since SME securities are riskier than those of more established firms, the recommendations of sales representatives concerning such securities are more likely to be judged unsuitable when analyzed with respect to investors' willingness to bear risk. The potential risk would be magnified by the fact that their practice would be limited to small business offerings. Thus, sales representatives would not be able to reduce the risk of unsuitability claims by recommending less risky investments. Accordingly, for the involvement of unregistered sales representatives to be more than just a possibility, investors should retain the responsibility to determine investment suitability.

This does not mean that investors would be left without protection. The shingle theory requires that recommendations made by dealers have a reasonable and adequate basis in fact. For dealers to have a reasonable basis for their investment recommendations, they must make a reasonable investigation into the quality of the securities and base their recommendations on the findings of such investigation. Furthermore, the facts known or reasonably ascertainable which bear on the justification of the recommendation must be disclosed. Where any essential information about issuers is lacking for a complete analysis of the securities, dealers must disclose this lack of knowledge to investors seeking advice.

306 This is at least the trend in the U.S. See D.C. Langevoort, supra note 268, at 690.


308 H. Shefrin & M. Statman, supra note 250, at 26 (remarking that the suitability rule has encouraged dealers to pursue low risk investments).


The requirement for a reasonable basis arises in connection with a recommendation. Thus, in principle, the requirement should apply to actions implying more aggressive or positive conduct than mere offer for sale or sale of securities.\(^{311}\) In this respect, the participation of the dealer in the selling process represents a relevant criterion to identify the transactions that are more usually accompanied by recommendations.\(^{312}\) It is reasonable to assume that, where the dealer is actively engaged in selling the securities, he will provide additional efforts beyond the mere sale of the securities, in the form of recommendations, to ensure the success of the distribution and earn the commissions.\(^{313}\) For example, recommendations are more likely to accompany the sale of securities where the dealer has undertaken to distribute a substantial block of securities. Likewise, the number of investors contacted by the dealer can give an indication of the extent of the selling efforts. In addition, it seems economically justifiable to impose a duty of reasonable investigation on the dealer in such circumstances given that such investigation will benefit from scale economies.\(^{314}\)

In this perspective, unregistered sales representatives, whether acting as traditional salespersons, or providing matching services, should be governed by the reasonable basis rule as they would generally be actively involved in the sale of the securities. Among the possible exceptions would be cases where the salespeople receive and execute an unsolicited purchase order since the presence of a recommendation would evidently not be important to the success of the sale.\(^{315}\) Neither would it be economically justified to impose a reasonable basis duty to salespeople in the context of isolated transactions because of the costs associated with the investigation.

The reasonable investigation that dealers must accomplish will depend upon the circumstances. At the minimum, the dealer should amass the pertinent facts and rationally analyze

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\(^{312}\) A.S. Jacobs, *supra* note 272, at 887.

\(^{313}\) *Ibid.* at 561.


\(^{315}\) A.S. Jacobs, *supra* note 272, at 887.
them to have a reasonable basis for their recommendation. In the IPO market, it is contended that dealers should have skepticism towards the information disclosed in the prospectus and analyze it rigorously.

Moreover, the dealer’s role in the distribution will also influence the reasonableness of the investigation. Thus, the existence of a special relationship between the dealer and the issuer requires greater diligence in the investigation. Similarly, “[a]s the number of shares being sold by the broker, the number of customers approached, and the dollar volume involved increase, so should the amount of facts and depth of analysis required.”

Accordingly, investors dealing with unregistered sales representatives will retain access to information that allows them to make their own determination of suitability. To minimize the concerns arising from the elimination of the suitability rule, it is suggested that the reasonable basis rule be complemented by the imposition of regulatory requirements along the lines of the short-lived OSC Policy 1.10 which purported to regulate the marketing and sale of penny stocks. The regulatory framework could firstly mandate the delivery of a generic information statement about the nature of SME investments to unsophisticated investors, along with the preliminary and final prospectuses. This statement, which is also recommended by the Task Force on Small Business Financing in the context of exempt offerings, would indicate to potential investors the type of information that should be considered and assessed before making the investment decision, such as information concerning:

(a) the business and technical background of senior management;
(b) the composition of the board of directors;
(c) an audited balance sheet of the issuer;

Ibid. at 888.

D.T. Rice, supra note 309, at 585-586.

Ibid. at 584; H.L. Pitt et al. supra note 273, at 335.

A.S. Jacobs, supra note 272, at 888.

Task Force Report, supra note 153, at 53-54.
(d) historic financial statements and auditors’ report, if any;
(e) the assumption underlying the forecasts or projections, including auditors’ reports, if any;
(f) length of operating history;
(g) the possibility of litigation regarding claims to intellectual property;
(h) plans for utilization of funds raised through the investment and whether such funds are sufficient to finance the project; and
(i) the liquidity of the security.\textsuperscript{121}

Further, the information statement should recommend that investors unable to assess the above information should seek professional advice. In this respect, unregistered sales representatives should have the obligation to provide along with the information statement a statement concerning their qualifications to give investment advice. This specific disclosure requirement should be made at the time of each new investment recommendation to investors.

To ensure that investors consider the information provided rather than dismiss it as meaningless boilerplate language, the delivery of the statements should have a disruptive effect on the selling process.\textsuperscript{122} This could be achieved by requiring that, prior to the execution of the transaction, investors return to the sales representatives a signed copy of both of the statements acknowledging that they have given consideration to the information disclosed.\textsuperscript{123} The requirement would interfere with the selling process by delaying the moment of closure. Sales representatives would have to interrupt their selling efforts to allow customers the time to receive and consider the disclosure documents. During this interruption, customers would also have the possibility to reconsider their decision away from the salespeople’s influence.

\begin{itemize}
\item \textsuperscript{121} \textit{Ibid.}
\item \textsuperscript{122} D.C. Langevoort, \textit{supra} note 268, at 682-685.
\item \textsuperscript{123} A similar requirement was introduced in the \textit{Penny Stock Reform Act} in the U.S. See J.I. Goldstein et al, \textit{supra} note 275, at 827-830; D.C. Langevoort, \textit{ibid.} at 686-687.
\end{itemize}
iii) Protection from Related Party Transactions

As intermediaries in the distribution of the securities of SMES, sales representatives may have the opportunity of getting involved as principal in the financing of enterprises making an IPO. These intermediaries develop a network of relations with issuers, investors, and other intermediaries, that can provide them with attractive investment opportunities. In addition, their activities in the capital market gives them knowledge of the firms and of the marketplace which helps to overcome information asymmetries surrounding firms in the early stage of development. In fact, anecdotal evidence indicates that it is not unusual for investment dealers to take direct participation in the financing of emerging enterprises, particularly in the early stages.\footnote{Strengthening Emerging Company Markets, supra note 17. at 8.} The involvement of dealers in early stage financing is important as they provide capital, expertise as well as access to a network of investors.

The most important risk raised by the presence of dealers holding stakes in firms going public arises where the dealers provide information or advice to prospective investors as the dealers attempt to force the sale of inflated securities:\footnote{N. Wolfson, supra note 126. at 367-368. For an example, see Burke v. Cory, (1959) 19 D.L.R. (2d) 252 (Ont.C.A.). More recently see B. Critchley & D. Westell, “Stock debacles spur probe”, Fin. Post, September 13, 1996 at 1 (debacles of Cartaway Resources Corp. and Timbuktu Gold Corp. raise suspicion of conflicts of interest by First Marathon brokers).} In an environment of steadily rising stock prices, there is a temptation for brokers and other employees in member firms to participate in early stage financings, and sell out quickly at profits which are significant in relation to the underlying economic risk. This opportunity is often not readily available to the broker’s clients, which leads to the perception of advantageous rules and opportunities for insiders, and therefore of unfairness to other investors.\footnote{Strengthening Emerging Company Markets, supra note 17. at 15.}

A related concern is the fact that the conflict of interest may affect the allotment of IPO securities and prevent investors from having an equal opportunity to participate in attractive financings, especially when issues are oversubscribed.\footnote{Ibid. at 7. See for example Beaulieu v. L.O.M. Securities Ltd., (1993) 50 C.P.R. (3d) 112 (B.C.S.C.)}
To reduce these concerns, the conflicts of interest of registrants involved in the distribution of IPO securities are regulated through the same disclosure requirements and restrictions on activities as underwriters.\textsuperscript{328} Thus, registrants are compelled to file a self-dealing policy with the securities commission. They are also prohibited from acting as a selling group member in connection with a distribution of securities of a related issuer, unless the prospectus contains comprehensive disclosure of the relationship between the issuer and the registrant,\textsuperscript{329} and that an independent underwriter underwrites a specified portion of the issue and signs the underwriter certificate. These obligations are completed by the "shingle theory" which imposes on investment dealers a general duty to deal fairly, honestly and in good faith with its customers and clients.\textsuperscript{330}

It has been argued previously that the independent underwriter requirement was not cost-effective for SMES and should be therefore abolished.\textsuperscript{331} The case for mandating an independent underwriter where a selling group member is involved in the distribution of securities of a related issuer is even weaker. The selling group is generally formed in the late stages of the offering.\textsuperscript{332} For this reason, selling group members have very limited involvement, if any, in the decision to distribute securities, or in the due diligence, disclosure and pricing decisions.\textsuperscript{333} Accordingly, the members have little or no opportunities to influence those decisions or to obtain undisclosed benefits from the transaction and their involvement in the distribution of securities of their related issuers raise minimal conflict of interest concerns. Accordingly, the participation of dealers in these roles should not trigger the independent underwriter requirement.\textsuperscript{334}

\textsuperscript{328} See in general V.P. Alboini, \textit{supra} note 44, at §13.1 ss.; M.R. Gillen, \textit{supra} note 34, at 382-386.

\textsuperscript{329} Recall that issuers must disclose the holdings of any promoter or person, including registered dealers, known to it that beneficially owns 10 per cent or more of any class of its securities. \textit{Supra} note 228 and related text.

\textsuperscript{330} \textit{O.S.R.} s. 221. 222. See however See \textit{R. v. Haldenby, supra} note 217, following which \textit{O.S.R.} s. 222 is \textit{ultra vires.}

\textsuperscript{331} \textit{Supra} notes 232-238 and related text.


\textsuperscript{333} \textit{Conflicts of Interest in Underwriting, supra} note 126, at 3182.

\textsuperscript{334} \textit{Ibid.}
The disclosure of the relationship between a selling group member and a related issuer in the prospectus should nevertheless remain mandated. The disclosure of the identity of selling group members and of their relationships with issuers can impose costs and delays on issuers when selling group members are selected after the prospectus has been finalized. However, as it will be argued below, this information provides an important check on sales representatives that can reduce the risk of abuses and ensure the viability of the proposal.

Neither the Securities Act, nor the Regulation, however enact “client priority rules” ensuring investors a fair opportunity to participate in attractive financings. The rules, which exist under every SRO regime, require that the dealer give priority to customer orders over all other orders. Following these rules no dealer can therefore buy securities ahead of its clients. These rules, which apply particularly in the case of hot issues, promote the integrity and fairness of the capital markets and foster the investor perception of fair play. Although the client priority rules can be inferred from the existence of a fiduciary relationship between the client and the dealer, as shown by the recent case of Beaulieu v. L.O.M. Western Securities Ltd., it is suggested that such a rule should be codified so as to ascertain its application and the uniformity of its content.

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335 Ibid.
337 1 See, e.g., IDA, "Business Conduct - By-Law No. 29", in Canadian Securities Law Reporter, supra note 82, s. 29.3A; Toronto Stock Exchange, "TSE Members Manual", in Canadian Securities Law Reporter, ibid., s. 11.10
336 See Beaulieu v. L.O.M. Western Securities Ltd., supra note 327 (case where a dealer took down securities in an IPO ahead of his clients).
338 Supra note 329.
339 The client priority rule can arguably also be inferred from the shingle theory that compels dealers to deal fairly with their clients A.S. Jacobs, supra note 272, at 879-880: "The shingle theory in reality can be applied to any act the SEC or courts believe a broker should not perform."
c) Possible Objections to the Elimination of the Registration Requirement for Sales Representatives

The use of standards to ensure an adequate level of quality in a service places emphasis on the *ex post* enforcement of misconduct. In the framework proposed in this dissertation, the enforcement of the standards established would be primarily accomplished by the OSC from its own initiative or from investor complaints. The OSC could sanction misconduct through various compliance orders such as a reprimand, a permanent or temporary suspension of activities, or a review of practices and procedures.\textsuperscript{340}

The principal objection to the removal of the registration requirement is that the level of adherence to the legal standards would diminish after the implementation of the proposal. The objection can be divided into two propositions. Firstly, unregistered sales representatives will have greater incentives to engage in corrupt practices. Secondly, the elimination of the registration requirement will compromise the effectiveness of the enforcement of legal standards.

To understand the first proposition, recall that misconduct can be considered to be rational to the extent that the expected return from the conduct exceeds the potential loss, in the form of loss of future income, reputational penalty, and litigation costs. Thus, it can be argued that unregistered salespeople, with little investments at stake in the form of reputation or sunk registration costs, will be more likely to engage in misconduct that registered salespeople, thereby raising the level of non-compliance. However, this argument oversimplifies the issue.

To the extent that the involvement of unregistered sales representatives increases the risk of abuse, reasonable investors are likely to respond to this risk by requiring a discount to buy the securities distributed by such salespeople.\textsuperscript{341} The discount will reflect the risk of abuses as a result of buying securities from unregistered salespeople, and this discount would reflect the latter's

\textsuperscript{340} See the power given by the Commission by O.S.A. s. 127

\textsuperscript{341} S.C. Choi, supra note 146, at 15-16; J.E. Fisch, supra note 146, at 30-31.
reputation. Thus, to avoid this loss, issuers wishing to use unregistered salespeople will provide some level of investor protection by relying on reputable salespeople. Accordingly, less reputable sales representatives will remain marginal in the market, unable to benefit from their corrupt activities.

For investors to be able to discount securities effectively, information on salespeoples' reputations has to be available at a low cost. Imperfect information on unregistered sales representatives reputation will lead to adverse selection and possibly to the breakdown of the market. Mandating the disclosure of the identity of sales representatives involved in an IPO in the prospectus could provide a mean of economizing on information costs. It would enhance the public scrutiny of the activities of sales representatives and permit the establishment of a correlation between a sales representative and his reputation, as it is the case for other intermediaries. In turn, investors would be able to discount the securities of the issuer in accordance with the reputation of the seller involved in the distribution.

The availability of this information at low cost could also allow third-party certifiers to emerge and provide a review of sales representatives useful to issuers and investors. For this to happen, however, these new intermediaries will have to overcome the public good aspects of this information in order to obtain remuneration for their certification activities. Otherwise, they will find it uneconomical to act as certifiers.

Since reputation remains a noisy signal of quality, as mentioned above, it will be important that there exist other mechanisms reducing the incentives and ability of unregistered sales representatives to engage in corrupt practices. In this respect, underwriters could play an important

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342 S.J. Choi, supra note 144, at 584.
343 V.P. Goldberg, supra note 128, at 304.
role as gatekeepers for the quality of sales representatives. Underwriters have the incentives to screen for sales representative quality and possess the ability to do so. The underwriter in a small firm IPO has important control over the offering, including broad authority in all aspects of the distribution.\textsuperscript{345} Thus, it is likely that the underwriter will be instrumental in selecting sales representatives that will assist its own employees in the distribution of new issues, and in negotiating the sales representatives' compensation, as it is the case with managing underwriters in large offerings.\textsuperscript{346} Since, the involvement of corrupt sales representatives may have a spillover effect on an underwriter's reputation and business prospects, underwriters would have incentives to screen sales representative to minimize the risk of such reputational spillover penalty.

But would underwriters leave the gates closed to relatively unknown unregistered sales representatives? There is already an impressive number of consultants who have built a reputation providing various financing services to Canadian SMEs. Most promising are the consultants concentrating in investment matching services in the exempt market.\textsuperscript{347} Investment matching services (IMS) purport to bring together suppliers of capital, especially angel investors, and SMEs needing equity capital. Firms and individuals providing IMS maintain a database containing a list of potential investors categorized according to their investment preferences and patterns. They submit to these investors information on investment opportunities which they have located and previously screened for suitability.

Currently, the function accomplished by IMS is generally limited to an introductory role as they are engaged primarily in matching issuers and investors, rather than in selling securities or advising other as to investments. However, the elimination of the registration requirement for the

\textsuperscript{345} Underwriters exercise a significant influence on the selection of auditors. Supra Chapter III notes 185-187 and related text.

\textsuperscript{346} See e.g. S.N. Allen. Supra note 332. at 320-322.

\textsuperscript{347} For an overview of the diversity of SME financing consultants, see Letter from Sharwood and Company, dated September 15\textsuperscript{th} 1995, in response to request for comments, pp. 7-9, Exhibit 2-4; Letter from Business Centurions, dated September 15\textsuperscript{th} 1995, in response to request for comments. See also Letter from Aird & Berlis, dated October 6, 1995, in response to request for comments, at 18: "there is no apparent reason that a mature IMS [Investment Matching Service] system could not service public offerings by SME's."
distribution of IPO securities could lead some IMS to become involved in the sale of new issues. Presently, most firms and individuals providing IMS perform their services without any registration or exemption from registration and cannot therefore trade in securities.\(^{348}\) Eliminating the registration requirement would allow these firms to use their existing network of potential investors to distribute new issues.\(^{349}\)

Undoubtedly, not every IMS would get involved in the IPO market. However, the absence of a registration requirement would allow these firms and individuals to play a role in distributions where they can bring value-added services. In this respect, it is worth noting that since IMS operate on a regional basis they could help fill the gap created by the lack of strong investment dealer regional presence.\(^{350}\) Moreover, since an important number of IMS are not fly-by-night operators, most would have a sufficiently good reputation to be considered by underwriters.

The extent to which the removal of the registration requirement increases the incentives of sales representatives to engage in corrupt practices is ultimately an empirical question. Nevertheless, as we saw above, two market-based mechanisms are likely to emerge to act as significant deterrent of salespeople opportunistic behaviors. To have a complete view of the impact of the elimination of registration, it is necessary to examine the enforcement mechanisms available

\(^{348}\) Some of the activities performed by IMS arguably meet the definition of "market intermediary", and should therefore require registration, unless an exemption is granted. The Ontario Securities Commission Task Force on Small Business Financing considers that IMS may be in technical violations of securities legislation and has proposed exempting IMS from registration under certain circumstances. However, the question of whether IMS should be registered when operating in the exempt market is beyond the scope of this dissertation, which concentrates on the public equity market. See generally Task Force Proposals, supra note 258, at 75-77.

\(^{349}\) Uncertainty with respect to the legality of IMS may also exist because of the exchange-like activities that perform some IMS. Those IMS may be in contravention with section 21(1) of the O.S.A. that prohibits any person or company from "carrying on of a business as a stock exchange" unless recognised by the Commission. In this context, the Task Force Report recommends that regulatory guidance as to what constitutes the "carrying on of a business as a stock exchange". Task Force Report, supra note 153, at 68-69.

to sanction misconduct. The effectiveness of these mechanisms will influence the rational calculus of salespeople by affecting the likelihood of potential loss from opportunistic behavior.\(^{351}\)

Presently, the supervision of registered dealers involved in the sale of securities in the new issue market is accomplished by SROS — in particular the IDA — as well by the OSC. With the removal of the registration requirement, it is the OSC which would be solely responsible for the enforcement of standards of conduct for unregistered sales representatives.\(^{352}\)

Critiques will stress that the absence of SROS will negatively affect the level of adherence to standards of conduct because of the central role these organizations play in ensuring not only the legal conduct of market participants but also their ethical conduct.\(^{353}\) Membership in a self-regulatory organization gives individuals and firms a common goal in the long-term survival of their enterprise and provides them with greater moral and financial incentives to make the system work.\(^{354}\) At a more practical level, SROs, with their great experience in the industry, provide training, education and guidelines which are crucial for their members to comprehend and meet the standards of conduct.\(^{355}\)

The potential of SROs to instil higher standards of conduct and ensure greater compliance should not be overstated as indicated by the results of a 1992 survey about the state of ethics in the securities industry in North America. The most significant deterrents to unethical behaviour were found to be: (i) governmental sanctions, (ii) moral and religious beliefs, (iii) concern that family and

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352 The “securities dealers” are not subject to the oversight of the IDA since they do not have to meet any membership requirement. Supra note 74 and related text.

353 See e.g. R.S. Karmel, supra note 80, at 1304 (citing authorities); S.A. Romano, supra note 82, at 4826. In the background comments to OSC Policy 1.10, the Commission stressed that it was concerned with the business practice of securities dealers, which are not members of the IDA or the TSE, because they are not subject to the compliance, investigation, disciplinary or other rules, regulations, policies and by-laws of self-regulatory organizations. See OSC Policy 1.10, supra note 329, at 1459-1460.

354 R.S. Karmel, ibid. at 1305.

355 Regulation of Conflicts of Interest. supra note 125, at 5281.
friends will find out, (iv) SRO sanctions, and (v) having a published code of ethics. These results, which may be disappointing for supporters of self-regulation, suggest that SROS may not enforce rules as stringently as securities commissions when disciplining their members.

More particularly, the results may be explained by the important conflict of interest facing SROS face in disciplinary proceedings. Self-regulatory organizations must decide between the commercial interests of their members and a specific regulatory principle. Commentators in Canada and in the U.S. have contended that SROS will generally let the interests of their members prevail by enforcing the rules leniently. The poor ability of SROS in enforcing the standards of conduct with their members was noted by David Lipton, who recommended that "decisions involving conflicts of interest between the self-interests of a regulatory party and a specific regulatory goal should be resolved by the regulatory institution not involved in the conflict." While the whole issue of the division of power between SROS and regulators is beyond the scope of this thesis, the foregoing discussion suggests that leaving the OSC as the sole authority supervising unregistered sales representatives would not necessarily lead to a lower level of compliance regarding the standards of conduct.

A second critique that could prompt the absence of self-regulatory organization relates to the issue of cost. It is generally argued that self-regulation is less costly to the public than government regulation since it is accomplished by organizations financed by the industry. In addition, since they are not subject to the same constraints as a government, SROS are seen as operating more casually and achieving goals more efficiently and at lower cost.

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357 *Supra* notes 80-86 and related text.


359 R.S. Karmel, *supra* note 80, at 1305.
The argument that self-regulation generates lower cost than government regulation appears somewhat more fragile than is commonly supposed. While self-regulation is industry funded, the considerable expenses that it generates are nevertheless inevitably passed back to investors. Furthermore, to have a complete view of the cost-effectiveness of SRO enforcement, it is necessary to consider the cost of the Commission's supervision of SRO decisions, which appears to be necessary given the shortcomings of their disciplinary proceedings. The supervision of the disciplining process generates costly duplication that should be taken into account when assessing the cost-effectiveness of self-regulation. In any case, in the absence of empirical evidence, whether the total cost of self-regulation is less than that of government regulation of the securities industry remains an open question.

In addition, the supervision of unregistered sales representatives' activities by the OSC could be funded by the fees small issuers would pay to file the new small business prospectus form. Indeed, now that it is self-funded, the Commission does not have to give back its surplus of operation to the general accounts and can use the surplus to enhance regulatory compliance. The OSC could therefore use those fees to set up a special small business section charged with the review of the SBPF and the policing of this segment of the market.

Finally, although the securities commission is the most adequate forum to deal with issues pertaining to the conduct of market participants because of its expertise and relative flexibility of intervention, it is important to keep in mind that investors would nevertheless retain private rights of actions to sanction unregistered sales representatives misconduct. Two sources of actions are noteworthy: fiduciary duties and the duty of care.

Investors can rely on the common law of trusts to impose fiduciary duties on salespeople in conflict of interest situations. Salespeople may be considered to be fiduciaries when the

360 P. Dey & S. Makuch, supra note 1, at 1435.

361 Undoubtedly, the Commission enacted Policy 1.10 as the basis of its enforcement activities with respect to penny stocks dealers. See Ainsley Financial Corp. v. Ontario, supra note 280, at 514-515.
circumstances of their particular relationship with their clients make it reasonable to expect that they will act in the best interests of their clients with respect to transaction at issue. The factors courts consider in making this determination are discretion, influence, vulnerability and trust. Applying these principles, courts have found a fiduciary relationship to exist between an investment dealer and his client on numerous occasions. If courts were to find salespeople to be relationship-based fiduciaries, salespeople would be subject to three main duties: (1) the duty of full disclosure; (2) the duty of confidentiality; (3) the duty of loyalty. The scope of the duties would, however, vary with the nature of the particular relationship and require an examination of the precise undertaking of the fiduciary, as well as of the reasonable expectations of the plaintiff.

Aside from the duties arising out of a fiduciary relationship, salespeople may be found to owe a duty of care to their customers. In the seminal case of *Hedley Byrne & Co. v. Heller & Partners Ltd.*, the House of Lords ruled that individuals possessed of a special skill have a duty of care when they undertake to apply that skill for the assistance of another person who relies upon such skill. Applying this principle to the salespeople-customer relationship, Courts could find that salespeople have a special skill in the investment business and therefore have a duty not to be negligent when giving, or failing to give, advice or information to their customers, or executing trades for the latter. If this were to be the case, investors would have a right of action for economic losses arising out of salesperson negligence.

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These alternative sources of duties may hold interesting promise in curbing sales representative misconduct. However, the effectiveness of these duties will remain constrained by the difficulty of establishing the existence of the elements necessary for a cause of action to arise. Investors will have to analyze the specific circumstances of their relationship with the salesperson to determine the existence and the specific content of the duties owed. This analysis, which will involve the costly determination of difficult factual and technical issues, will prove to be a particularly complex task given the uncertainty surrounding the existence and the content of the duties. In addition, investors will have to ascertain that the loss suffered is the result of some breach of the applicable duties.

The significant information and transaction costs associated with these investigative activities will generate a low level of litigation against sales representatives in cases where misconduct has in fact occurred. For this reason, until clearer principles emerge from the application of these duties to sales representatives, the rules enacted by securities legislation, as enforced by securities commissions, will play a central role in protecting investors from the misconduct of salespeople.

See generally J.R.S. Prichard supra note 201, at 311-316; Regulation of Conflicts of Interest, supra note 125, at 5275; A.D. Wolfson et al., supra note 32, at 198-203.
SECTION C: EXPERIMENTING WITH ALTERNATIVE SELLING MECHANISMS: THE (UNCERTAIN) CASE OF COMPETITIVE BIDDING

The dominant type of underwriting used by issuers is the 'negotiated' variety which includes both firm-commitment and best efforts contracts. Commentators, pointing to the systematic mispricing of IPO securities, have suggested that issuers should experiment with other selling mechanisms, and particularly with competitive underwriting.\(^{368}\) This section will examine whether SMEs should use this alternative method to reduce their flotation costs and enhance pricing accuracy.

1. An Overview of Competitive Bidding

The competitive bidding mechanism allows issuers to use an auction to select the lead underwriter of the IPO.\(^{369}\) There are three different sort of auctions that firms can use to conduct competitive bidding: the English, or ascending bid, auction, the Dutch auction, and the sealed bid auction.\(^{370}\) In an English auction, bidders announce publicly their bids and may make as many bids as they like for the good. The good is allocated to the bidder who makes the final and highest bid. In a Dutch auction, the price of the good is set at an initial, high level and then lowered until someone makes a bid. The first and only bidder receives the good. Finally, in a sealed bid auction, prospective buyers submit secret bids and the good is allocated to the highest bidder.

The costs incurred by firms in issuing securities under negotiated and competitive bidding mechanisms include two components: the direct cost, or underwriter commission, and the changes in the market price of the securities. Proponents of competitive bidding submit that both of these


costs would be reduced if issuers would experiment with this alternative selling mechanism.\textsuperscript{371} Specifically, they stress that competition among underwriters would lower direct issuer costs. Auctions would place underwriters in direct competition for the compensation they will earn. Hence, the resulting classic price competition would lower the spread that issuers must pay.\textsuperscript{372}

Likewise, it has been argued that competition will increase the price issuers receive for their securities.\textsuperscript{373} In the traditional negotiated offering, the underwriter polls prospective investors for indications of interest to discover the price the latter are willing to pay for the new securities. However, the issuer cannot evaluate the information marshalled by the underwriter because it has nothing with which to compare it. Thus, the negotiated offering creates information asymmetry that increases moral hazard and makes it easier for the underwriter to pursue its own interest at the expense of the issuer.\textsuperscript{374} More particularly, the underwriter can underprice the issue to facilitate the sale of the securities and earn the commissions.\textsuperscript{375}

Competitive bidding enhances the competition among underwriters and introduces an arm’s length bargaining into the underwriting process. When issuers rely on auctions, they reduce underwriters’ power to set inaccurate market-clearing prices for their securities by reducing


\textsuperscript{373} This argument is based on Stigler’s search cost theory. G.J. Stigler, "The Economics of Information", (1961) 69 J. Pol. Econ. 213. For an application to auction theory R. Kessel, supra note 105.

\textsuperscript{374} Under the traditional selling contract, underwriters have arguably incentives to act contrary to the issuers’ best interests. See Supra Chapter II, notes 59-59.2, 62-65 and related text.

\textsuperscript{375} Auctioning New Issues, supra note 105, at 1389-1392; B.A. Banoff, supra note 156, at 151-153. This theory of new issue underpricing is not supported by empirical evidence. Supra Chapter II note 66 and related text.
information asymmetry. The solicitation of bids allows issuers "to poll the market directly to see what the securities are worth." Thus, issuers are given many opinions about the securities' value and are not limited to a single estimate, as in negotiated underwritings.

Moreover, the auction process induces underwriters to value the securities accurately: undervaluation will result in the loss of a business opportunity, while overvaluation will generate losses. In this respect, the heightened competition between underwriters for new issues leads them to engage in more research, and this information is reflected in the price offered for the securities. Indeed, as the number of prospective investors polled rises, "the chances of finding the customer willing ... to pay the higher price for an equity offering also increases." Accordingly, auctions appear to offer a mechanism whereby an issuer can choose the underwriter which offers the highest and most accurate bid for its issue.

2. **Barriers to Issuing Securities Through Competitive Bids**

Although the evidence indicates that competitive offerings involve lower total flotation costs than negotiated offerings, firms which are not compelled by regulation to use competitive offerings tend overwhelmingly not to use them. As Hansen remarks, "the intractable historical fact [is] that, unless required by fiat to use the competitive bid method, corporate managers have virtually always elected to use a negotiated arrangement."

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376 N. Wolfson, *supra* note 126, at 370: "...competitive bidding eliminates the potential for improper relationships between issuers and their investment bankers."

377 *Auctioning New Issues, supra* note 105, at 1391.


380 B.A. Banoff, *supra* note 156, at 152.


One explanation offered for the dearth of competitive underwriting relies on the agency conflict theory which posits that managers may not act in the best interest of shareholders. This explanation proposes that managers may benefit from the use of negotiated offerings at the expense of the shareholders. Negotiated contracts give managers the opportunity to receive side payments from the underwriter awarded the offering contract. Managers may also increase their compensation when they use negotiated offerings where their compensation is tied to accounting profits, as explains Bhagat:

In a negotiated offering, management can include payment for past (present or future) consulting advice (unrelated to raising new equity) given by the investment bankers in the underwriter fee. Accounting profits are not lowered by underwriter fees (or other expenses incurred in raising equity capital), but they are lowered if the investment bankers are compensated explicitly for consulting advice unrelated to raising new equity.

In this respect, it is worth mentioning that the variance of issuing costs tends to be greater in competitive offerings than in negotiated offerings. Thus, negotiated offerings may be favoured by managers who prefer a more stable and predictable bottom line when their compensation is tied to accounting earnings.

While there is empirical evidence supporting the proposition that agency conflicts are a determinant of the choice between negotiated and competitive offerings, this explanation is not entirely satisfactory as it overlooks several factors which increase the cost of competitive offering and renders them less attractive for non-regulated firms in comparison with negotiated offerings.

Firstly, the existence of information asymmetry between managers and outside shareholders produces a demand for certification of management disclosure that is not adequately fulfilled in competitive offerings. In competitive offerings, the role of underwriters is considerably reduced.

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383 S. Bhagat, supra note 371. at 184-185; S. Bhagat & P.A. Frost, supra note 381. at 254-255.
384 Ibid.
385 S. Bhagat, ibid. at 185.
386 S. Bhagat & P.A. Frost, supra note 381. at 245-246.
387 Ibid.
Issuers retain control over the terms of their offer and therefore have more opportunity to structure it to exploit investors' information disadvantage. In addition, since underwriters are not certain of being allocated the offering, they cannot afford to make an exhaustive investigation. Thus, they must rely on the bidding information provided by the issuer and assume that it is accurate and complete when submitting their bids.\(^\text{389}\)

The more limited involvement of underwriters lowers the level of certification provided in competitive issues and induces, in turn, prospective investors to discount the price of the securities to protect themselves from the risk of abuses.\(^\text{390}\) Moreover, it is likely that the poor information environment in which underwriters place their bids reduces investor confidence: "Recognizing that the underwriter made the bid without investigating the value of the issue, investors will wonder why the company is forcing the investment banker to make the bid ahead of time, instead of letting them examine the firm's condition."\(^\text{391}\) For this reason, competitive bids appear be more appropriate where the information asymmetry between issuers and potential investors is limited, given that the need for investigation will be limited.\(^\text{392}\) Hence, Wolfson remarks: "[i]n the case of small issues, and particularly for relatively new corporations, the cost of competitive bidding makes it an impractical procedure."\(^\text{393}\)

Secondly, underwriters are likely to be less certain of the demand for the offering in competitive bids. The assessment of the demand for the securities generates significant costs in the

\(^{389}\) N. Wolfson, supra note 126, at 371.


\(^{391}\) B. Jurin, supra note 369, at 57.

\(^{392}\) J.R. Booth & R.L. Smith, supra note 172, at 262; B. Jurin, ibid; C.W. Smith, supra note 388, at 18. Competitive bids are used predominantly by regulated industries and firms issuing more senior claims, such as debt and preferred stock. See S. Bhagat & P.A. Frost, supra note 381, at 242-244 (reporting lower degree of underpricing for utility firms using competitive biddings). See however R.H. Pettaway & T. Kaneko, “The Effects of Removing Price Limits and Introducing Auction upon Short-term IPO Returns: The Case of Japanese IPOs”, (1996) 4 Pac.-Bas. Fin. J. 241 (finding evidence that the introduction of public auctions lowers the level of underpricing; however the characteristics of firms in the sample are not known).

\(^{393}\) N. Wolfson, supra note 126, at 371.
form of surveying potential investors. However, underwriters will not find it profitable to conduct as thorough and expensive a study of market demand in a competitive as in a negotiated offering, since they are not assured of getting the contract. Accordingly, they will place their bids without good knowledge of the demand for the new securities. To be compensated for this risk, underwriters will set the bid at a lower price, or will require a greater spread, thereby making this type of underwriting more costly.

Thirdly, auction theory suggests that it may not be appropriate for firm managers to rely on competitive bidding to select the lead underwriter for an IPO. In a path breaking article, French and McCormick show that, where potential buyers face sunk costs in the preparation of the bids in an auction, each buyer bids less for the goods than their true value in order to recoup their sunk costs. In the initial public offering context, the underwriters’ sunk costs include the search cost in that market, the cost of preparing the bids, and the cost of estimating the market value of the securities. The bulk of these costs are specific to the particular auction and cannot therefore be spread among several potential issuers. According to French and McCormick, since firms must recoup the sunk costs of preparing the bid as well as their marginal costs if they are to survive, the bids equal the value of the securities sold less these preparation costs. Thus, the value issuers get for the securities offered is equal to the expected present value of the securities minus all the bid preparation costs. Given the significant sunk costs that underwriters would incur bidding on IPOs, it is likely that competitive bids would not be profitable for new issuers if they were to internalize all of the sunk costs. Hence, it may well be that issuers’ reluctance to use competitive bidding results in fact from an incentive to reduce underwriter pre-bid sunk costs as suggested by Macey:

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394 L.H. Ederington. *supra* note 372, at 19: B. Jurin. *supra* note 369, at 57. Ultimately, if the cost of preparing the bid is greater than the probability of being awarded the securities times the profit realisable with the securities, underwriters will not participate in the auction. This could be the case for new issuers which are relatively unknown to the market. *Auctioning New Issues, supra* note 105, at 1403-1404.


In particular, at times it will be in the sellers' interest to reduce competition among buyers by providing them with information, limiting the number of bidders, or, in some instances, by abandoning auctions altogether in favor of negotiated sales. 399

Finally, it is worth stressig that negotiated bids do not totally shield underwriters from competition. Anecdotal evidence indicates that issuers "shop around" for underwriters before entering into a negotiated bid. 400 This allows issuers to bring about a certain level of competition into the negotiated bids. 401 In addition, underwriter compensation constitutes information which becomes publicly available in both competitive and negotiated offerings. To the extent that the threat of potential competition may replicate the effects of actual competition, "the threat of loss of future business to other investment bankers will induce the underwriter to charge a competitive price." 402

SECTION D: SUMMARY

Commentators have noted that SMEs appear to be not well serviced by investment dealers in Canada. Although direct empirical evidence does not exist on the dearth of investment dealers interested in SMEs financing, several indicators seem to point in that direction. As we saw in this Chapter, the Canadian investment dealer industry is characterised by the predominance of large securities firms that are not interested in getting involved in smaller offerings. Furthermore, regulatory and economic barriers appear to hinder the entry of new firms into the market to service the financing needs of SMEs. Given the adverse impact of the relative absence of investment dealers servicing smaller issuers, this Chapter has sought to explore the reforms which can be undertaken to increase the supply of underwriter services addressed at SMEs.

399 J.R. Macey, supra note 370, at 93. See also ibid. at 431-433.
401 According to Wolfson, "intelligent shopping around leads to an offering price that is set by competition." N. Wolfson, supra note 126, at 368-369. See also R.C. Perez, supra note 109, at 53-54.
402 S. Bhagat, supra note 371, at 184.
Our analysis reveals that caution is warranted when considering reducing dealer registration requirements. While registration requirements do constitute a barrier to entry for new firms, the elimination of those requirements would generate disruptive consequences that would not improve the accessibility of the public equity market for SMES. This is not to say that no reform of the regulatory framework should be considered. Indeed, some of the functions performed by dealers appear presently to be over-regulated.

Most notably, the regulatory requirements governing the distribution function performed by investment dealers could arguably be reduced without compromising the public interest. Relaxing the regulatory requirements would permit other professionals and individuals to carry out the distribution function presently performed by registered dealers. The entry of new intermediaries to the distribution function would create a form of inter-occupational substitution that would enhance competition and benefit SMES.401 Although this reform could lead to an increase in the supply of dealer services provided to smaller issuers, it is suggested here that further research should be undertaken to get a better understanding of the economic barriers that hinder the entry of dealer firms servicing SMES.

Finally, this Chapter examined whether SMES should consider using alternative selling mechanisms, such as competitive bidding, to overcome the adverse consequences of the low level of investment dealer competition. The analysis revealed that the characteristics of the small firm IPO market would not make competitive bidding a viable alternative for SMES.

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401 T.R. Muzondo & B. Pazderka, supra note 40, at 164. See also D.C. Langevoort, supra note 115, at 15.
CHAPTER VI

SOME ASPECTS OF THE DEVELOPMENT OF A SECONDARY MARKET TRADING SYSTEM FOR SMALL AND MEDIUM-SIZED ENTERPRISES

The reform of the regulatory framework governing initial public offerings in Ontario considered in this dissertation purports to reduce the cost of public equity capital and thereby increase the accessibility of this source of financing for small and medium-sized enterprises. Prerequisite to the success of this reform of IPO regulation is however the existence of an active and liquid secondary market for the trading of SMEs securities. Without such a market, investors will be reluctant to participate in the primary market, or will require a premium to do so that will increase firms’ cost of equity. This chapter discusses some aspects of the accessibility of secondary markets for SMEs making public offerings in Ontario.

The first section presents an overview of the salient functions performed by organised stock exchanges in order to get a better understanding of their importance for the initial public offering market. The accessibility of Canadian stock exchanges for SMEs is then examined. As the analysis shows, enterprises making small securities offerings in Ontario may have difficulty accessing an organised stock market. Thus, alternatives to fill this gap in the financing of SMEs are explored.
SECTION A: THE FUNCTIONS OF ORGANISED STOCK EXCHANGES

It is generally recognised that the existence of an organised secondary market for the trading of newly issued securities directly influences the ability of firms to raise public equity capital. This section provides an overview of the salient functions performed by organised stock exchanges in order to get a better understanding of their importance for the success of the initial public offering market.

1. Liquidity on Stock Exchanges

The most widely understood function of stock exchanges is to provide liquidity for listing enterprises. This section discusses the importance of liquidity for the vitality of the IPO market and the role of stock exchanges as suppliers of liquidity.

a) Liquidity and Securities Values

The most important economic function of a secondary market is to create liquidity.1 Liquidity refers to the conversion power of the market, i.e. the ability of the market to convert securities into cash, and cash into securities.2 More precisely, liquidity is a market characteristic that allows investors to “promptly purchase or dispose of stock at a price closely related to the market’s best estimate of the present value of future income stream that the stock will generate for investors.”

Market liquidity encompasses two dimensions that are valuable for investors. The first dimension concerns the cost in terms of time and money for investors to find counterparts who wish to trade. Because investors can dispose quickly of liquid securities, they do not have to face

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severe opportunity costs when waiting for the arrival of a buyer willing to pay the full market value of their securities. For this reason, the cost of immediacy services is relatively low for liquid securities since the market-making dealers who provide such services anticipate holding the securities for a short period of time. Thus, liquidity facilitates the trading of securities by reducing overall transaction costs.

The second dimension of liquidity relates to the reasonableness of the prices at which trades can be made. In a perfectly liquid market, the price at which investors trade their securities is not affected by the size of the transaction itself. Differently stated, the impact of buy and sell orders has only limited impact on the price of liquid securities. The minimal market impact of trades stems from the depth and breadth of the market which refer to the sufficient investor interest which exists on the sell side and the buy side near the price at which the securities are currently trading. When the market for a security exhibits sufficient depth and breadth, the price of the last transaction closely matches the price of the preceding transaction, to the extent that it continues to reflect the market’s estimates of the firm’s earnings prospect.

Since liquidity is valuable, investors are willing to pay more to buy liquid securities. Conversely, investors require a premium for the trading costs they bear when holding securities.

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9 N.S. Poser, supra note 1, at 886. As Macey and Kanda have argued, supra note 3, at 1012-1013, the Efficient Capital Market Hypothesis implies, in its semi-strong form, that price movements fully reflect any information contained in previous stock prices and adjust to reflect new information about the earnings prospect of relevant companies. For this reason, the price at which a security trades will reflect the preceding price only in so far that new information has not been impounded into the new price or has not arrived.
that trade in a less liquid market.\textsuperscript{11} From this it follows that the existence of a liquid secondary market has important consequences for the vitality of the IPO market.\textsuperscript{12} If investors expect the secondary market to work poorly, issuers will have to heavily discount the new securities offered and thereby face a higher cost of capital.\textsuperscript{13} Thus, the more liquid the secondary market, the more accurately securities prices will reflect the true value of the securities and the easier it will be for firms to raise funds through sales of securities.\textsuperscript{14}

In addition, the existence of a liquid secondary market is particularly important for venture capitalists and other early-stage investors for whom the IPO is an opportunity to realise their investments totally or partially. If these investors expect to sell into an illiquid secondary market, they may refrain from getting involved in early-stage financing, as the low level of liquidity will considerably reduce the profitability of their investments.\textsuperscript{15}

b) Stock Exchanges as Providers of Liquidity

Organised stock exchanges play a crucial role in ensuring the liquidity of the secondary market. The centralisation of trades in a single marketplace, such as a stock market, enhances the liquidity of the secondary market by reducing the search costs for the purchasers and sellers of securities.\textsuperscript{16} As Macey and Kanda point out, "[i]f a security is listed on an exchange, would be traders will

\begin{footnotesize}
\begin{enumerate}
\item P. Halpern \textit{et al.}, \textit{Canadian Managerial Finance}, 3\textsuperscript{rd} ed., (Toronto: Holt, Rinehart & Winston of Canada, 1991) at 53; \textit{Liquidity and Asset Prices. supra note 4, at 6.}
\item J.G. MacIntosh, \textit{Legal and Institutional Barriers to Financing Innovative Enterprise in Canada} (Kingston, Queen's University, Government and Competitiveness School of Policy Studies, Discussion Paper Series No. 94-10, 1994) at 137 [hereinafter \textit{Financing Innovative Enterprise}].
\item M. Mendelson & J.W. Peake, "Intermediaries' or Investors': Whose Market is it Anyway?", (1994) 19 \textit{J. Corp. L.} 443 at 444.
\end{enumerate}
\end{footnotesize}
know immediately where to go to make trades." However, where a security is not traded on a stock exchange, "traders must search for a party willing to appear on the other side of the transaction."

The trading of securities in a central location also fosters immediacy by permitting transactions to be executed with minimum delay. Brokers can quickly execute customer's orders at the best available price on a stock exchange since they have prompt access to a large number of buyers and sellers at a central location. This immediacy is valuable to investors since trading delays increase the risk of price fluctuations that prevent investors from obtaining the best price for their securities. This is particularly true for risky assets that cannot be expected to trade at a constant price.

The markets maintained by stock exchanges are known as auction markets because buy and sell orders are executed at a central location at the best available price any time that they meet a matching contra-order. In addition, the stock exchanges function as agency markets because trading is reserved to exchange members who act as agents and execute their customers' orders by sending it to the exchange's floor or central trading facilities. Thus, in a typical trade on a stock exchange, an investor who wishes to buy or sell securities will give the order to an exchange member who executes the order on the "floor" of the exchange by finding another party willing to trade.

17 J. Macey & H. Kanda, supra note 3, at 1019.
18 Ibid.
19 Ibid.
20 N.S. Poser, supra note 1, at 889.
21 J.C. Groth & D.A. Dubofsky, supra note 4, at 328.
23 N.S. Poser, ibid. at 889. See also M. Pagano & A. Roell, "Transparency and Liquidity: A Comparison of Auction and Dealer Markets with Informed Trading", (1996) 51 J. Fin. 579 at 582. The Toronto Stock Exchange (TSE) is a continuous auction where prices are formed over time upon observing the order flow up to that moment.
Within stock exchanges, the individuals performing the broker function with respect to each listed security play a crucial role in the auction trading of securities. When a security is listed for trading, the exchange attributes it to a particular registered trader. The most important function of the registered trader is to perform a market-making function in respect of their assigned security and maintain an orderly market. Where there is a temporary imbalance between supply and demand for their assigned security, the registered traders are required to take the other side of the trade to stabilise prices. Thus, the registered traders provide liquidity to the market by dealing as principal in their assigned security using their own capital to make bids to buy stock or to make offers to sell stock. These market participants are essential for a continuous market "where there is a higher probability of the occurrence of momentary situations wherein there is an imbalance between the supply and demand of a particular security."

Empirical evidence support the proposition that listing on organised stock exchanges enhance the liquidity of the securities of the firms listed on such exchanges. Studies show that security values increase when issuers list their securities on stock exchanges after having been traded in the over-the-counter market. Moreover, the listing decision is found to be associated with an improvement in the securities' liquidity, as measured by the size of the bid-ask spread. Likewise, a threat of delisting non-voting and subordinate securities by a stock exchange, which

24 On the Toronto Stock Exchange, the registered trader performs the brokers' broker function. The registered traders have a similar role to that of the New York Stock Exchange's specialists. See T.H. Maynard, supra note 1, at 841-843; N.S. Poser, ibid. at 889-891; N. Wolfson & T.A. Russo, "The Stock Exchange Specialist: An Economic and Legal Analysis". [1970] Duke L.J. 707. For a critique of the role of the specialists, see J. Macey & H. Kanda, supra note 3, at 1025-1034.

25 The registered trader maintains a market quotation no wider than a specified spread subject to negotiations with exchange officials.


was not in response to an action of management, was found to affect negatively the value of the securities, thereby reflecting the impact on share value of the loss of liquidity.29

Because of the impact of liquidity on securities values, issuers will attempt to pursue policies directed at increasing the liquidity of their securities. Issuers will therefore select the secondary market that is the most consistent with this objective, balancing the benefits of higher liquidity with the cost of accessing this market.30 Ultimately, the trading mechanisms that best serve the liquidity needs of issuers will be revealed through competition.

It should be noted, however, that the overall liquidity of Canadian stock markets is relatively low. A study by Fowler and Rorke reports that only 5.3 per cent of the shares traded on the TSE can be characterised as widely or frequently traded while 35.3 per cent are moderately traded.31 The remainder 59.4 per cent was infrequently or thinly traded. This study can be taken as suggesting that infrequent trading is a major problem in the Canadian capital market.32 Indeed, as Daniels and MacIntosh affirm, since the TSE "exhibits that greatest depth of any public exchange in Canada, there is little doubt that other Canadian exchanges are dominated to an even greater degree by thinly traded stocks."33

The dominance of illiquid and relatively thinly traded securities on Canadian stock markets has important consequences on the Canadian cost of public equity.34 The demand for highly liquid securities is likely to be greater than the supply of such securities in Canada given the preference of

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30 Liquidity and Assets Prices, supra note 4, at 6.
investors, particularly institutional investors, for marketable securities. Accordingly, investors are likely to require a high expected return for holding infrequently traded securities.\(^{35}\)

2. **The Certification Role of Stock Exchanges**

Stock exchanges impose quantitative and qualitative listing requirements on issuers in order to ensure the fairness, efficiency and liquidity of the secondary market.\(^{36}\) Listing requirements represent quality standards that can convey information to investors on firm value. By seeking to list on a stock exchange, an issuer asserts that it meets the initial listing standards, that it intends to satisfy the continued listing standards, and that it is committed to respecting the exchange's corporate governance standards.\(^{37}\) Thus, a listing application can be taken as an important expression of managerial confidence in the business prospects of the firm.\(^{38}\)

The information that a stock exchange listing signals is valuable to investors because it is costly for low-quality issuers to replicate. Afflek-Graves *et al.* summarise the costs of this signal for issuers.

First, the firm expends resources on preparing the initial listing forms and payment of the initial listing fees and subjects itself to recurring annual listing fees. Second, by agreeing to abide by the system's corporate governance standards, the firm incurs higher shareholder servicing costs and potential managerial inconveniences and inflexibilities. Third, the firm exposes itself to the risk of being delisted if it fails to maintain the continued listing standards.\(^{39}\)

These costs reduce the likelihood that a stock exchange listing will be used to send dishonest signals.\(^{40}\)


\(^{36}\) *Infra* notes 64-104 and related text.


\(^{39}\) J. Afflek-Graves *et al.*, *supra* note 37, at 101.

\(^{40}\) H.K. Baker & S.E. Meeks, *supra* note 27, at 64.
More importantly, the credibility of the signal is provided by the evaluation and the approval of the issuer by the stock exchange. By approving an application for listing, a stock exchange provides an independent verification of quality. This verification is credible since the exchange risks its reputational capital by certifying that the issuer meets its qualitative and quantitative standards.

In this respect, note that stock exchanges have strong economic incentives to maintain a good reputation as a credible quality screen for listed firms. The long-run profitability of a stock exchange depends on the trading commissions earned by its members which are, in turn, "a function of the ability of the exchange to attract listing and facilitate trading of securities of listed companies." If investors lose confidence in the integrity of a stock exchange, they will demand higher returns for investing in listed firms, resulting in a higher cost of capital for the latter, and ultimately a lower level of business conducted over the exchange. Accordingly, the exchange, which damages its reputation by making a false certification of quality, will lose substantial future business opportunities that will exceed the short-term gains from such a false certification.

Furthermore, competition among stock exchanges for the listing of issuers and the business of investors increases the incentives of exchanges to maintain an effective quality screening mechanism. Exchanges that fail to do so will tarnish their reputation and lose business to other exchanges inspiring more confidence in investors. This is particularly true with the growing

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44 D.R. Fischel, ibid. at 122.


internationalisation of the securities market which has magnified competition for stock exchange listing.47

From this it follows that the certification role of stock exchanges reduces information costs for investors and issuers. Macey and Kanda explain: “listing on a stock exchange reduces the costs to investors of searching for high quality investment opportunities and lowers the costs to issuers of signalling to investors that their securities are high quality.”48 Therefore, stock exchange listing has the potential to resolve, at least in part, the information asymmetry between issuers and potential investors which influences the degree of underpricing.49 Empirical evidence remains, however, inconclusive on this point.50

Still, it is worth emphasising that a stock exchange listing is only a valuable signal when it conveys information above what the market can already derive from the evaluation of other information sources.51 While listing on an exchange provides a valuable filter to investors, informing them of the quality of the securities, lawyers, investment bankers, accountants and other information intermediaries serves as close substitute for the services of the exchange in providing reputational capital. Furthermore, the liability provisions sanctioning misrepresentations in disclosure documents diminish the value of the exchange as provider of reputational capital. The existence of substitutes to the certification function of stock exchanges implies that this function may be less important than it is generally believed, unless stock exchanges can provide certification more cost-effectively than the other substitutes.

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48 J. Macey & H. Kanda, supra note 3, at 1023.

49 J. Afflek-Graves et al., supra note 37.


51 H.K. Baker & S.E. Meeks, supra note 27, at 64.'
3. Monitoring of Trading Activities

Stock exchanges monitor the markets in which issuers' securities trade to prevent abuses arising from the latter's failure to comply with disclosure obligations, insider trading, market manipulation, frontrunning, and other forms of market misconduct. This ancillary service is valuable to investors who wish to avoid losses arising from trading violations. It therefore affects positively the value of shares subject to such surveillance and arguably reduces the cost of capital for issuers.

Stock exchanges have incentives to conduct surveillance of trading activities because they internalise the costs and benefits of deterring misconduct. The potential for manipulation and other forms of abuse increase the cost of transacting for investors, and thus lead to a reduction in trading volume on the exchange, irrespective of the level of competition faced by the exchange. More importantly, since investors will likely discount the price of issuers' securities to reflect their expected losses from such abuses, it is issuers that will bear the cost of such events. As a result, issuers will not be willing to pay to get listed on an exchange that does not monitor trading and will seek listing on an exchange that conducts effective market surveillance. Given that the profits of the stock exchange's members increase with trading volume, the exchange will avoid losing market share — and hence trading volume — by conducting surveillance of trading activities.


55 F.H. Easterbrook & D.R. Fischel, supra note 41, at 690.

56 J.R. Macey & H. Kanda, supra note 3, at 1021-1022.
The detection of insider trading and manipulation is a difficult task if only because of the number of market participants and individual transactions that must be monitored. Insider trading is particularly hard to detect since it can be conducted under complete secrecy. Moreover, market surveillance is “further complicated because the market effects of manipulative activity may be camouflaged by the market effects of other market actions that are not legally classified as being manipulative” such as the stabilisation of share price in the post-issue market.

The centralisation of trades on a single location however helps alleviates some of these difficulties by giving stock exchanges the ability to provide low-cost monitoring services to protect investors from abuses in the secondary market. Because of economies of scale associated with centralised monitoring of trading, stock exchanges can invest in sophisticated surveillance technology that can detect unusual trading patterns. For example, the Toronto Stock Exchange uses electronic market surveillance tools which facilitate the detection of unusual trading patterns and potential violations of exchange rules or securities legislation for every stock listed. The specialised skills and technology needed to conduct monitoring can be used simultaneously with respect to all of the shares listed on the exchange reducing thereby the cost of monitoring single stocks. Indeed, the single specialised monitoring provided is more efficient “than having hundreds of individual firms acquire the technology and expertise necessary to monitor stock trading.”

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58 L. Kryzanowski, ibid., at 279-280.

59 J.R. Macey & H. Kanda, supra note 3, at 1021-1022.


62 J.R. Macey & H. Kanda, supra note 3, at 1022.
Section B: The Accessibility and the Viability of Organised Stock Exchanges for Small and Medium-Sized Enterprises

The foregoing discussion underscores the importance for firms seeking public equity financing of listing their securities on an organised stock market. Stock exchanges can increase the value of securities by enhancing the liquidity of securities, certifying firm quality, and enhancing monitoring of trading. Higher securities value translates, in turn, into lower cost of capital. Thus, it is generally acknowledged that the existence of a healthy secondary market is a prerequisite to a vibrant small firm IPO market.

In Canada, there are five stock exchanges on which issuers can list. Each exchange imposes conditions, in the form of listing requirements, which firms must meet if they are to be admitted for quotation. The exchanges' listing requirements purport to ensure the fairness, efficiency, and liquidity of the market. Although they pursue laudable goals, the listing requirements may restrict the ability of SMES to raise public equity financing if the conditions they set out prevent these enterprises from getting listed.

Therefore, this section will review the salient features of the Canadian stock exchanges' listing requirements to determine whether they hinder the access of SMES to organised stock markets. As we will see, there exists potential for SMES making small securities offerings to access an organised secondary market. It is, however, the regional stock markets of Alberta and Vancouver, and to a lesser extent the Montreal Exchange, that are the most accessible for SMES raising small amounts of equity capital. In Ontario, the stringent listing requirements of the Toronto Stock Exchange (TSE) effectively limit the exchange to medium and large firms raising significant amount of capital.

This section will also emphasise that it is not sufficient that listing requirements be adapted to SMES to ensure that the accessibility of organised stock exchanges will facilitate the use of public equity financing by these enterprises. Indeed, stock exchanges must also provide facilities that minimise the costs for these enterprises of maintaining a secondary market. Otherwise, the
accessibility of stock exchanges will be irrelevant, as the secondary market that they provide will not be viable for SMES.

1. The Minimum Listing Requirements of Canadian Stock Exchanges

There are five Canadian stock exchanges constituted as non-profit, self-regulatory organisations owned by their member firms who may be regional, national or international investment dealers or stock brokers: the Toronto Stock Exchange (TSE), the Montreal Exchange (ME), the Vancouver Stock Exchange (VSE), the Alberta Stock Exchange (ASE), and the Winnipeg Stock Exchange (WSE). The TSE, ME, VSE and ASE are the four principal Canadian exchanges.

The Toronto Stock Exchange is the country’s largest stock exchange by value and volume of shares traded and one of North America’s most important exchanges. The TSE together with the Montreal Exchange have substantially all of the secondary trading in listed securities in Canada. The two western stock exchanges nevertheless play an important role in the Canadian capital market by specialising in niche sectors. The VSE is a speculative exchange involved primarily in public financing of high-risk early stage companies in the resource sectors; in the non-resource sector, the exchange caters increasingly high technology firms. The ASE for its part concentrates on oil and gas and mineral exploration companies, and province-based SMES. Because of its

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64 Electronic Trading Systems, supra note 26, at 2519. See generally Focusing on Value, supra note 64.
65 Electronic Trading Systems, ibid.
66 Financing Innovative Enterprise, supra note 13, at 138; P. Johnston, Nothing Ventured...Investing in Canada’s Winners (Toronto: Toronto Stock Exchange, 1980) at 24. The VSE and ASE are increasingly servicing the venture capital needs of information technology (IT) companies. Many IT companies, including software companies, now trade on the Alberta and Vancouver exchanges. Several firms, notably SoftKey International (now based in the U.S.) credit the VSE with providing them with the capital that they could not locate elsewhere that launched them on their growth paths. Other successful Canadian IT companies that have used the VSE as a launch pad include InContext, Metroworks and Spectrum Signal Processing. See D. Paterson, Financing Canadian Software Company Development: Observations and Trends — Public Venture Capital Markets (Ottawa: Industrie Canada, 1996) (http://strategis.ic.gc.ca).
lackluster reputation, the VSE is however having difficulty attracting startup companies that prefer listing on the ASE, NASDAQ or the Canadian Dealing Network.⁶⁹

To provide a fair, efficient and liquid secondary market, stock exchanges impose conditions for admission to quotation in the form of listing requirements. Thus, for an issuer’s securities to be listed on a stock exchange, the issuer must apply for listing and meet the exchange’s listing requirements.

a) Financial and Assets Requirements

Financial and assets requirements refer to the net tangible assets, earnings, and working capital which issuers must meet for an original listing on a stock exchange.⁷⁰ There is considerable variation in the financial and assets requirements of Canadian stock exchanges as shown by Tables 1 to 4, with the TSE having the highest minimum standards followed, in descending order, by the ME, the VSE and the ASE.

Thus, to be listed on the TSE as industrial emerging companies, SMEs with less than $100,000 in pre-tax earnings in the fiscal year immediately preceding the listing application must have net tangible assets of at least $5 million.⁷¹ In addition, issuers must provide evidence, satisfactory to the exchange, of a reasonable likelihood of profitability. This requirement can be fulfilled by filing a complete set of forecast financial statements accompanied by an independent auditor’s opinion which forecasts pre-tax cash flow and earnings for the next fiscal year.

The listing requirements of the ME do not distinguish between emerging and operating companies in the industrial sector. Unless an exemption is granted by the exchange, issuers must have pre-tax earnings of at least $100,000 in the fiscal year immediately preceding the listing

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⁷⁰ Note that applicants can meet these financial requirements by including the proceeds of the public offering in the assets of the issuer.

application and have net tangible assets of $1 million. Issuers that do not meet the earnings threshold can however apply for an exemption of this requirement if they have substantial operations in Canada and can provide evidence, satisfactory to the exchange, of a reasonable likelihood of profitability.

The listing requirements of the VSE which deal with industrial issuers allow firms without a history of earnings to apply for listing where they have net tangible assets of at least $3,000,000. In addition, issuers must provide evidence, satisfactory to the exchange, of a reasonable likelihood of profitability.

By contrast, the VSE has more lenient listing requirements for venture companies. Venture companies consist of firms that meet the exchange’s minimum listing requirements but do not qualify as industrial companies. Listing requirements applying to venture companies do not have provisions dealing with minimum earnings or net tangible assets. Those requirements are replaced by the disclosure of forward-looking information such as a management plan, a financial report and a feasibility report.

Finally, the ASE has the lowest financial and assets requirements applying to industrial companies. Firms seeking a listing on this stock exchange need only have net tangible assets of $500,000 when they have pre-tax earnings of $50,000 in the fiscal year preceding the listing application, or a minimum average of $50,000 for the two of the last three fiscal years. Where firms do not meet the earnings requirement, they can meet the listing requirements when they have a working commercial prototype of the product, have the requisite level of net tangible assets, and have incurred at least $300,000 in development expenses in the previous five years. They must

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73 Vancouver Stock Exchange, “Listing Department Policies, Policy No. 1”, in Canadian Stock Exchanges Manual, ibid., s. 1.3 [hereinafter VSE Policy No. 1].

74 VSE Policy No. 1, ibid. s. 1.2.

75 Alberta Stock Exchange, “Circular No. 1”. in Canadian Stock Exchanges Manual, supra note 71, s. 3.1 [hereinafter ASE Circular No. 1].

76 Ibid., s. 3.2.
also submit a management plan, which demonstrate that the product is sufficiently developed and that there is a reasonable expectation of profit from the business.

With respect to working capital listing requirements, every stock exchange requires applicants to have "adequate working capital" and capitalisation to carry on the business. The expression "adequate working capital" is interpreted as requiring that firms have sufficient working capital to meet all disclosed capital requirements for the next 12 months. 77 Where such is not the case, issuers must convince the exchange that the working capital is nevertheless adequate as demonstrated by cash flow forecasts, off-balance-sheet funds, industry trends or third party financing commitments.

Because of their flexibility, the foregoing financial and asset requirements of stock exchanges with respect to earnings do not preclude young SMES without a history of earnings from applying for listing. Likewise, although SMES tend not to have significant working capital, 78 the working capital requirement may not weigh too heavily on these enterprises as they can meet the requirement in several different ways, including through the use of cash flow forecasts.

However, the net tangible assets requirement may excessively burden SMES, especially those that operate in the high technology sector. Indeed, as mentioned previously, smaller enterprises tend to have fewer fixed assets than larger enterprises. 79 Thus, SMES may have difficulty satisfying the more stringent net tangible assets requirements of the ME and the TSE.

b) Public Distribution

To ensure that the secondary market in which the securities listed trade will exhibit an adequate level of liquidity, the stock exchanges impose specific requirements with respect to the breadth of

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78 See e.g. P. Johnston, supra note 66, at 18.

79 Financing Innovative Enterprise, supra note 13, at 57-58; P. Johnston, supra note 66, at 18: "Smaller firms have roughly half the fixed assets of their rivals."
the issues’ distribution.\textsuperscript{80} Thus, every exchange requires that the securities of applicants seeking listing as industrial companies be held by a minimum of 300 public shareholders, each of whom holds at least one board lot.\textsuperscript{81} Public shareholders are defined as those shareholders exclusive of directors, officers, other insiders, promoters, control persons, and their agents or trustees.

In addition, the listing requirements establish a minimum number of free-trading securities, commonly called the public float, that must be listed and a minimum aggregate market value that these securities must represent. The requirements differ among all of the stock exchanges as shown by Tables 1 to 4. The TSE, which requires that issuers have a minimum number of 1 million free-trading shares representing an aggregate market value of $2 million, has the toughest requirements of the Canadian stock exchanges.\textsuperscript{82}

Issuers seeking listing as industrial companies on the VSE must comply with almost as stringent a requirement as they must have a minimum of 1 million freely tradable shares representing a public float of $1.8 million.\textsuperscript{83} However, more lenient requirements apply to venture capital companies which need only distribute 300,000 freely tradable shares generating net proceeds of at least $450,000.\textsuperscript{84}

The ME and the ASE have lower requirements for industrial companies. ME industrial issuers must have 1 million free-trading shares representing an aggregate market value of $1 million.\textsuperscript{85} The ASE, which has the most lenient standards, requires only that 500,000 securities be issued with an aggregate market value of $500,000.\textsuperscript{86}

\begin{footnotes}
\item[80] G.R.D. Goulet, \textit{supra} note 12, at ¶14.120.
\item[81] A board lot is a term referring to a certain number of shares, usually 100.
\item[82] \textit{TSE Company Manual}, \textit{supra} note 71, s. 310.
\item[83] \textit{VSE Policy No. 1}, \textit{supra} note 73, s. 1.3.1
\item[84] \textit{Ibid.}, s. 1.2.3.
\item[85] \textit{ME Rule Nine}, \textit{supra} note 72, s. 9053.
\item[86] \textit{ASE Circular No. 1}, \textit{supra} note 75, s. 3.7
\end{footnotes}
The foregoing overview suggests that the distribution requirements of Canadian stock exchanges allow SMES to raise equity financing through relatively small initial public offerings on the regional stock exchanges and, to some extent, on the ME. The TSE for its part remains reserved for medium and large enterprises with offerings of over $2 million. Still, one author remarks, "[d]ue to the costs of listing, for practical purposes, most of the regular IPOs on these exchanges will not be much below the $1 million level."87

c) Corporate Governance Standards

Every stock exchange considers that the management of the applicant issuer is an important factor in the review of the listing application.88 For this reason, each scrutinises the past behaviour and activities of the applicant’s management and principal shareholders to assess their integrity and financial responsibility.89 In particular, stock exchanges look for events such as securities-related criminal convictions, civil proceedings involving fraud, proceedings by securities commissions, stock exchanges or other regulators, bankruptcies and outstanding judgements, which may raise doubts with respect management’s integrity.90

In addition, the exchanges consider the competence of the applicant’s managers by examining their background in the particular area in which the company carries on business and the expertise that a reasonable investor would expect them to possess. However, Goulet notes that “[t]he greater emphasis appears to be on integrity rather than on expertise, perhaps because it is easier to apply an objective standard to integrity than to competence.”91

The emphasis on the quality of management has lead some stock exchanges to make significant inroads into the realm of corporate governance. For instance, the ME requires that every

87 M.J. Robinson, supra note 68, at 607.
88 See e.g., TSE Company Manual, supra note 71, s. 311.
89 Ibid. s. 325.
90 G.R.D. Goulet, supra note 12, at 373.
listed companies have at least two independent directors. The VSE has the power to prohibit a person from acting as a director of a listed company and has, to this end, the power to remove a director. The ASE requires that at least one of the directors or officers of the applicant have public company experience, and that management devote a sufficient amount of time to corporate affairs.

In addition, the TSE and the ME have adopted the recommendations of the Report of the Toronto Stock Exchange Committee on Corporate Governance (the Dey Report) established in the wake of the failures of high profile Canadian corporations. The Report proposes a set of guidelines for improved corporate governance which focus on the board of directors and the quality of its members. While compliance with the guidelines remains voluntary for firms listed on the TSE and ME, listed firms are required to disclose their corporate governance practices, so that they can be judged against these recommendations. In other words, compliance with the guidelines is expected to be achieved through the pressure of shareholders on management via the disclosure of governance practice.

The imposition of corporate governance standards to issuers by stock exchanges is criticised on the ground that such standards, to the extent that they are concerned with the relationship between the management of public corporations and their shareholders, have no place in rules governing secondary market trading. According to one commentator, stock exchange

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93 Vancouver Stock Exchange, “Policy No. 3”, in Canadian Stock Exchanges Manual, ibid., s. 2.1.3.
94 ASE Circular No. 1, supra note 75, s. 2.1.3.
96 Dey Report, ibid. at 51-52; TSE Company Manual, ibid., s. 473.
corporate governance standards are not designed to protect shareholders, but rather as marketing tools used by stock exchanges: "the voluntary efforts by the NYSE to develop corporate governance listing standards were undertaken in order to capture or retain trading business and commissions for its members, though a by-product was to promote shareholder participation." 99

While the corporate governance standards may have been adopted by stock exchanges to increase the welfare of their members, the standards may yield benefits for issuers and investors. Leaving aside the value of the specific corporate governance standards imposed, 100 commentators remark that the provision of such "off-the-rack" contract terms decreases intra-firm contracting costs. 101 Furthermore, since these standards are enforced by the stock exchanges, they reduce the monitoring costs of shareholders and, thereby, the overall cost of the contracting process. Besides, it is suggested that the standardisation of corporate governance rules may also reduce information costs to investors by facilitating the comparison of investment contracts. 102

Nevertheless, the standards of corporate governance imposed by stock exchanges may have an adverse effect on SMES by raising the cost of getting listed. As argued previously in this dissertation, standardised rules are not value maximising for every firm. 103 In particular, the standardisation of corporate governance rules may not be value maximising for SMES where the expenses associated with compliance contain a high fixed cost component which is not offset by the benefits. 104 Presently, it should be noted that the bulk of corporate governance standards are not

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99 D.C. Michael, ibid. at 1476. Embedded in this argument is the more general rent-seeking problem. See S.G. Pirrong, supra note 53, at 158-163.


104 See also A. Belcher, supra note 97, at 326. This is not to say that SMEs may not benefit from improvements in corporate governance. See e.g. C.M. Daily & D.R. Dalton, "Board of Directors Leadership and Structure: Control and Performance", (1993) 17:3 E.T. & P. 65; H. Edelson, "Problems with Boards of Small Companies", Directors & Boards, Fall 1994 at 4; R. Lawson, "Corporate Governance on a Smaller Scale", Accountancy, December 1994 at 8.
mandatory but rather recommended. Accordingly, the impact of these standards on the costs of getting listed remains rather limited. Any attempt by stock exchanges at increasing mandatory corporate governance standards should however be undertaken with caution by considering the cost-effectiveness of the imposition of new standards for smaller issuers.

**Table I**

**Alberta Stock Exchange**  
**Minimum Financial Listing Requirements**  
**Industrial Companies**

<table>
<thead>
<tr>
<th>Requirements</th>
<th>Alternative I</th>
<th>Alternative II</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Tangible Assets</td>
<td>$400,000</td>
<td>$400,000</td>
</tr>
<tr>
<td>Earnings</td>
<td>$50,000 after taxes in the fiscal year preceding immediately filing of the listing application, or a minimum average net income of $50,000 after taxes for the two of the last three fiscal years.</td>
<td>Working commercial prototype of the product. Minimum of $250,000 in development expenses spent in the previous five years.</td>
</tr>
<tr>
<td>Property</td>
<td>N/A</td>
<td>Management plan outlining Development of the business for a Period of 24 months and Demonstrating that the product, service or technology is sufficiently developed and that there is a reasonable expectation of earnings from its business.</td>
</tr>
<tr>
<td>Supporting Reports</td>
<td>N/A</td>
<td>Adequate to carry on the business And have a minimum of $100,000 in unallowed funds.</td>
</tr>
<tr>
<td>Working Capital</td>
<td>Adequate to carry on the business</td>
<td>Same</td>
</tr>
<tr>
<td>Distribution</td>
<td>A minimum of 500,000 shares, with An aggregate market value of $400,000, held by a minimum of 300 public holders of one board lot. In addition, 20 per cent of the issue And outstanding shares must be freely-trading and held by public shareholders.</td>
<td></td>
</tr>
</tbody>
</table>

## Table II

**Montreal Stock Exchange**

**Minimum Financial Listing Requirements**

**Industrial Companies**

<table>
<thead>
<tr>
<th>Requirements</th>
<th>Alternative I</th>
<th>Alternative II</th>
<th>Alternative III</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net Tangible Assets</strong></td>
<td>$1,000,000</td>
<td>$5,000,000</td>
<td>N/A</td>
</tr>
<tr>
<td><strong>Earnings</strong></td>
<td>$100,000 before taxes in the fiscal year preceding immediately filing of the listing application.</td>
<td>Evidence satisfactory to the Exchange indicating a reasonable likelihood of profitability.</td>
<td>$200,000 before taxes in the fiscal year preceding immediately filing of the listing application.</td>
</tr>
<tr>
<td><strong>Cash Flow</strong></td>
<td>$400,000 before taxes in the fiscal year preceding immediately filing of the listing application.</td>
<td>N/A</td>
<td>$500,000 before taxes in the fiscal year preceding immediately filing of the listing application.</td>
</tr>
<tr>
<td><strong>Working Capital</strong></td>
<td>Adequate and capitalisation to carry on the business</td>
<td>Same</td>
<td>Same</td>
</tr>
<tr>
<td><strong>Distribution</strong></td>
<td>At least 1,000,000 freely tradable shares with an aggregate market value of $2,000,000 and at least 300 public holders of one board lot.</td>
<td>Same</td>
<td>Same</td>
</tr>
</tbody>
</table>


## Table III

**Toronto Stock Exchange**

**Minimum Financial Listing Requirements**

**Industrial Companies**

<table>
<thead>
<tr>
<th>Requirements</th>
<th>Alternative I</th>
<th>Alternative II</th>
<th>Alternative III</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net Tangible Assets</strong></td>
<td>$1,000,000</td>
<td>$5,000,000</td>
<td>N/A</td>
</tr>
<tr>
<td><strong>Earnings</strong></td>
<td>$100,000 before taxes in the fiscal year preceding immediately filing of the listing application.</td>
<td>Evidence satisfactory to the Exchange indicating a reasonable likelihood of profitability.</td>
<td>$200,000 before taxes in the fiscal year preceding immediately filing of the listing application.</td>
</tr>
<tr>
<td><strong>Cash Flow</strong></td>
<td>$400,000 before taxes in the fiscal year preceding immediately filing of the listing application.</td>
<td>N/A</td>
<td>$500,000 before taxes in the fiscal year preceding immediately filing of the listing application.</td>
</tr>
<tr>
<td><strong>Working Capital</strong></td>
<td>Adequate and capitalisation to carry on the business</td>
<td>Same</td>
<td>Same</td>
</tr>
<tr>
<td><strong>Distribution</strong></td>
<td>At least 1,000,000 freely tradable shares with an aggregate market value of $2,000,000 and at least 300 public holders of one board lot.</td>
<td>Same</td>
<td>Same</td>
</tr>
</tbody>
</table>

Table IV

Vancouver Stock Exchange
Minimum Financial Listing Requirements
Industrial Companies

<table>
<thead>
<tr>
<th>Requirements</th>
<th>Alternative I</th>
<th>Alternative II</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Tangible Assets</td>
<td>$3,000,000</td>
<td>$900,000</td>
</tr>
<tr>
<td>Earnings</td>
<td>Satisfactory evidence indicating</td>
<td>$100,000 before taxes in the fiscal year preceding immediately filing of the listing application.</td>
</tr>
<tr>
<td></td>
<td>Reasonable likelihood of Future profitability.</td>
<td></td>
</tr>
<tr>
<td>Working Capital</td>
<td>Adequate and capitalisation to</td>
<td>Same</td>
</tr>
<tr>
<td></td>
<td>Carry on the business</td>
<td></td>
</tr>
<tr>
<td>Distribution</td>
<td>A minimum of 1,000,000 freely</td>
<td>Same</td>
</tr>
<tr>
<td></td>
<td>Tradable shares with an aggregate</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Market value of $1,800,000 and</td>
<td></td>
</tr>
<tr>
<td></td>
<td>a minimum of 300 public holders of</td>
<td></td>
</tr>
<tr>
<td></td>
<td>one purchase lot.</td>
<td></td>
</tr>
</tbody>
</table>

Vancouver Stock Exchange
Minimum Financial Listing Requirements
Venture Companies

<table>
<thead>
<tr>
<th>Requirements</th>
<th>Non-Resource Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>Seed capital price per share</td>
<td>$0.25</td>
</tr>
<tr>
<td>Net Seed Capital Proceeds</td>
<td>$400,000</td>
</tr>
<tr>
<td>Minimum Prospectus Price per Share or Unit</td>
<td>$0.30/share</td>
</tr>
<tr>
<td></td>
<td>$0.40/unit</td>
</tr>
<tr>
<td>Combined net proceeds from seed capital and first public distribution by prospectus</td>
<td>$850,000</td>
</tr>
<tr>
<td>Minimum number of shares in public float</td>
<td>300,000</td>
</tr>
<tr>
<td>Minimum number of shares sold under prospectus</td>
<td>600,000</td>
</tr>
<tr>
<td>Number of public shareholders holding at least one purchase lot</td>
<td>300</td>
</tr>
<tr>
<td>Prior expenditures on properties or business to be funded by prospectus</td>
<td>$300,000</td>
</tr>
<tr>
<td>Minimum funds allotted for exploration in prospectus</td>
<td>N/A</td>
</tr>
<tr>
<td>Unallocated working capital on full listing</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

Source: Vancouver Stock Exchange, Listing Policy and Procedure Manual, 199

Empirical studies of the pricing of SMEs securities reveal that small firms listed on stock exchanges produce higher risk-adjusted returns than listed large firms, contrary to what is predicted by the most widely used pricing model. This phenomenon, which is known as the small firm effect, has important consequences for the cost of public equity for smaller enterprises. Indeed, the small firm effect implies that investors in small firms demand a higher risk-adjusted return than investors in large firms, and that this demand results in a higher cost of capital for smaller enterprises.

The causes of the small firm effect are the subject of an ongoing debate in the finance literature. While no definite explanation seems to account entirely for the phenomenon, the two leading explanations underline the factors which may be responsible for the higher risk-adjusted returns demanded by investors. Any organised exchange interested in providing an accessible and viable secondary market for smaller enterprises should therefore attempt to reduce the impact of those factors.

a) **The Size Effect and the Cost of Capital**

The capital asset pricing model (CAPM) is the most widely used model to explain the relationship between risk and return and specify how it is impounded into the market’s valuation of financial assets.\(^{105}\) In a nutshell, the model posits that, under certain assumptions, the rate of return on a risky asset is equal to the rate of return on riskless treasury bills plus a premium proportional to the asset’s market risk (or \(\beta\)).\(^{106}\) An important corollary of the CAPM is that investors can only earn higher returns by assuming higher risks. Stated differently, securities with the same level of risk should yield the same returns to investors.

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\(^{105}\) See R. Brealey et al., *supra* note 77, at 178-180.

In 1981, studies by Banz\textsuperscript{107} and Reinganum\textsuperscript{108} found evidence that small firms listed on stock exchanges produced higher risk-adjusted returns than listed large firms, contrary to what is predicted by the CAPM. Banz noted that for the 1936 to 1975 period, smaller enterprises listed on the New York Stock Exchange (NYSE) had higher returns than larger enterprises even after adjusting for risk. Likewise, in the same year, Reinganum examined firms listed on the NYSE and the American Stock Exchange (AMEX) and found higher risk-adjusted returns for smaller firms over the period 1963 to 1977. The work of Banz and Reinganum spurred many other studies which produced similar results for the stock markets of major industrialised countries, including Canada.\textsuperscript{109} Further studies of this anomaly discovered that a large part of the annual risk-adjusted returns earned by listed small firms accrues in January.\textsuperscript{110}

The small firm effect formally identified by Banz and Reinganum constitutes a serious challenge to the CAPM.\textsuperscript{111} Moreover, this pricing anomaly questions the more general efficient capital market hypothesis (ECMH) which asserts that securities prices cannot be predicted on average and that anomalies quickly disappear as soon as they are known by rational investors.\textsuperscript{112} Dimson and Marsh aptly underline the implication of this anomaly for the ECMH: "The existence of a market regularity, such as persistent outperformance by smaller companies, would imply inefficiency, since an investor could use the regularity to devise a trading strategy which produced above-normal returns."\textsuperscript{113}


\textsuperscript{113} E. Dimson & P. Marsh, \textit{supra} note 109, at 17.
Financial economists have attempted to address the issues raised by the size effect by examining whether the small firm effect is a statistical artifact, or whether it implies a general rejection of the CAPM or of the ECMH. While biases in the measurement of return and risk have been found, these biases only exaggerated the magnitude of the small firm effect which nevertheless remained after adjustments.

Since the small firm effect is not the product of statistical mismeasurement, it has potential important consequences on SMES’ cost of capital. Indeed, the benefit to capital market participants arising from the small firm effect represents a higher cost of equity finance to small enterprises than is predicted by the CAPM on the basis of their systematic risk. Accordingly, as Day et al. remark, the size effect “implies that investors in small firms demand a higher risk-adjusted return than investors in large firms, and this demand results in a higher cost of capital for small firms.”

b) The Competing Explanations of the Small Firm Effect

Several intriguing theories have been put forward by financial economists to explain the small firm effect. This section reviews two of the most important explanations found in the literature. It is should be noted that none of the theories crafted so far completely account for the size effect. Indeed, it appears increasingly certain that no single theory can explain entirely this stock market anomaly and that the latter results from a combination of factors. Accordingly, the explanations reviewed should be perceived as pieces of the small firm effect puzzle. They however shed light on the characteristics of the secondary market for small firm securities.


117 T.E. Day et al., supra note 115, at 103.
i) *The Neglected Firm Effect*

In a series of studies following the formal identification of the small firm effect, Arbel and Strebel have suggested that the abnormal returns generated by small enterprise securities may be the result of these securities' information deficiency which is not captured by the usual measures of risk of the pricing models.\(^{118}\) The authors emphasise that the segment of the equity market populated by small firms is less informationally efficient than the remainder of the market. Few professional analysts follow the securities of small firms on a regular basis to assess and disseminate information continuously.\(^{119}\) In addition, institutional investors tend to avoid the securities of small firms.\(^{120}\) The relative absence of institutional shareholders exacerbates the information deficiency of these securities. In particular, the authors stress that “since financial institutions have little equity and therefore little interest or control over the company, there is less monitoring of management performance.”\(^{121}\)

Arbel and Strebel contrast the information environment of small firm securities, which they characterise as generic stocks, with brand-name securities, *i.e.* securities enjoying considerable analyst following and being widely held by institutional investors.\(^{122}\) They argue that investors buying such brand-name securities pay an extra fee for the stamp of approval and the monitoring services provided by these sophisticated market participants. In return, they benefit from more and better quality information, resulting in less estimation risk and, consequently, less uncertainty.


\(^{120}\) *Supra* Chapter III notes 270-289 and related text.

\(^{121}\) *Giraffes and Neglected Firms*, supra note 118, at 5.

\(^{122}\) *Neglected Firms*, *ibid.*, at 40-41; *Generic Stocks*, *supra* note 118, at 5-6.
The information deficiency of small firm securities results in higher estimation risk regarding the firm's performance, its potential, and investors' own eventual benefits as outsiders. For this reason, generic stocks sell for less as investors don't have to pay for the monitoring services, research and stamp of approval that is not provided. Investors may choose to reduce the information deficiency of generic stocks by doing their own monitoring. Alternatively, they may elect to live with the higher estimation uncertainty resulting from neglect. In either case, they are compensated for this high uncertainty, and for these costs, through a generic premium. In other words, the extra returns on small firm securities should not be interpreted as abnormal, but as a fee for the low quality of the risk estimate.

Central to the argument of Arbel and Strebel is the fact that the information deficiency, which drives the small firm effect, and the resulting estimation risk is not accounted for by the usual pricing models. Indeed, Arbel notes that the pricing models:

> implicitly assume that the usual risk measures like price or return volatility and the beta coefficients capture all dimensions of risk and that they are perceived by investors to be identical for different companies, if they have the same measured magnitude.

Otherwise, the returns accruing from neglect could not be considered to be abnormal by the existing pricing standards.

The misspecification of the CAPM was supported in an empirical study conducted by Arbel and testing the neglected firm hypothesis. Arbel showed that when estimation risk is added to the CAPM specification, it is as important as beta (β) in explaining return variability. This confirmed the insight that “part of what seems to be abnormal return when risk is adjusted according to the standard CAPM is, in fact, a result of a missing variable or an incomplete measure of risk.”

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123 *Generic Stocks, ibid.* (information deficiency and the resulting estimation risk are directly associated with degree of neglect: the more neglected a stock is, the higher the estimation risk).


125 *Generic Stocks, supra note 118. at 5.*


The neglected firm hypothesis yields two important implications. Firstly, for information deficiency, or neglect, to command higher returns, it must be a source of undiversifiable risk. Indeed, if the estimation risk generated by information deficiency were diversifiable, this risk could be diversified away in a portfolio of many securities. Thus, investors should not expect to be compensated for the risk that results from the lack of information about firms and about the securities that firms issue. This implication is supported empirically by studies suggesting that the systematic risk ($\beta$) of securities increases as the amount of information available decreases. Accordingly, since systematic risk is affected, information deficiency increases portfolio risk and thereby required returns.

Secondly, in addition to increasing securities risk, information deficiency may also create a market environment wherein mispricing can occur. Information inefficiencies may enable investors to realise excess returns on neglected firms by identifying undervalued securities. Such will be the case where the higher returns on neglected securities are not exactly offset by the information deficiency or the cost of eliminating it. However, contrary to the returns generated by the neglected firm effect, the excess returns accruing from the identification of mispriced securities will be self-destructing and unlikely to persist over time. Indeed, the collection of information by investors to uncover the inefficiency will contribute to erode the mispricing and move the stocks' price closer to its accurate level.

In sum, the neglected firm hypothesis presented by Arbel and Strebel suggests that the small firm effect may be related to the limited availability of information on smaller issuers. The

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130 Giraffes and Neglected Firms, supra note 118, at 61-62.

131 To understand this difference, recall that the higher returns generated by neglect are not abnormal but are the proxy for a higher risk caused by information deficiency. Thus, the neglected stocks are not mispriced as they do not generate higher risk-adjusted returns when the estimation risk is integrated into the CAPM. E. Dimson & P. Marsh, supra note 109, at 17, fail to make this difference in their critique of the neglected firm hypothesis.

impact of neglect on securities return is not limited, \textit{per se}, to SMES.\textsuperscript{133} Given the institutional features of the secondary market for these enterprises' securities, it is likely that the neglected firm effect will be stronger for smaller enterprises, than for larger ones.

\textit{ii) Limited Marketability}

Small issuers have several characteristics that impair the liquidity of their securities. These include a small number of shareholders, a small transaction volume, and a poorly developed track record.\textsuperscript{134} A number of authors point to the relative low liquidity of SMES securities as a likely cause of the small firm effect.\textsuperscript{135} More particularly, they argue that the small firm effect arises from the failure of the \textsc{capm} to take into account the impact of this characteristic of SME securities which imposes costs of several varieties on investors trading in these securities.\textsuperscript{136} Once these costs are taken into account by the pricing model, they assert, the size effect should disappear.\textsuperscript{137}

Undoubtedly, trading in illiquid securities can be costly for investors.\textsuperscript{138} Finding willing buyers and sellers will involve out-of-pocket and time-consuming search costs. Likewise, the execution of transactions will require a sacrifice of desired immediacy and the risk of facing price pressure for large transactions. Furthermore, investment dealers facilitating transactions will require greater compensation for dealing in illiquid assets in the form of greater bid-ask spreads. Emphasising the impact of these costs, commentators assert therefore that, \textit{ceteris paribus}, investors will expect returns that are a positive function of illiquidity to offset these direct and indirect costs, which cannot be diversified away,\textsuperscript{139} hence the small firm effect.\textsuperscript{140}

\begin{itemize}
\item \textsuperscript{133} \textit{Neglected Firms. supra} note \textsuperscript{118}, \textsuperscript{at} 39.
\item \textsuperscript{134} Y. Amihud \& H. Mendelson, "Asset Pricing and the Bid-Ask Spread", (1986) \textit{17 J. Fin. Econ.} 223.
\item \textsuperscript{135} For a review of the literature see B.I. Jacobs \& K.N. Levy, "Forecasting the Size Effect", \textit{Fin. Anal. J.}, May-June, 1989 \textit{at} 38.
\item \textsuperscript{137} Y. Amihud \& A. Mendelson, "The Effects of Beta, Bid-Ask Spread, Residual Risk, and Size on Stock Returns", (1989) \textit{44 J. Fin.} 479. See also "Small Wonders", \textit{The Economist}, March 26\textsuperscript{th} 1994 \textit{at} 98.
\item \textsuperscript{138} \textit{Supra} notes \textsuperscript{2-15} \textit{and related text}.
\item \textsuperscript{139} Y. Amihud \& H. Mendelson, \textit{supra} note \textsuperscript{137}, \textsuperscript{at} 485: "The effect of illiquidity is nondissipative since it can hardly be eliminated by diversification. An investor who wishes to take advantage of the excess (gross) returns on high-spread
Several researchers tested the limited marketability hypothesis with mixed results. Stoll and Whaley used the Banz and Reinganum findings, which were based on gross returns, by computing after-transaction-cost, risk-adjusted returns.\textsuperscript{140} The authors found that the size effect of New York Stock Exchange securities disappeared for a three-month investment horizon, after controlling for the higher bid-ask spreads and brokerage commissions on small firm securities.\textsuperscript{142} As the investment horizons is increased, the after-transaction cost abnormal returns become positive, although only weakly statistically significant.

Shultz criticized the findings of Stoll and Whaley by extending the analysis to American Stock Exchange securities.\textsuperscript{143} He found that transaction costs did not completely explain the abnormal returns of small firm securities for the sample. Indeed, his study indicated that small firms earned positive abnormal returns after controlling for transaction costs for investment horizons of one year or less.\textsuperscript{143 1}

However, further research yielded additional support to the transaction costs hypothesis. Amihud and Mendelson found that returns — both gross and net of transaction costs — were an increasing function of bid-ask spread, a measure of liquidity.\textsuperscript{144} Hence, the small firm effect was negligible after controlling for liquidity. Likewise, Beedles, who examined securities listed on the New York, American and Australian stock exchanges, found that the relative lack of liquidity of

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{141} H.R. Stoll & R.E. Whaley, \textit{ibid.}
\item \textsuperscript{142} \textit{Ibid.} at 78.
\item \textsuperscript{143 1} See also E.F. Fama, "Efficient Capital Markets: II", (1991) \textit{46 J. Fin.} 1575 at 1587-1588 (greater institutional investor interest in small firm securities tends to dissipate the abnormal returns).
\item \textsuperscript{144} Y. Amihud & H. Mendelson, \textit{supra} note 134
\end{itemize}
\end{footnotesize}
small firm securities is an important contributor to the high cost of equity experienced by these firms.\textsuperscript{145}

Given the mixed results of empirical research, the transaction costs hypothesis is not entirely satisfying in accounting for the small firm effect. Still, it is important to acknowledge that factors related to secondary market transaction costs are relevant in explaining the size and price effects.\textsuperscript{146}

c) Summary

The small firm effect has important consequences for SMES' cost of capital. The existence of this pricing anomaly implies that investors in small firms demand a higher risk-adjusted return than investors in large firms. This demand translates in a higher cost of capital for smaller enterprises.

Amongst the various theoretical models put forward to explain the small firm effect, the neglected firm hypothesis appears to be the most satisfying. Although not completely irrelevant, the limited marketability hypothesis has more limited explanatory power given the results of empirical tests. In any event, while they have been presented separately, these two theories should not be considered to be entirely independent from each other. Indeed, informational efficiency and liquidity are closely intertwined: "the same dynamic market forces that cause markets to become efficient also cause markets to be liquid."\textsuperscript{146}

An important policy implication of the small firm effect is that it is not sufficient that organised stock markets be accessible to SMES through better adapted listing requirements to facilitate the use of public equity financing for these enterprises. Stock exchanges seeking to cater to SMES should provide trading mechanisms that reduce the transaction costs associated with trading in small firm securities. Concurrently, they should design trading infrastructures that


\textsuperscript{146} T.E. Day et al., supra note 115, at 123.

\textsuperscript{146} J. Macey & H. Kanda, supra note 3, at 1014.
facilitate the flow of trading information in order to enhance informational efficiency. Otherwise, the costs of maintaining a secondary market may nevertheless prevent issuers from raising public equity capital.

SECTION C: EXPLORING ALTERNATIVES TO STOCK EXCHANGE LISTING IN ONTARIO: THE POTENTIAL OF THE CANADIAN DEALING NETWORK

Enterprises making small initial public offerings in Ontario have difficulty accessing an organised stock market in that province. The main secondary market for Ontario, the Toronto Stock Exchange, has the most stringent listing requirements of the Canadian stock exchanges. Thus, smaller issuers must seek listing on the Alberta Stock Exchange, the Vancouver Stock Exchange, or the Montreal Exchange, which have lower listing requirements. Despite the existence of alternatives to a listing on the TSE, there may nevertheless be a gap in the financing of SMEs in Ontario as these stock exchanges may not even prove to be accessible or suitable for small IPOs from out-of-province firms. This gap will become particularly worrisome if the regulatory framework governing IPOs in Ontario is reformed to facilitate public equity financing for SMEs.

From this perspective, the purpose of this section is to discuss the possibility of filling the gap in secondary markets in Ontario to facilitate public equity financing for SMEs. The section focuses more particularly on the potential of the Canadian Dealing Network, which operates the over-the-counter market in Ontario, in providing a viable and accessible secondary market for smaller issuers.

1. Special Secondary Markets for Small and Medium-sized Enterprises: The Options

The difficulty for SMEs in accessing stock exchanges is a pervasive problem that has been preoccupying regulators for several decades.147 Amongst the solutions considered in the various proposals developed throughout the years, the implementation of second-tier markets is

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undoubtedly the idea that has received the widest support until recently. Second-tier markets are essentially special segments that are created by stock exchanges in their equities markets with the objectives of lowering regulatory and cost barriers to entry for SMES.

In Canada, the creation of special stock markets segments for SMES was proposed by a study sponsored by the Toronto Stock Exchange in 1980. The report suggested the creation of three listing categories for the TSE: (1) ‘A’ companies which would enjoy full status; (2) ‘B’ companies with a limited track record but unable to meet the full status listing requirements; (3) ‘C’ or speculative companies. The proposal, though innovative, was never implemented and seems to have been abandoned. Instead, the most interesting Canadian stock exchanges initiatives aimed at improving the accessibility of stock markets for SMES have taken the form of specialised programs assisting start-up firms in raising equity capital. Thus, the Alberta Stock Exchange has set up a Junior Capital Pool (JCP) program which is considered to be a success in that province. Recently, the Vancouver Stock Exchange implemented the Venture Capital Pools (VCP) program modelled on the JCP and which is still in infancy.

Second-tier markets have been more popular in Europe where many stock exchanges have sought to establish special stock markets for SMES. The most notable European second-tier market initiatives include the Mercato Ristretto of Italy, the Second Marché of France, the Officiele Paralle Marka (OPM) of the Amsterdam Stock Exchange, and the Unlisted Securities Market (USM)...

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149 G. Bannock, *ibid.* at 7.

150 P. Johnston, *supra* note 66.


152 In a careful review of the performance of the JCP program, professor Michael Robinson suggests that the success of the JCP may be idiosyncratic to the conditions prevailing in Alberta and which may not exist in other jurisdiction. For this reason, he suggests that the success of the JCP model may not be easily reproduced in other Canadian provinces. M.J. Robinson, *supra* note 68, at 617-619. See also E. Kirzner, “Comment”, in P.J.N. Halpern, *supra* note 15, at 681.

of the London Stock Exchange. These second-tier markets, which were all under the management of the main markets, purport "to bring access to public securities markets nearer to the SMES, providing lower costs of capital, the availability of equity capital in larger amounts, and the opportunity for exits for early stage investors." The common approach adopted by the markets was to reduce cost barriers to entry for SMES by relaxing listing requirements.

Initially, European second-tier markets were considered to be a success as their implementation coincided with a very rapid growth in the number of new entrants. The stock market collapse of 1987 and the following recession, however, marked the permanent decline of these markets. Thus, the Mercato Ristretto, the Second Marché, the OPM, the USM, and other second-tier markets, are now considered a failure.

Without minimising the impact of the events of 1987 and of the recession, commentators argue that the failure of the European junior stock markets was caused by more important structural deficiencies. Bannock stresses that since second-tier markets were under the same management as the main exchanges, they were not actively promoted as "stock market managements [were] inevitably predominantly interested in the main market, which accounts for most of their income and prestige." This lack of active promotion coupled with the relative similarities of listing requirements caused second-tier markets to be widely considered as merely ante-chambers for the main markets. Thus, issuers moved their listings to the main market as

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155 G. Bannock, ibid. at 7.
156 Ibid. at 27-103.
157 Commission des Communautés Européennes, Communications de la Commission, "Rapport concernant la faisabilité de la création d'un marché européen des capitaux pour les jeunes sociétés entrepreneuriales de croissance rapide", COM (95) 498 final 1 at 6 [hereinafter Feasibility of capital markets]
158 M. Anolli et al., supra note 148, at 225-226; G. Bannock, supra note 148, at 103-107. See also "Europe's second markets; Small, but not yet beautiful". The Economist, January 25, 1995 at 80.
159 G. Bannock, ibid. at 112.
160 Ibid.; M.J. Robinson, supra note 68, at 611.
soon as practicable, with a depressing effect on volume and liquidity. Furthermore, because of their transitory nature, junior stock markets listed few high quality firms and thereby acquired a reputation of posting inferior securities.\textsuperscript{161}

Some commentators also stressed that the relative dearth of institutional investors as buyers of small firm securities may have played an important role in preventing the market from developing efficiently and effectively.\textsuperscript{162} Undoubtedly, the lack of institutional investments in second-tier markets securities has dampened the development of efficient market infrastructures. However, this factor is likely to exist with respect to small firm securities in any stock market and cannot therefore be considered to be the determining factor in the failure of junior stock markets.\textsuperscript{163}

The widespread failure of second-tier markets in Europe casts doubts on the value of this policy option for improving the accessibility of secondary markets to SMES. According to several commentators, a more promising alternative may be to enhance the OTC market as a secondary market for the securities of junior issuers.\textsuperscript{164}

The OTC market is a decentralised market where issuers which do not list their securities on an organised stock exchange have their securities traded. The OTC market is known as a dealer market since the orders of a buying customer and a selling customer never meet directly; every transaction involves a professional dealer who participates in buying and selling for his own account.\textsuperscript{165} Thus, transactions are executed continuously among broker-dealers and between broker-dealers and their customers.\textsuperscript{166}

\begin{footnotesize}
\begin{enumerate}
\item M.J. Robinson, \textit{ibid.} For a description of the lemon problem which can result from the concentration of poor quality securities on an exchange see \textit{Financing Innovative Enterprise}, supra note 13, at 138-139.
\item M.J. Robinson, \textit{ibid.} See also supra Chapter III, notes 270-289 and related text.
\item G. Bannock, supra note 148, at 121, 159; \textit{Feasibility of Capital Markets}, supra note 157, at 6-7.
\item Groupe de travail sur la prospérité, \textit{Innover pour l’avenir} (Ottawa: Supply and Services, 1992) at 28; Letter from J.P. Bunting, president and CEO of the Toronto Stock Exchange to Edward Waitzer, chair of the Ontario Securities Commission, dated April 14, 1994 at 6-7; M.J. Robinson, supra note 68, at 618-619; E. Kirzner, supra note 152, at 681.
\item T.H. Maynard, supra note 1, at 845-846; N.S. Poser, supra note 1, at 894-895.
\item N.S. Poser, \textit{ibid} at 894-896.
\end{enumerate}
\end{footnotesize}
The potential which lies in the development of an organised OTC market in improving the access of SMEs to secondary markets is underscored by the phenomenal success of the National Association of Securities Automatic Quotation (NASDAQ) system. Although it is necessary to proceed with some caution when comparing the Canadian OTC market with NASDAQ, the experience of NASDAQ can provide valuable information for the development of an efficient OTC market. Indeed, prior to the introduction of NASDAQ in 1971, the American OTC markets were very thin, suffered from lack of information, and had a poor reputation. By providing efficient trading infrastructures, NASDAQ has marked an important change in the OTC market which has spurred a spectacular and sustained growth in trading volume and quotations.

The relevance of the NASDAQ experience for the Canadian OTC market is buttressed by the recent creation of EASDAQ in Europe by the European Association of Securities Dealers. Launched in 1996, EASDAQ is a pan-European quote-driven stock exchange that is independent of existing stock exchanges. It is established along the lines of NASDAQ and specifically designed to improve liquidity for SMEs. Prompted by the failure of European second-tier markets, the creation of this pan-European stock exchange was made possible, from a regulatory standpoint, by Directives of the European Union adopted as part of its efforts to enhance the free flow of capital inside the Union.

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167 M.J. Robinson, supra note 68, at 607; Financing Innovative Enterprise, supra note 13, at 139-140.


More than merely attempting to reproduce the success of NASDAQ, the development of the OTC market would provide an additional choice to issuers which could enhance the level of competition among stock exchanges. Strong competition among market centres is desirable as it creates pressures to innovate and improve trading systems. For instance, competition was arguably an instrumental force in driving stock exchanges to introduce automation and modern trading procedures that facilitate trading and reduce liquidity costs. Furthermore, competition offers to issuers the broadest possible choice of trading systems given the uncertainty which surrounds the superiority of a particular system for the trading of SME securities. This allows issuers to select from among the trading systems the one which can best maximise the firm's securities value and liquidity.

2. Improving the Vitality of the Current Over-the-Counter Market

a) Background and Overview of the Canadian Dealer Network (CDN)

The Canadian Dealer Network (CDN) based in Ontario is the only organised OTC market in Canada. The development of this organised OTC market in Ontario is fairly recent and dates only from 1986. Prior to 1986, trading with respect to unlisted securities was conducted in an institutional vacuum. OTC trading was supervised indirectly by the Investment Dealers Association (IDA) which regulated securities firms that held themselves out as willing to buy and sell these securities for their own account.


176 Infra note 227 and related text.

177 In 1996, 2.8 billion shares traded, an increase of 70% from 1995.

The oversight of the IDA fell short, however, from providing the requisite institutional features to ensure the efficiency of the market. Indeed, the unorganised OTC market was characterised by the paucity and poor quality of information available.\textsuperscript{179} Although trading records were maintained by the IDA, these records lacked completeness, accuracy and timeliness. Likewise, it was difficult to identify market makers since a list of active market makers was produced only on an annual basis. Thus, securities firms and investors trading in the market were evolving in a rather inefficient market that did not command a high level of public confidence. The risk of trading in this market was exacerbated by the fact that the OSC, hampered by poor quality and quantity of information, was unable to conduct effective surveillance and enforcement.\textsuperscript{180}

In light of the deficiencies of the OTC market, the Ontario Securities Commission implemented the Canadian Over-the-Counter Trading System (COATS) "to overhaul the antiquated OTC reporting system."\textsuperscript{181} At the same time, the OSC sought "to incorporate features necessary to provide the public with up-to-date, accurate and complete trading and quotation information with respect to unlisted securities trading in Ontario."\textsuperscript{182} Thus, the COATS facilities were set up to provide up-to-date information on quotations (bid and ask price posted by market makers), trading statistics, and approved market makers.\textsuperscript{183} The implementation of COATS increased the accuracy, timeliness and completeness of information which enhanced the efficiency of the market and public confidence. It made also possible a more effective surveillance of the market by the securities commission.\textsuperscript{184}

\begin{itemize}
  \item \textsuperscript{179} \textit{Ibid.}, at 1090.
  \item \textsuperscript{180} \textit{Ibid.}
  \item \textsuperscript{181} \textit{Ibid.}, at 1091. COATS was created by the promulgation of Part VI of the \textit{Securities Regulation} and by the OSC Policy Statement 1.8, "Canadian Over-the-Counter Automated Trading System (COATS) — Policies", (1986) 9 \textit{O.S.C.B.} 2035; repealed (1991) 14 \textit{O.S.C.B.} 857.
  \item \textsuperscript{182} \textit{COATS Task Force}, \textit{ibid.}
  \item \textsuperscript{183} The Toronto Stock Exchange provided the computer facilities to disseminate the information. See "Canadian Over-the-Counter Automated Trading System", (1985) 8 \textit{O.S.C.B.} 5028.
  \item \textsuperscript{184} The Regulation enacted specific requirements with respect to trade reporting and market making. See \textit{O.S.R.}, s. 154-156.
\end{itemize}
The OSC operated COATS from 1986 to 1991. In 1991, it transferred the operation of the trading system to the Toronto Stock Exchange. This transfer was arguably necessary to ensure the improvement and efficient functioning of COATS. Indeed, the securities commission had limited experience in running a trading system. Furthermore, some discomfort was felt in the commission’s role as both operator and regulator of a stock trading system. Thus, the operation of COATS was taken over by the Canadian Dealing Network, a wholly owned subsidiary of the TSE incorporated to provide an efficient, visible and fair secondary market to facilitate capital formation for SMES.

While CDN is Canada’s only organised OTC market, it is by no means comparable to NASDAQ, the principal organised American OTC market. In 1993, CDN’s trading values were approximately 7 per cent of the TSE trading, while NASDAQ’s trading dollar value was 43 per cent of the New York Stock Exchange’s trading value. Trading activity has nevertheless grown significantly since the debut of CDN from a volume of 281 million shares in 1991 to a volume of almost 3 billion in 1997. Likewise, CDN seems to be attracting a growing number of new issuers. In 1997, 75 new firms were approved for quotation on CDN, an increase of 25 per cent over the previous year.

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186 Ibid. at 3.

187 COATS Task Force, supra note 178, at 9: “due to its role as government regulator, the OSC has not been able to market COATS properly.” See also P.S. Taylor, “Pennies from Hell”, Canadian Business, February 27, 1998 at 69.


192 Ibid.
CDN undoubtedly plays an important role in SMEs capital formation in Ontario by providing visibility and liquidity to emerging companies unable to meet stock exchange listing requirements. However, the vitality of CDN should not be overstated, and several reforms are necessary if it is to provide trading facilities comparable with those provided by NASDAQ. In this respect, recent legislation has paved the way for a reform of CDN by granting to the latter the statutory authority to regulate the OTC market in Ontario. The new legislation confers on CDN the authority to enact rules governing the market and to regulate registered securities dealers. CDN has announced that it would “proceed over the next one to two years with the formulation and implementation of a comprehensive set of rules governing the CDN quotation and trade reporting system.”

b) The Quotation Process

The CDN system is divided into two segments. The first segment encompasses issuers (reported issuers) which comply with the minimum mandatory trade reporting requirement of the Regulation. Following the Regulation, every purchase or sale in Ontario of an unlisted security transacted by a registered dealer, as principal or agent, must be reported through the system developed for trading over-the-counter.

The second segment of the system comprises issuers (quoted issuers) for which, in addition to trade reporting, a market is maintained by registered dealers quoting continuous bid and ask prices. While quoted issuers represent about 400 of the 1,100 issuers for which trading is

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195 K. Cowan, supra note 185, at 6.

196 Ibid. at 8-10.

197 O.S.R. s. 154.

198 Securities issued under a prospectus exemption or traded on a recognized stock exchange are exempted from the trade-reporting requirement. O.S.R., s. 152.

199 O.S.R., s. 155-156.
reported on CDN, they are the most actively traded securities as they account every year for in excess of 90 per cent of the system’s total trading volume.\textsuperscript{200}

To be admitted on CDN as quoted issuers, firms must comply with the requirements set in the CDN policy.\textsuperscript{201} The quotation requirements are considerably less stringent than those of stock exchanges and can be easily met by most issuers. As a general principal, CDN will approve quotation when it determines that it is not prejudicial to the public interest.\textsuperscript{202}

Moving from the general to the specific, the applicant must be a reporting issuer in Ontario and carry on an active business as a going concern.\textsuperscript{203} It must have a public float of shares comprising a minimum of 100 shareholders holding a minimum of 500 shares each to enable an orderly market to develop.\textsuperscript{204} In addition, although the current quotation requirements do not specify minimum financial standards which issuers must meet, the latter must have sufficient financial resources to implement the objectives of its business or exploration plan.\textsuperscript{205} Finally, the issuer must have at least one market maker approved by CDN to be quoted on the system.\textsuperscript{206} When issuers seeking quotation are conducting an IPO, CDN expedites the review of the application and issuers can be granted quotation within a few days following the issuance of the final receipt for the prospectus.\textsuperscript{207}

\textsuperscript{200} K. Cowan, supra note 185, at 4.

\textsuperscript{201} CDN Policy, s. C. The quotation requirements are completed by the Canadian Dealing Network, Guide to Quotation (Toronto: Canadian Dealing Network, 1997) [hereinafter Guide to Quotation].

\textsuperscript{202} CDN Policy, ibid. s. C.1.

\textsuperscript{203} For the relevant criteria used in determining the existence of a business see In the Matter of Inland National Capital, (1996) 19 O.S.C.B. 773 commented by K. Cowan, supra note 185, at 17-20.

\textsuperscript{204} CDN Policy, s. C.1: Guide to Quotation, supra note 201, at 3. Note that a security listed on a stock exchange cannot be admitted for trading on CDN as long as it is not suspended from trading. O.S.R., s. 152.

\textsuperscript{205} K. Cowan, supra note 185, at 20-21; Guide to Quotation, ibid. at 4-7.

\textsuperscript{206} Guide to Quotation, ibid. at 4.

\textsuperscript{207} K. Cowan, supra note 185, at 14.
The low listing requirements of CDN imply that quotation on the system cannot be perceived by investors as a strong signal of firm quality.\textsuperscript{208} The uncertainty with respect to the system's certifying role should not be perceived as a source of concern even though it may affect the level of underpricing for quoted issuers.\textsuperscript{209} Indeed, issuers, including SMES, can obtain the services of a wide variety of reputational intermediaries such as auditors, bankers, underwriters, and venture capitalists, to reduce the \textit{ex ante} uncertainty about the value of their IPOs.\textsuperscript{210} These intermediaries serve as "close substitutes" for the certification provided by stock exchange listing.\textsuperscript{211} Given the importance for smaller issuers of accessing a liquid secondary market, it seems preferable for CDN to maintain lenient listing requirements rather than to attempt to take on a certifying role by increasing listing standards that would reduce the accessibility of the market for smaller issuers.\textsuperscript{212} Instead, as it will be argued below, CDN should focus on enhancing the liquidity and the integrity of the market.

c) The Trading Mechanism of the Canadian Dealing Network

CDN is a dealer, or quote-driven, market. A dealer market is a market where dealers are the primary means of trading for investors.\textsuperscript{213} In such a market, every trader's order must always go through a designated dealer, the market maker, that holds an inventory of certain securities and is prepared to buy and sell those securities on a continuous basis. The dealer acts as a counter-party by trading for itself as principal and does not act as an agent for investors. Thus, the matching orders of investors never interact directly in a dealer market.\textsuperscript{214}


\textsuperscript{209} See J. Affleck-Graves et al., \textit{supra} note 227.

\textsuperscript{210} \textit{Supra} Chapter III.

\textsuperscript{211} J.R. Macey & H. Kanda, \textit{supra} note 3, at 1040-1042.

\textsuperscript{212} H.K. Baker & S.E. Meeks, \textit{supra} note 27, at 64: "the tradeoff between the cost of listing and any increase in value may produce different results among firms."

\textsuperscript{213} \textit{Electronic Trading Systems, supra} note 26, at 2527-2528.

As mentioned above, CDN requires every issuer seeking quotation to have at least one registered dealer acting as market maker. In order to act as market maker on CDN the registered dealer must obtain the approval of the securities commission and of CDN. Generally, the investment dealer that underwrote the initial public offering will act as market maker. Once approval is granted, the registered dealer must comply with the CDN Policy which prescribes that it maintains continuous and uninterrupted quotations during business hours in the security for which it has received approval as market-maker.215

In practice, securities are traded on the CDN by telephone through dealers making a market for the particular securities.216 The market maker holds an inventory of the securities for which it has elected to act as such and posts a bid and ask quotation indicating the prices at which it is willing to buy or sell securities.217 The quotes are displayed on CDN's network of terminals and are viewed by all dealers trading in CDN securities. When a trade takes place in a CDN security, information concerning the trade is reported within three minutes of the transaction using terminals connected to the system.218 Market information generated by CDN is available on the system's electronic network, from commercial quotation vendors, as well as some from newspapers.219

When executing investors' orders, market makers are subject to a duty of best execution.220 Pursuant to the CDN Policy, a dealer must, prior to filling a customer's order for a security, attempt to satisfy any competing market maker's live quotation where such quotation is better than the price the dealer is offering by five per cent or more. In other words, market makers have a duty to seek to improve execution of customer orders by ensuring that orders are directed to market makers providing the most advantageous terms.

215 Presently, the CDN Policy does not have statutory basis. The Policy is imposed on market makers through a contractual agreement entered into with CDN (the User Agreements). The agreement imposes, inter alia, an obligation to comply with the requirements of the Policy. See CDN Policy, s. A.1; K. Cowan, supra note 185, at 5-6.

216 CDN Policy, ibid. s. A.2. See K. Cowan, ibid. at 11-12;

217 CDN Policy, ibid. s. D.1.

218 Ibid. s. E.1.

219 Ibid. s. A.2.

CDN, as a dealer market, enhances the liquidity of quoted securities by reducing transaction costs. The market making services provided by CDN help traders economise on search cost to find a counterpart willing to trade.221 Traders know that they can buy or sell immediately at the quotes given by the market maker that can be easily identified. Furthermore, market makers reduce execution risk for traders which can arise from temporary imbalances between buyers and sellers in a security.222 In an order-driven market, i.e. a stock exchange, there is a risk that a trader’s order will not immediately encounter another trader’s order on the other side of the transaction at the same price, thereby preventing the transaction from being promptly executed at a price reasonably related to the current market price.223 By standing ready to trade at the quoted bid and ask price, the dealers provide insurance against such execution risk to traders.224

The reduction of execution risk for investors in dealer markets is particularly important for small firm securities which are characterised by a lack of widespread investor interest, a small public float, and a small trading volume.225 These characteristics may make it difficult for a viable auction market to develop. Thus, traders will face substantial execution risk when trading in these securities since their orders may execute at an unfavourable price because of the lower likelihood that offsetting orders reach the market at the same time. Accordingly, traders will require a higher rate of return to offset the execution risk, which will increase the cost of getting listed on the stock market for the firms.226

Empirical evidence comparing the ability of NASDAQ and stock exchange trading mechanisms to enhance liquidity offers, however, mixed results on the relative superiority of

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222 J.R. Hardiman, supra note 169, at 11-12.

223 N.S. Poser, supra note 169, at 43-44. However, registered traders or specialist reduce the execution risk by supplying immediacy to investors by buying and selling unwanted securities.


225 K. Garbade, supra note 16, at 426-428, 438; N.S. Poser, supra note 169, at 48 (securities that trade on the New York Stock Exchange are usually more active and better known than those traded over the counter).

226 Supra notes 2-19 and related text.
dealer markets in providing liquidity for small and medium-sized firms securities.\textsuperscript{227} This leads Poser to argue that "it is unlikely...that any particular trading system will succeed in providing substantially greater liquidity for inactive stocks."\textsuperscript{228} While there is insufficient evidence to demonstrate the clear superiority of any trading mechanism (order-driven or quote-driven), Poser's remark should not be taken as suggesting that attempts should not be undertaken to improve the OTC market. Rather, the uncertainty surrounding the superiority of trading systems supports experimentation through competition and, thereby, the improvement of the OTC trading system.\textsuperscript{229}

3. The Economics of Market Making

The most important function of an organised stock market is to provide liquidity for the trading of securities. In a quote-driven market, such as CDN, this function is performed by investment dealers acting as market-makers for particular securities. Thus, the effectiveness of CDN as a trading system depends largely on the willingness of investment dealers to enter the market and act as market makers.

A central prerequisite for securities firms entering the market is that they must be able to earn revenues that allow them to cover their costs and earn a competitive return on capital.\textsuperscript{230} Market-makers earn their revenues by selling securities at an offer price greater than the bid price they pay for the securities. The difference, the bid-ask spread, "compensates them for providing to


\textsuperscript{228} N.S. Poser, \textit{supra} note at 49.

\textsuperscript{229} G. Bannock, \textit{supra} note 148, at 132. See also J.L. Hamilton, \textit{supra} note at 500 (as an automated OTC market gains efficiency, it may eventually displace the stock exchange).

\textsuperscript{230} D.E. Van Zandt \textit{supra} note 221, at 986.
occasional market participants the liquidity of an immediately available market, and also for the risk the dealers incur when they position an issue in their inventory.\textsuperscript{231}

The profitability of market-making is closely related to the volume of transactions on the market.\textsuperscript{232} The volume or rate of transactions on the market determines the level of revenues earned by investment dealers. At the same time, it affects the average cost of market-making by diminishing the proportion of the fixed cost that each transaction represents.\textsuperscript{233}

While trading volume is critical for the viability of any secondary market, the concept of volume presents serious difficulties for analytical purposes. Trading volume is a market characteristic which is tributary on both exogenous factors to issuers, such as the trading system's rules and procedures, and endogenous factors to issuers, such as the number of shares outstanding.\textsuperscript{234} For this reason, the concept of trading volume is not a useful guide in the design of a trading system, even though it is central to the viability of the latter.

Instead, it is argued here that it is preferable to focus on the cost of liquidity services provided by market-makers. More particularly, a viable trading system should seek to ensure that the cost of liquidity services provided by market-makers are kept at a minimum.\textsuperscript{235} The cost of liquidity services affects the incentives of investors to purchase and trade in securities on a given market. Where the cost of liquidity services is high, market-makers must set wide bid-ask spread to cover their costs and earn a competitive return on capital. Traders must therefore require returns on securities that will be large enough to offset this cost: otherwise it will not be profitable to purchase or trade in the securities. In turn, the higher returns demanded by traders affect issuers by increasing their cost of equity. Where the returns required become too high, issuers will not find it

\textsuperscript{231} K. Garbade, \textit{supra} note 16, at 424.

\textsuperscript{232} \textit{Ibid} at 426-427.

\textsuperscript{233} D.E. Van Zandt \textit{supra} note 221, at 985-986.


\textsuperscript{235} For a presentation of the competing goals of market design, see M. O'Hara, \textit{Market Microstructure Theory} (Cambridge: Blackwell, 1995) at 268-271.
economically justifiable to have their securities traded on the market and will therefore seek listing or quotation on another organised exchange.

This section presents the three principal costs of market-making which the bid-ask spread must cover for dealers to stay in business. As we will see, the characteristics of the small firm securities market suggest that the costs of market making will tend to be higher in this segment of the market.

a) Order-Processing Cost

Market makers must incur costs to process the buy and sell orders of investors. Stoll identifies four components of the cost of processing orders. The first component arises from the need to establish an information system which provides data on past transactions prices and transactions volumes. The second component pertains to the setting up and maintenance of an order routing system for orders. The third component proceeds from the establishment of an execution system that deals with the queuing and matching of incoming orders. Finally, the market-makers must bear the cost of actually conducting the transaction, i.e. of exchanging the securities for cash.

The bulk of the order-processing cost is assumed collectively by investment dealers through the payment of fees and charges to use the trading system facilities. Thus, dealers must only assume a fraction of those order-processing costs.

However, it must be noted that dealers also incur costs to carry out the transactions themselves. The importance of these costs depends on the efficiency of the organisation of

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237 Since a dealer market is decentralised, procedures must be established to determine how orders are placed, collected, routed, and delivered to the point of execution.
239 See e.g. CDN Policy, s. G.
securities firms. In any event, all order-processing costs must be recouped in every transaction conducted by market-makers.

b) Risk Bearing Cost

Market makers supply immediacy by buying and selling unwanted securities. To supply immediacy to other investors, market makers must sacrifice holding well diversified portfolios in order to satisfy the needs of investors to buy or sell a security in which they make a market.\(^{240}\) In doing so, they assume a level of risk and return which may not correspond to their preferences and the proper diversification. Thus, by taking inventory positions, dealers assume holding costs, or inventory costs, that they would not otherwise incur and for which they require compensation.

The risk taken on by the dealers arises from unpredictable changes in the price of the securities for which they make a market, after they take on inventory. This “inventory risk” is influenced by the volatility of the securities. Securities with a large variance in their rate of returns, such as SMES securities, impose a greater risk on market makers than securities with a lower variance.\(^{241}\)

The level of volume trading in the securities also affects inventory risk.\(^{242}\) Securities with a high trading volume will shorten the holding period of the market marker and thereby reduce the period during which adverse changes can arise. Conversely, when securities trade infrequently, dealers may have to maintain an inventory imbalance for a long period. Since SMES securities tend to be less actively traded than the securities of larger enterprises, the market-makers’ will face longer holding periods and therefore support a greater risk when they deal in small firms securities.


\(^{242}\) K. Garbade, supra note 16, at 474
It is important to note that capital requirements or regulatory requirements cannot compel risk bearing.\textsuperscript{243} However, risk bearing responds to profit opportunities. Accordingly, a dealership market should provide sufficient flexibility so that risk-bearing is channelled to securities that need it. Stoll notes that such a market should have multiple dealers, many securities per dealer, free entry and competition, and public limit orders.

c) Adverse-information Cost

Traders typically fall into two categories: informed and uninformed.\textsuperscript{244} Uninformed traders, or liquidity traders, are investors whose selling and buying decisions are determined by their desire to consume or save respectively. Uninformed traders may also trade on the basis of “noise”, \textit{i.e.} of sentiment and information unrelated to fundamental value.\textsuperscript{244\textdagger} In contrast, informed traders trade in order to realise a profit from public, or undisclosed, material firm-specific information that they possess with respect to the future value of a security.

Market-makers are at an informational disadvantage relative to informed traders where they cannot have access to the undisclosed information or identify informed traders.\textsuperscript{245} Thus, the presence in a market of unusually well informed traders impose a risk on dealers, as Garbade explains:

> Insiders are willing to buy at the offering price of a dealer because they have information, not yet available to others, which will lead to an increase in the price of the security when it is ultimately disclosed. Dealers, therefore, always sell to insiders at prices below what may be interpreted as the “true” equilibrium value of a security. Conversely, dealers buy from insiders at bid prices above “true” equilibrium values. The special information available to insiders allows them to extract gains from, and transfer losses to, dealers. Their trading consequently reduces the net profits earned by dealers.\textsuperscript{246}

\textsuperscript{243} H.R. Stoll, \textit{supra} note 236, at 82-83.


\textsuperscript{246} K. Garbade, \textit{supra} note 16, at 477.
In other words, market makers consistently lose when they trade with investors holding undisclosed information.247

To protect themselves from informed trading, dealers widen their bid-ask spreads.248 This allows them to earn enough from trading with ordinary investors to offset the losses incurred in trading with insiders. Accordingly, an important component of the bid-ask spread results from the necessity to compensate dealers for taking on the risk of trading with investors who may possess superior information.249

Since the size of bid-ask spreads is positively influenced by the presence of informed investors, bid-ask spreads will be wider for smaller enterprises than for larger enterprises. To understand this phenomenon, recall that the segment of the market populated by SMES has a lower degree of informational efficiency because these enterprises elicit little institutional investor or analyst interest.2491 In such an inefficient market, there is a greater probability that market-makers will face traders transacting on the basis of private information.250 Thus, market-makers will widen their bid-ask spreads to protect themselves from the greater risk of informed trading associated be greater for smaller enterprises.

4. Market Design Issues

SMES securities present a significant challenge to the design of a viable secondary market. As the foregoing analysis reveals, the characteristic of SME securities tend to increase the cost of the liquidity services provided by dealers making a market in those securities. The higher cost of liquidity services for smaller issuers’ securities has direct implications for the success of a secondary market catering to SMES. It diminishes the incentives of investors to trade in this market


249 M. Pagano & A. Roell, supra note 23, at 581.

2491 Supra notes 119-129 and related text.

250 Infra notes 292-295 and related text.
by increasing trading costs. Furthermore, it augments the cost for issuers of maintaining a secondary market for issuers by forcing them to offer higher returns to maintain the interest of investors in their securities.

Undoubtedly, the efficiency of the secondary market impacts significantly on the cost of liquidity services. However, the range of issues raised by market efficiency appears to be well beyond the scope of a trading system’s jurisdiction. While the general regulation of securities markets is the province of the Legislator and of the securities commission, CDN has nevertheless a role to play in enhancing the vitality of the secondary market it operates. Indeed, microstructure theory increasingly demonstrates the importance of institutional features and trading mechanisms for the vitality of stock markets. More particularly, the theory emphasises the central function of trading mechanisms in the price formation process:

[M]icrostructure can influence both supply and demand by making trading easier or harder. more or less costly, and by providing information to potential traders that influences their trading decisions and induces them to participate in the market. In short, microstructure can make markets more attractive.

In this perspective, CDN, as an organised secondary market catering to SMES, should seek to ensure that the features of its trading system minimise the cost of liquidity services provided by market-makers. For the purpose of this dissertation, three issues appear particularly relevant for the improvement of CDN. The first issue concerns the degree of market transparency on CDN, i.e. the extent to which traders have access to order flow information. The second issue concerns the manner in which incoming orders are matched in the trading system. The third issue deals with the possibility of increasing the depth and breadth of the market through the consolidation of the Canadian over-the-counter market.

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251 See Toronto Stock Exchange Act, supra note 194, s. 13.2


a) Market Transparency

Market transparency refers to the ability of market participants to observe the information in the trading process which relates to current and past prices, quotes or volumes, the sources of order flow, and the identities and motivations of market participants. Market transparency arguably "plays a fundamental role in the fairness and efficiency of the secondary market."255

The real-time disclosure of trading information can promote fairness in a number of ways.256 It reduces the disparity of information among investors on factors that are likely to have an impact on prices. The dissemination of market information also enables investors to choose the best location and time to trade. In addition, transparency complements public investor protection mechanisms by allowing investors to themselves monitor the quality and cost of their orders' execution.257

In parallel, market transparency influences efficiency through its impact on the price discovery process.258 The price discovery process refers to the transformation of the latent demand of investors into realised transactions.259 In other words, it is "the process of finding market clearing prices."260 Transparency of trading information enhances the price discovery process in allowing

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255 Market 2000 Study, supra note 190, at §85,039. See also B. Becker et al., ibid. at 331; C. Bronfman, "If It Ain't Broke, Don't Regulate It", in K. Lehn & R.W. Kamphuis, supra note 174, at 410; Electronic Trading Systems, supra note 26, at 2521.

256 B. Becker et al., ibid. at 331-332; Transparency on Secondary Markets, supra note 254, at 14-17.

257 B. Becker et al., ibid. at 336.

258 Transparency on Secondary Markets, supra note 254, at 19-21; Market 2000 Study, supra note 190, at §85,039.


market participants to infer new information from quotes, prices, volumes and trader identity. Two types of market transparency can be identified: pre-trade transparency and post-trade transparency. Both types of market transparency are discussed below.

i) Pre-Trade Transparency

Pre-trade transparency refers to the ability of market participants to clearly see the prices available on the market. In a dealer market, pre-trade transparency is provided by the instantaneous communication of bid and ask quotations to securities firms. The disclosure of real-time quotations tends to reduce transaction costs by reducing the costs for dealers of finding the best possible execution prices for their customers.

Moreover, the dissemination of quotations enables market makers to deduce their competitors' order flow from their pricing behaviour. Although a market maker can only observe directly the flow of orders that are placed with him/her, he/she can infer information from the flow of orders received by competing market makers by observing their quote revisions. This process of quote decoding allows the market maker to adjust his/her quotation as well as his/her inventory position. Furthermore, the visibility of the order flow facilitates the detection of informed trading by enhancing the precision of market makers' inferences about whether orders are information- or liquidity-driven, thereby reducing the adverse selection component of the bid-ask spread.

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265 E. Avgouleas, *supra* note 262, at 166.

266 This is the technique of trade/price decoding.

In addition, the disclosure of quotations enhances investor protection by enabling investors to monitor trading for themselves. Pre-trade transparency allows investors to determine *ex ante* whether the prices they are provided with by the market-makers are the best prices and thereby “monitor, after the fact, the quality of the execution they receive.” Furthermore, investors can use quotation information to assess the mark-up or commission on their transactions by comparing the prices paid with the prices reported to the market.

The nature of trading on a quote-driven market, such as CDN, limits the level of pre-trade transparency. The CDN system disseminates the bid and ask quotations among market-makers’ on a real-time basis through its network of computers. However, the quotations provide an imperfect visibility of the best price at which any incoming order can be executed: “the quotes only give vague indication of the real transaction prices which are arrived at by telephone negotiation.” This is because although market-makers have the duty to provide investors with the best price available at the time of the transaction, as determined by the bid and ask quotations, the prices quoted are only usually good for one board lot. Thus, the real transaction prices may differ from the quoted prices depending on the customers’ bargaining power and the size of the transaction. Where this is the case, the bid and ask spreads do not reveal the full information to market participants: “only the market maker has full but private information.”

While the limited level of pre-trade transparency appears to be inherent in a quote-driven market, improvements to pre-trade transparency may nevertheless be possible. In particular, pre-

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268 B. Becker et al., *supra* note 254, at 336.


271 *CDN Policy*, s. D.I. F.

272 O.D. Hernandez, “Broker-Dealer Regulation Under the New Penny Stock Disclosure Rules: An Appraisal”, [1993] *Colum. Bus. L. Rev.* 27 at 51; J.R. Macey & M. O’Hara, *supra* note 220, at 203 (unlike retail trades, large trades typically involve negotiated prices); N.S. Poser, *supra* note at 44 (quote-driven markets allow institutional investors to negotiate with a market maker to obtain a better price); P.S. Taylor, *supra* note 187, at 70: “Try to buy more than 100 shares of a stock trading at $1 per share and the cost often shoot skyward, making it difficult for a small investor to get a good price.”

273 *Transparency on Secondary Markets*, *supra* note 254, at 32. In such circumstances, post-trade transparency may have a greater role to play in ensuring efficient price discovery.
trade transparency could be enhanced by making real-time quotations widely available to investors electronically. Rather than being available only to Users on CDN's computer terminals, real-time quotations should be made available to any interested person. This would avoid the need for investors of communicating with a securities firm to have access to real time bid and ask quotations and prices. Accordingly, CDN should explore the possibility of increasing disclosure of quotations to the public through the use of an internet-based system.

Although enhancing the transparency of quotations would furnish investors with timely and accurate information to make informed investment decisions, it may be argued that the wider dissemination of quotations to the public would not provide substantial benefits to investors. In a dealer market, it is the market-makers that are the price-setters. In this perspective, the dissemination of real-time quotations to investors would not have a significant influence on the latter's trading costs.

This critique overlooks the benefit of the heightened monitoring of market makers by investors, which can result from greater pre-trade transparency. On quote-driven markets such as CDN, it is the competition among market-makers which provides the best price to investors, rather than the competition of investors' orders in a central location as is the case for stock exchanges. However, the level of market-maker competition on CDN tends not to be very high as few investment dealers act as market-makers for particular securities. In this context, increasing the level of pre-trade transparency could complement competition in enforcing the best execution of transactions by enhancing the monitoring of trades by investors. Furthermore, the dissemination of quotations through an internet-based system could enhance the monitoring of market-makers by facilitating the emergence of third parties certifying agents taking advantage of the information to collect, sort and analyse the performance of market-makers and of particular issuers.

274 Quotations are also available to investors through quotation vendors, newspaper providing OTC trading statistics and through the new Monthly Statistical Report. CDN Policy, s. A.3.

275 Every person who reports trade on the CDN system is a User. CDN Policy, ibid., s A.1.

276 M. Pagano & A. Roell, supra note 23, at 581.

277 N.S. Poser, supra note at 44.
In this respect, the experience of NASDAQ shows that the enhancement of transparency brought by the application of automation technology to the American over-the-counter market in the 1970s has been instrumental to the growth of this market.\textsuperscript{278} Prior to 1971, quotation information about OTC securities was not readily accessible to the public and lacked reliability.\textsuperscript{279} The automation of the quotation system through the implementation of NASDAQ, and later of the National Market System, translated into heightened investor interest which increased trading volume.\textsuperscript{280} The interest of investors was particularly stimulated by the availability of inter-dealer quotations to the public "which allowed closer monitoring and the use of technical analysis for OTC stocks."\textsuperscript{281} Although the level of transparency on CDN is considerably higher than that of the pre-1971 OTC market in the U.S., the NASDAQ experience suggests that increasing further the transparency of quotations could have some positive impact on the interest of investor in CDN.

A second avenue that CDN should explore to enhance the level of pre-trade transparency is the disclosure of customer limit orders.\textsuperscript{282} Limit orders are trading instructions given by investors to their brokers to buy or sell a security at a particular price.\textsuperscript{283} Currently, the CDN system does not provide for the disclosure of limit orders. The failure to disclose limit orders is particularly open to criticism where the latter are priced better than the best available quotes. Indeed, it prevents investors from assessing accurately trading interest and leads thereby to unfair and inferior trade executions as market makers can set wider spreads.\textsuperscript{284} For example, where transactions occur at the

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\textsuperscript{280} M.J. Simon & R.L.D. Colby, \textit{supra} note 168, at 42.

\textsuperscript{281} \textit{Ibid.} Note that quotations and prices are now made publicly available with a 15 minute delayed quotes on NASDAQ Web site at no charge. There are also Internet services which real time quotes for a monthly service charge. See http://WWW.NASDAQ.com.

\textsuperscript{282} The disclosure of limit orders was proposed by the Market 2000 Study and addressed by NASDAQ in its reform of the Small Order Execution System (SOES). See \textit{Market 2000 Study, supra} note 190, at ¶85,039; R.G. Ketchum & B.E. Weimer. \textit{supra} note 175, at 577-578.

\textsuperscript{283} R.W. Quinn, "Déjà Vu All Over Again: The Sec's Return To Agency Theory In Regulating Broker-Dealers", [1990] \textit{Col. Bus. L. Rev.} 61 at 62 n. 3.

\textsuperscript{284} \textit{Market 2000 Study, supra} note 190, at ¶85,039; R.G. Ketchum & B.E. Weimer, \textit{supra} note 175, at 577-578.
bid or ask price, as is the case for small orders, the failure to disclose orders that are better priced than the quotes will enrich dealers at the expense of investors. In corollary, the concealment of limit orders impairs the price discovery process by reducing the competitive pressure on market makers.285

Although the disclosure of limit orders that are priced better than the current quotes would enhance transparency, consideration should be given to the need for anonymity in certain circumstances.286 It has been argued elsewhere that enhancing pre-trade transparency through mandatory disclosure of the limit orders could reduce liquidity and increase volatility in thin markets.287 Such could be the case, for example, where the mandatory disclosure of every limit order prevents a block positioner from placing a large order with limited market impact.288 Thus, if CDN is to attract the interest of institutional traders, it would seem preferable that CDN leaves to investors the right to keep a limit order from being disclosed as part of an attempt to design special facilities for trading large blocks of shares.

ii) Post-Trade Transparency

Post-trade transparency refers to the speed at which recent trading history is made public and the extent of the details provided on prices, volumes and the identities of the traders.289 The degree of post-trade transparency affects the extent to which the transactions of informed traders are observable. The disclosure of trading information gives dealers access to the prices of the

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286 On the issue of trader anonymity, see in general M. O'Hara, supra note 235, at 260-268.

287 A. Madhavan, supra note 254, at 264-272; P.G. Mahoney, supra note 244, at 845-846. In a market with few informed investors, such as the thinly traded OTC market, market structure that discloses little about agents' willingness and motivation to trade achieves lower costs of executing liquidity-motivated trades. M.M. Forster & T.J. George, "Anonymity in Securities Markets", (1992) 2 J. Fin. Intermediation 168.

288 Market 2000 Study, supra note 190, at ¶85,039; L. Harris, "Consolidation, Fragmentation, Segmentation and Regulation", (1993) 2-5 Financial Markets, Institutions & Instruments 1 at 6-7 (Large traders fear that if their orders are widely disclosed before trading other traders would front-run them and increase their trading costs.); Transparency on Secondary Markets, supra note 254, at 42.

289 M.D. Flood et al., supra note 262, at 25-26; Transparency on Secondary Markets, ibid. at 23; M. Pagano & A. Rotili, supra note 23, at 580.
transactions as well as the size and direction (buying or selling) of the order flow from which they can infer information.\textsuperscript{290} The information allows market-makers to gain information about the price of the securities and set their quotations accordingly.\textsuperscript{291}

Post-trade transparency is particularly important for thinly traded securities such as those traded on CDN which are characterised by wide bid-ask spreads. Easley \textit{et al.} show that the risk of information-based trading is higher for infrequently traded securities than for active securities.\textsuperscript{292} The authors attribute this finding to the impact of information asymmetry and the lack of market depth for thinly traded securities.\textsuperscript{293} There is arguably less uninformed traders in thinly traded issuers as the latter tend to be more closely held and less widely followed by securities analysts.\textsuperscript{294} For this reason, market-makers face a higher probability that any trade comes from an informed trader. In other words, "[t]he problem with less active stocks, therefore, is not that there are too many informed traders, but that there are too few uninformed ones."\textsuperscript{295} In order to protect themselves from informed trading, market-makers must set wider bid-ask spreads for infrequently traded securities than for active securities.

In this context, the dissemination of transaction data can convey relevant information to traders that will reduce information asymmetry and enhance thereby price discovery: "knowing how much a stock has traded in the last hour gives a good idea of market interest in that stock."\textsuperscript{296}

\begin{itemize}
\item \textsuperscript{290} M. Pagano & A. Roell, \textit{ibid.} at 597-598.
\item \textsuperscript{291} K.C. Chan \textit{et al.}, "Market Structure, Price Discovery, and the Intraday Pattern of Bid-Ask Spreads for Nasdaq Securities". (spreads for NASDAQ securities decline over the day). The trading interests of potential buyers and sellers also convey information to market-makers as it provides them with an idea of the characteristics of the demand and supply schedule of investors. While this information is valuable, it is difficult to exploit at an economically justifiable cost since it requires dealers to remain informed of the trading interest of a large number of investors. Dealers can however have access to this information at a more affordable cost with block trading. See K. Garbade, \textit{supra} note 16, at 493-494.
\item \textsuperscript{292} D. Easley \textit{et al.}, \textit{ibid.}, at 1428-1429.
\item \textsuperscript{293} D. Easley \textit{et al.}, \textit{ibid.}, define depth as the size or scale of uninformed trading.
\item \textsuperscript{294} H.R. Stoll, \textit{supra} note 241, at 197.
\item \textsuperscript{295} D. Easley \textit{et al.}, \textit{supra} note at 1428. See also B. Becker \textit{et al.}, \textit{supra} note 254, at 332.
\item \textsuperscript{296} \textit{Transparency on Secondary Markets}, \textit{supra} note 254, at 38.
\end{itemize}
Furthermore, information on past trading may enable market participants to infer some indications of insider presence.

The Securities Act Regulation and the CDN Policy have provisions ensuring a minimum of post-trade transparency. The Regulation provides that every purchase or sale in Ontario of a CDN security made by a registered dealer must be reported through the CDN system. Pursuant to the CDN Policy, “a purchase or sale in Ontario” encompasses two situations: (i) a transaction where the person to whom the trade is confirmed, other than a market-maker, is a resident of Ontario; (ii) a transaction where the market-maker’s trade or sales representative handling the trade is acting from an Ontario office. Any trade taking place during business hours must be reported through the terminals connected to the system within three minutes after execution by the market-maker designated by the Policy. The trade report will include, among other things, the identity of the security traded, the number of shares traded, the price of the trade, the identities of the purchasing and selling market-makers, and the time of execution of the transaction.

However, the level of post-trade transparency on CDN may be considered limited in at least three ways. First, the price reported to the system is not necessarily the actual price agreed upon by the parties. Where an investor trades with a market-maker, the Policy requires that the latter report “the inside market that is quoted on the system at the time the trade is consummated” rather than the actual price. For sales to investors, the inside market price is the lowest ask price currently offered by any dealers making a market for the security. For purchases from investors, it is the highest bid price that is currently posted by any market-maker. Differently stated, market-makers must report the transactions at the best quoted market price. The only exception to this rule

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297 O.S.R., s. 154.
298 CDN Policy, s. E.1.
299 Transactions made after business hours must be reported between 8:00 AM and 9:30 AM the next business day.
300 E. Avgouleas, supra note 254, at 166 (noting than post-trade transparency is higher in auction markets).
301 CDN Policy, s. E.4.
is where the transaction takes place between two market-makers, acting as agent or principal. In such a case, it is the actual price agreed upon by the parties that is reported to the system.

The report of the inside market rather than the actual price of transactions may be seen as a feature which facilitates the trading of large blocks of securities. Indeed, the immediate disclosure of actual trading information can impede effective market-making for block trades. Where transactions must be disclosed on a real-time basis, a dealer that purchases a large block of securities becomes exposed to the risk that competitors deduce its identity and trade against its interests. Accordingly, in such a market, dealers “would be less willing to risk their capital and would widen their spreads for block trades or stop making markets altogether.”

Several commentators, pointing to this undesirable outcome, suggest that market-makers should be allowed to delay trade reporting when handling large orders. Such a delay would allow market-makers to sell their large inventory position to investors who are unaware of the large block trade. This solution is however criticized on the ground that it would lead to a transfer of wealth from uninformed traders to informed traders.

When dealers are able to purchase blocks of securities in a principal capacity without disclosing those transactions and to sell the securities in the retail market at a profit, the cost (equalling the profit made by the dealer) is borne by the retail investors. In an opaque market, where dealer trades are not disclosed, the customer may be, in a sense, subsidizing the dealer’s block trading activities.

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102 CDN Policy, s. E.4.
103 M.M. Mendelson & J.W. Peake, supra note 14, at 467-468; N.S. Poser, supra note 46-47; Transparency on Secondary Markets, supra note 254, at 43-44.
104 Transparency on Secondary Markets, ibid. at 44.
105 B. Becker et al., supra note 254, at 334.
106 N.S. Poser, supra note 47. On the United Kingdom (UK) Stock Exchange Automated Quotation (SEAQ), small transactions (up to six times the median transaction size) must be published immediately, while larger transaction may be published within 60 minutes. The UK regulators have taken a favourable position towards delayed reporting arguing that it impacts positively trading volume. See M.D. Flood et al., supra note at 1-2; M. Pagano & A. Roell, supra note 23, at 580.
107 M.D. Flood et al., ibid. at 25-26. See also E. Avgouleas, supra note 254, at 166-167.
108 Transparency on Secondary Markets, supra note 254, at 44.
Although it is apposite, this critique may understate the benefits of facilitating block trading in the OTC market. Block trading is likely to primarily concern institutional investors, which have traditionally been absent from this market. The relative absence of institutional traders in the OTC market, as previously noted in this dissertation, has important consequences for the market’s level of information efficiency. By requiring the real-time disclosure of trading information, regulation may raise the costs and the difficulty of block trading and thereby contribute to the dearth of institutional investing.

Empirical evidence on this matter however sheds limited insight into the desirability of delaying large trade reporting.\(^{309}\) In this context, the rule which requires that market makers report the inside market of trades may constitute a compromise that reduces the costs of trading large blocks of securities while not unduly imposing costs on retail investors.

A second limitation on post-trade transparency on CDN stems from the difficulty of monitoring trade reporting. Even though CDN has rules imposing fast reporting of trades after their execution, it remains very difficult to enforce such rules given that trades on the market are conducted bilaterally by telephone, and only reported \textit{ex post} to the system.\(^{310}\) Hence, regulatory authorities cannot verify precisely the exact time at which the transactions take place.

Thirdly, under the existing rules, issuers need only report into the system trades that are made in Ontario. Thus, when an issuer’s securities are bought or sold outside Ontario on another province’s OTC market, the transaction is not subject to CDN trade reporting requirements, provided that the transaction is conducted through a securities firms registered and operating outside that province.\(^{311}\)

The existence of a shadow market for CDN quoted securities outside Ontario impedes the transparency of the market by fragmenting order flow information. However, the problem cannot

\(^{309}\) Ibid at 45-46 (citing studies).

\(^{310}\) M.D. Flood \textit{et al.}, supra note 262, at 6.

\(^{311}\) K. Cowan, supra note 185, at 8-9.
be easily resolved by CDN alone. Indeed, the imposition of trade reporting requirements on investors and securities firms with whom CDN does not have contractual privity poses serious jurisdictional issues. One solution to the fragmentation of order flow would be to transform CDN into a nationally uniform OTC market system. CDN could, for instance, seek recognition as a recognised quotation and trade reporting system in other provinces. Suggested by the COATS Task Force, this bold proposal would undoubtedly face significant hurdles as has been shown by the many failed attempts at creating a national securities commission.\footnote{COATS Task Force, supra note 178, at 13. For an overview of the problems see e.g. J.G. MacIntosh, “A National Securities Commission for Canada?” in T.J. Courchene & E.H. Neave, (Eds.), Reforming the Canadian Financial Sector: Canada in Global Perspective (Kingston: John Deutsch Institute for the Study of Economic Policy, Policy Forum Series - 34, 1997) 185.}

While no hard data on the importance of trading outside the CDN system are available, the advantage of trading on CDN for investors would suggest that this problem should not be understated. As mentioned, market transparency tends to reduce trading costs for investors by reducing the breadth of the bid-ask spread. Furthermore, transparency has significant influence on the price discovery process “as it furnishes investors with timely and accurate information to make informed investment decisions.”\footnote{M. Mendelson & J.W. Peake, supra note 14, at 467. See also Electronic Trading Systems, supra note 26, at 2529; R.A. Schwartz, “Competition and Efficiency”, in K. Lehn & R.W. Kamphuis, supra note 174, at 386-388.} Flood et al. show in this respect that “[a]n increase of transparency in financial markets improves the informational efficiency of prices.”\footnote{M.D. Flood et al., supra note 262, at 26.} Thus, the superior transparency of CDN in comparison with unorganised OTC markets should be attractive to investors interested in obtaining prices that best reflect the available information about issuers and thereby reduce the extent of trading outside CDN.

b) Stimulating Competition on the Canadian Dealing Network Through Investors’ Limit Orders

Competition among market makers plays a central role in quote-driven markets.\footnote{See e.g. W.G. McGowan, “Why Nasdaq?” in K. Lehn & R.W. Kamphuis, supra note 174, at 19: “The heart of Nasdaq is its competitive, multiple market maker system”.} Recall that quote-driven markets rely on the competing bid and ask of investment dealers to offer the best
prices to investors.\textsuperscript{316} In contrast, order-driven markets, such as stock exchanges, seek to offer the best prices to investors through the interaction of investor orders in a central location.\textsuperscript{317}

The level of competition among CDN market makers is by no means comparable to that which exists on NASDAQ. Indeed, the average NASDAQ firm has more than ten market makers while most CDN firms have only a few market makers.\textsuperscript{318} The lower level of market maker competition on CDN undermines market liquidity in several ways.\textsuperscript{319}

In a market where investment dealers are price setters, competition enforces the relation between the price of the liquidity services, as determined by the bid-ask spread, and the actual cost of those services.\textsuperscript{320} Competition constrains market makers to quote bid and ask prices that only cover the marginal costs of conducting the next transaction (the reservation spread).\textsuperscript{321} In a market with competition, where a dealer quotes an excessive bid-ask spread on a security in light of the cost of supplying liquidity services for that security, other dealers will have an incentive to capture trading business by quoting narrower spreads.\textsuperscript{322} However, where competition is weaker, market makers have "the opportunity to consistently set the bid price below the reservation bid price and to set the ask price above the reservation ask price."\textsuperscript{323} In other words, when there is a low level of competition among market makers in a given security, the bid and ask prices can be set to yield monopoly profits for the dealers.

\begin{itemize}
\item \textsuperscript{316} N.S. Poser, supra note at 44.
\item \textsuperscript{317} Supra notes 16-35 and related text.
\item \textsuperscript{318} J.R. Hardiman, supra note 169, at 11; J.L. Watson, "Market Makers: The Hallmark of the Nasdaq Market", in K. Lehn & R.W. Kamphuis, supra note 174, at 233. CDN only requires that issuers have one market maker to be admissible to quotation. CDN Guide to Quotation, supra note 201, at 4. See also P.S. Taylor, supra note 137, at 70 (some CDN securities have only one market maker).
\item \textsuperscript{319} A low number of market makers in a security may be conducive of market manipulation.
\item \textsuperscript{320} K. Garbade, supra note 16, at 478-479.
\item \textsuperscript{321} H.R. Stoll, supra note 247, at 268-269. See also T.S.Y. Ho & H.R. Stoll, "The Dynamics of Dealer Market Under Competition", (1983) 38 J. Fin. 1053.
\item \textsuperscript{322} Ibid. See also J.C. Groth & D.A. Dubofsky, supra note 4, at 332; J.R. Macey & D.D. Haddock, supra note 12, at 348. A recent controversy has emerged in the literature as to whether Nasdaq market markets implicitly collude to set bid-ask prices above competitive levels. See P.K. Dutta & A. Madhavan, "Competition and Collusion in Dealer Markets", (1997) 52 J. Fin. 245.
\item \textsuperscript{323} H.R. Stoll, supra note 247, at 269.
\end{itemize}
Aside from leading to wider bid-ask spreads, the presence of few market makers in CDN securities may also increase the costs of transacting by limiting the capacity of the market to absorb large increases in volume or large transactions with limited price impact.324 Issuers for whom there are few market makers may also have a poorer information record. Fewer market makers' sponsored analysts will follow the securities. Moreover, market makers have less incentives to conduct research to uncover information under weaker competitive pressures.325

The poor level of competition among CDN market makers stems inevitably from the dearth of regional and boutiques dealers in Canada, in comparison to the United States, which has been noted previously in this dissertation.326 This characteristic of the Canadian securities industry is the product of a complex set of factors that will not be changed easily. For this reason, it cannot be expected that the number of market makers in CDN securities can be increased by simply mandating that issuers have at least two market makers, rather than just one as it is the case presently.

As an alternative option to increase the level of competition facing investment dealers in the OTC market, it is suggested here that CDN should explore the possibility of relying on the limit orders placed by investors. Presently, the CDN Policy provides for a certain level of interaction between investors' orders and limit orders. Following the Policy, where a market maker holds or has knowledge of any person associated with it which holds an unexecuted limit order that is priced in between the spread, it must refrain from conducting the transaction in order to permit the limit order to get executed against incoming orders.327 However, market makers do not have the duty, nor the ability, to survey the OTC market to determine whether there are unexecuted limit orders in the market that are priced in between the spread. Thus, the interaction between orders and limit orders remains confined at the market maker level.

324 J.R. Hardiman, supra note 169, at 11.
325 J.C. Groth & D.A. Dubofsky, supra note 4, at 333-334.
326 Supra Chapter V.
327 CDN Policy, s. F.4.
The interaction between orders and limit orders, which the CDN Policy permits, could be enhanced to take place at the market level in order to increase competition. Indeed, the experience of NASDAQ with the Small Order Execution System (SOES) suggests that investors' limit orders can play an effective role in supplementing the liquidity provided by dealers. SOES was put in operation in 1985 to provide retail customers of OTC broker-dealers with automatic execution of certain small orders at the best price quoted on NASDAQ.328 Mandatory for every market maker on NASDAQ since 1988, SOES allows brokers to execute a client's transaction which meets the size requirement (200, 500 or 1000 shares depending upon the security) at the best bid or ask price offered by any market maker at the time the order is entered.329 Brokers need only enter the order in the system and SOES determines the best available bid or offer, and executes the trade.

SOES enhances competition by permitting the matching of market-makers' quotations to investors' limit orders in the execution of transactions. In addition, the system relieves market makers from the effort of answering telephones to execute small orders in the securities in which they make markets and thereby reduces transaction costs.330 Furthermore, "SOES not only eliminates much of the telephoning and paperwork involved in small trades, but it also increases the volume of trading."331

Since its introduction, SOES has been complemented with a limit order service.332 The limit order service accepts investors' limit orders and executes them automatically when the inside bid or ask price reaches the limit order price. Even more interesting, the limit order service provides an order-match feature enabling limit orders sent to the system to interact with incoming orders when priced within the best bid and ask prices. Market makers however retain the possibility of

331 L.D. Soloman & L. Corso, supra note 22, at 314.
332 J.R. Hardiman, supra note 169, at 12.
executing the incoming orders at improved prices rather than leave the latter be executed against the limit orders. Nevertheless, by increasing competitive pressures on market makers, this feature offers the possibility of improving execution prices.\textsuperscript{333}

c) The Consolidation of the Canadian Over-the-Counter Market

The flow of actual transactions is an important source of information for market makers.\textsuperscript{334} When securities trade infrequently, the quality of information dealers can infer from the flow of transactions is poor. Thus, dealers are not able to ascertain the equilibrium price of the securities for which they make a market.

The uncertainty in the estimation of the equilibrium price, which results from thinness, has several consequences for the prices of securities transactions.\textsuperscript{335} Market makers will widen their bid-ask spreads to protect themselves against inadvertently making a bid above the actual equilibrium price or an offer below that price. It is also likely that market makers will reduce the breadth of their market by decreasing the size of the transaction for which their quotations will be good. Finally, transactions will have a greater market impact when securities are thinly traded as explained by Garbade:

If a dealer is confident in his current estimate, he will not be led to lower substantially that estimate just because he happens to execute a sequence of purchases from public investors, or if he happens to execute a sequence of sales. If on the other hand, he is highly uncertain, executing a single purchase may lead him to lower his estimate on the grounds that he might have been bidding above the equilibrium. Executing a sequence of purchase will almost certainly lead him to lower his estimate of the equilibrium price.\textsuperscript{336}

While a greater level of competition among market makers could reduce the impact of thinness on the cost of transacting, it does not seems reasonable to expect that market maker competition can be increased by mandating a higher number of market-markers for each quoted


\textsuperscript{334} \textit{Supra} notes 289-313 and related text.

\textsuperscript{335} K. Garbade, \textit{supra} note 16, at 494-495. Market fragmentation poses similar problems. See e.g. \textit{Trading Across Securities Markets, supra} note 4, at 1434.

\textsuperscript{336} K. Garbade, \textit{ibid.} at 495.
securities. Besides, the benefits of enhanced competition could be offset by the fragmentation of information over several dealers. Fragmentation of information will prevent dealers from estimating with a high degree of accuracy the equilibrium price. An alternative option to reduce the impact of thinness on transaction costs may be to increase the number of firms quoted on the market.

Since January 1995, a moratorium imposed by CDN prevents non-Ontario reporting issuers from participating in the CDN system.\(^{337}\) The principal impetus for this moratorium is CDN’s “lack of direct jurisdiction over issuers and the heightened difficulty in ensuring securities law and CDN policy compliance by out-of-province issuers.”\(^{338}\) New legislation has, however, given the authority to CDN to establish privity of contract with issuers through the quotation agreement.\(^{339}\) It is suggested here that, to the extent that contractual privity allows CDN to enforce compliance by non-Ontario reporting issuers with its rules and policies, the moratorium with respect to out-of-province issuers should be lifted.\(^{340}\)

Allowing non-Ontario reporting issuers to get quotation on CDN could enhance the liquidity of the OTC market in several ways. Increasing the number of quoted issuers and the variety of their geographic locations could enhance the interest of investors and traders in CDN and thereby improve trading volume.\(^{341}\) In this respect, note that the creation of EASDAQ rests in part on the

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\(^{337}\) K. Cowan, *supra* note 185, at 13. The *CDN Policy*, s. C.1., states that reporting issuers of Alberta, British Columbia, Newfoundland, Nova Scotia, Québec and Saskatchewan have adequate information in the marketplace and are therefore admissible to quotation.

\(^{338}\) K. Cowan, *ibid*.

\(^{339}\) *Toronto Stock Exchange Act, supra* note 194, s. 13.1 as amended by *An Act to reduce red tape by amending or repealing certain statutes administered by the Ministry of Finance and by making complementary amendments to other statutes, supra* note s. 26(7). On the status of quotation agreements, see Note, “Stock Exchange Listing Agreement”, *supra* note.

\(^{340}\) K Cowan, *supra* note 185, at 13: “CDN will review the possibility of removing its moratorium on non-Ontario reporting issuers.” See also COATS Task Force, *supra* note at 13 (suggesting that the operations of COATS should not be confined to Ontario).

The assumption that pooling investors and traders across Europe can improve the liquidity of small issuers.342

More importantly, accepting application to quotation from non-Ontario reporting issuers could reduce the impact of thinness on the costs of transacting through the process of substitution. When determining equilibrium prices, market makers do not limit their analysis to securities on an individual basis. They also obtain information by observing the markets of close substitute securities, i.e. securities with similar characteristics.343 The information gathered thereby will be particularly valuable where an actively traded security is a close substitute for a thinly traded security. In this perspective, permitting the entry of out-of-province reporting issuers could attenuate the undesirable characteristics of thinness by increasing the number of close substitutes.

5. Improving the Monitoring Function of the Canadian Dealing Network

Organised stock exchanges can enhance the value of the securities traded by monitoring the market to prevent abuses.344 Hitherto, CDN has had difficulty monitoring the conduct of market participants because of the lack of statutory basis for the rules governing the quotation and trading of securities.345 Undoubtedly, the limited monitoring ability of CDN has contributed to the poor reputation of the trading system and hindered its development.346

The recent legislative amendments granting CDN statutory authority to establish rules governing the OTC quotation and trade reporting process, and to regulate Ontario securities dealers, lay the foundation for an improvement of the monitoring of the OTC market by CDN. Indeed, the amendments will allow the authorities to transform the CDN requirements governing the quotation and trading of securities into rules, allowing for more effective enforcement. More than

344 Supra notes 52-62 and related text.
345 K. Cowan, supra note 185, at 5-6.
346 See P.S. Taylor, supra note 187.
reformulating the existing requirements into rules, it is argued here that CDN should, however, seize the opportunity to improve the existing regulatory framework by introducing provisions that will enhance the effectiveness of its monitoring function.

More particularly, CDN should give attention to two issues that can impede the development of the trading system. The first issue arises from the low level of market-maker competition on CDN. A non-competitive market may permit investment dealers to use their domination of the market to extract *supra*-competitive compensation from investors. Furthermore, a non-competitive dealer market may be conducive to manipulation, especially when it means that there is only one market-maker for a given security.

The second issue pertains to the level of compliance with disclosure requirements in the OTC market. According to a recent report sponsored by the Toronto Stock Exchange, compliance with continuous disclosure requirements may be particularly wanting in the junior issuer segment of the stock market. While mandatory disclosure is first and foremost an issue that should be addressed in securities laws, CDN has a role to play in administering the disclosure régime. Indeed, if the trading system was to tolerate systematic violation of disclosure requirements, this would negatively affect the system’s reputation and lead investors to shun the market.

a) Disclosure of Investment Dealer Compensation

Investors execute transactions in the OTC market through investment dealers acting either as agents or principals. Investment dealers provide agency services when they buy from or sell to market-makers on their customers’ behalf and receive a commission for their service. They act as principal where they sell or buy from their own inventory of securities and charge customers a mark-up or mark-down. A mark-up consists of “the difference between the amount of money a customer pays to a dealer for a security and the prevailing market price of the security.”\(^{347}\) Conversely, a mark-down represents “the difference between the price at which a dealer buys a security from a customer and the prevailing market price.”\(^{348}\)


\(^{348}\) *Ibid.* at 678.
The CDN Policy indirectly regulates the commissions or mark-ups that investment dealers negotiate with customers through a rule governing prices paid by customers. Under the Policy, the price paid or received by customers buying or selling a security from an investment dealer acting as principal must be reasonably related to the current market price of that security. Where the dealer conducts the transaction on an agency basis, the commission paid must be fair and reasonable in all the circumstances.

Mark-ups compensate investment dealers for the ordinary costs incurred in handling transactions. Ordinary transaction costs include the commissions of salespeople as well as the cost of processing trades. Mark-ups also compensate dealers for the risks associated with conducting transactions. However, the only risk that should influence the level of mark-ups is the risk associated with daily price fluctuations. Indeed, mark-ups must be distinguished from the bid-ask spread that compensates investment dealers for making a market in particular securities. Thus, they cannot be used to pass to investors some of the costs of market-making such as the cost of holding a position in a security.

To determine the reasonableness of mark-ups, it is crucial to ascertain the current market price of the security. In this respect, the CDN Policy, in line with the American case law, makes a distinction between riskless principal transactions and principal transactions. Riskless principal transactions are trades where dealers buy securities from market-makers after receiving the customers’ orders. Such transactions are riskless for dealers since they do not assume any risk associated with owning the securities, such as price fluctuations or liquidity problems. In contrast, in typical principal transactions, market-makers buy and sell securities from their own inventory on a continuous basis.

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349 CDN Policy, s. F.2.
350 Ibid.
351 J.I. Goldstein & L.D. Cox, supra note 347, at 682-683.
352 Ibid.
For riskless principal sales, the *CDN Policy* states that, in addition to being reasonably related to the then current market price of the security, the size of the mark-up should reflect the riskless nature of the transaction.\(^3\) To assess the price on the basis of which the mark-ups are computed, the leading authority in the United States holds that it is the investment dealer’s contemporaneous cost which provides the best evidence of the prevailing market price absent contrary evidence.\(^4\) The contemporaneous cost is normally determined by referring to the price that the dealer paid to buy the security from a market-maker in an arm’s length transaction closely related in time.\(^5\)

The contemporaneous cost standard is not considered to be appropriate in the case of principal transactions as this standard may deter investment dealers from acting as market makers.\(^6\) Instead, mark-ups are computed on the basis of the contemporaneous prices charged by market-makers to other dealers or, in the absence of such transactions, on the basis of representative bid and ask quotations.\(^7\) The use of contemporaneous quotations proves problematic, however, in non-competitive dealer markets. Indeed, where the market is controlled or dominated by a single market-maker, the latter has wide latitude in setting their quotations. Thus, quotations do not provide a reliable proxy for the current market price. Accordingly, in the absence of competitive market-makers, the Securities and Exchange Commission (SEC) has rejected the use of quotations in favour of the contemporaneous cost standard, i.e. the contemporaneous prices that the market makers are willing to pay other dealers for the securities they purchased from them.\(^8\)

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354  *CDN Policy*, s. F.2 a). *Supra* note and related text.

355  *In re Alstead Dempsey*, *supra* note 353, at 1035.


What constitutes a reasonable mark-up, calculated on the basis of one of the previous criteria, remains an elusive question. The SEC has generally held that mark-ups and mark-downs in equity transactions of more than 10 per cent are fraudulent.360 For its part, the National Association of Securities Dealers (NASD) has considered, since 1943, that for prices to be fair in equity transactions, mark-ups and mark-downs should not exceed 5 per cent.361 Despite their apparent simplicity, percentage thresholds are particularly unreliable where the dollar amount of the transaction is small, as it is the case with securities traded in the OTC market.362 For this reason, the NASD has indicated that mark-ups of more than 5 per cent may be justified for securities trading at less than $10. It is suggested here that CDN should provide some precision to market participants about what constitutes a reasonable mark-up or mark-down.

In any event, the most important issue with respect to mark-ups and commissions in the OTC market is the relative secrecy that surrounds them. Currently, the CDN Policy contains no provisions mandating the disclosure of commissions or mark-ups. Likewise, the Investment Dealers Association does not provide any rules concerning the disclosure of dealers' compensation.

The absence of such obligation can be criticised to the extent that it undermines the ability of investors to assess the reasonableness of the compensation paid to investment dealers.363 While investors can use price and volume information to determine the dealers' compensation, this information has limited relevance where market-makers dominate the market for a particular security. Indeed, in such circumstances, investors must calculate mark-ups using inter-dealer transactions rather than quotations. For the same reasons, the lack of disclosure of dealer compensation will considerably mitigate the possibility of CDN exercising a surveillance of the activities of investment dealers acting on the CDN system.

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360 See e.g. Staten Securities Corp., 47 S.E.C. 766 at 767 (1982).
361 The rule is set out in the Rules of Fair Practice of the NASD. See J.I. Goldstein & L.D. Cox, supra note 347, at 679-682.
363 According to the OSC, investors investing in penny stocks are often unaware of the commission and/or markup charged by dealers. OSC Policy 110, supra note 359, at 1469.
To overcome this deficiency, CDN should use its newly acquired power to regulate the conduct of "Participants" to implement disclosure requirements concerning dealer compensation. The requirements could be crafted along the lines of those proposed by the short-lived OSC Policy 1.10 on penny stocks and those implemented in the United States under the Penny Stock Reform Act of 1990. Thus, prior to a transaction in a quoted security, CDN should require the disclosure of the following information to customers:

1. the bid and ask price for the security;
2. the number of securities for which the bid and ask price apply;
3. the amount and description of the compensation received by the investment dealers, as well as any other associated person, in connection with the transaction.

The disclosure of compensation arrangements would provide investors with an indication of the dealers' self-interest in realising the transactions. For instance, the disclosure of this information could make investors aware that the compensation obtained by the dealer represents a significant percentage of the purchase price. Moreover, it would enable investors to exercise a role in policing unreasonable mark-ups of commissions. Besides, the information disclosed would enable investors to assess the price that they would pay for, and would receive from the immediate resale of, a security in relation to the bid and ask prices.

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364 Toronto Stock Exchange Act, supra note 194, s. 13.2 (1)b).
366 The requirement would compel the disclosure of the commission received by the dealer acting as agent as well as the mark-up received by the market-maker involved in the transaction as principal.
367 O.D. Hernandez, supra note 272, at 43.
368 L. Loss & J. Seligman, supra note 329, at 3811
b) Disclosure of Sole Market Maker Status

The presence of a sole market-maker in the securities of an issuer raises the risk of manipulation. Where there are no competing market makers to establish securities prices, the market price of securities depends on the judgment of a sole market-maker. In theory, the market-maker should establish quotations in response to supply and demand, increasing his inventory at lower prices while demand is rising, and going short when demand is falling.

However, the sole market-maker may use his domination and control of the market in a way that neutralises the competitive forces of supply and demand. More particularly, the market-maker may use his control of the supply of securities to raise, lower or maintain the security's price arbitrarily in order to realise a profit by trading as principal. Such conduct is unarguably manipulative.

Although manipulation is not prohibited explicitly by the Securities Act, several provisions are sufficiently wide to sanction manipulative actions. The "shingle theory", which requires that dealers act fairly, honestly and in good faith with their customers and potential customers, can form the basis of liability when dealers manipulate the market. Moreover, the Commission can

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369 According to Fischel and Ross, the concept of manipulation refers to a conduct designed to: "(1) interfere with the free play of supply and demand; (2) induce people to trade; or (3) force a security's price to an artificial level." D.R. Fischel & D.J. Ross, supra note 52, at 507.


371 Usually, pressure selling efforts will be undertaken simultaneously to prompt demand for the securities. See J.I. Goldstein et al., ibid. at 785-786.


use its power to cancel, suspend or restrict registration in the public interest to sanction abusive conduct such as manipulation.374

The provisions of the Securities Act are completed by the CDN Policy that prohibits expressly manipulative or deceptive trading.

An approved market-maker or other User shall not use or knowingly participate in the use of any manipulative or deceptive method of trading in connection with the purchase or sale of a CDN security that creates or may create a false or misleading appearance of trading activity or an artificial price for the security.375

Finally, the Criminal Code contains several provisions creating offences for fraudulently affecting the market price of securities.376

Sanctioning manipulations, however, remains problematic because of the difficulty of identifying manipulative trades.377 Since transactions that are part of a manipulative scheme are often not objectively different from all other trades, the proof of manipulation must centre on a determination of the intent of the trader, which is a particularly difficult task to accomplish when objective evidence is as consistent with manipulative activity as with normal market activity.378 In the absence of direct evidence of manipulative purpose, such purpose must therefore be inferred from patterns of behaviour, from apparent irregularities, and from trading data.379 Because of these difficulties, the probability of convicting investment dealers who manipulate the market, even when such manipulation can be detected, remains low.

Given the difficulty of sanctioning ex post manipulation, it seems preferable from a policy perspective to adopt rules that will reduce the risk of manipulation ex ante.380 In this respect, the

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374 O.S.A., s. 127.
375 CDN Policy, s. F.5.
376 Criminal Code, R.S.C., c. C-45, s. 380, 382, 384.
377 D.R. Fischel & D.J. Ross, supra note at 519-521.
378 See e.g. R. v. Jay, (1966) 1 C.C.C. 70 (Ont. C.A.) (it must be shown that orders were made with the intent of creating the appearance of an active market).
379 A. De Toro, supra note 370, at 254-256.
380 D.R. Fischel & D.J. Ross, supra note 52, at 248-249 (Stressing that the difficulty of distinguishing manipulative from non-manipulative conduct creates a risk of errors that can lead to over-enforcement).
existing CDN rules mandating the disclosure of bid-ask quotations and trading volume play an important role in allowing investors to monitor the price that they pay for securities. CDN also purports to deter manipulative practices by imposing restrictions on trading by Users during distributions. It also requires that Users that are insiders of or controlled by any issuer, disclose to customers prior to, and confirm, at the time of the transaction the nature and existence of such relationship.

To curb the risk of manipulation, CDN should consider enacting an additional requirement compelling dealers acting as sole market makers in a security to disclose their sole market maker status to investors. Sole market makers should also have the duty to disclose that such status confers upon them substantial influence over the market for the security. Moreover, the proposed rule should prohibit market makers from making representations that the transaction is being effected "at the market" or at a price related to the market price. Where transactions are conducted through a dealer that is not acting as market-maker, the dealer should correspondingly have the obligation to disclose such information to investors. This proposal, which is inspired by the American penny stock reform, would contribute to preventing manipulative activities by sole market-makers in the OTC market.

6. The Role of the Canadian Dealing Network in the Mandatory Disclosure Regime

Regulators have regularly voiced concerns with respect to the degree of compliance of junior issuers, particularly unlisted companies traded in the OTC market with respect to continuous disclosure requirements. This is not the time and occasion to discuss in depth the policy issues related to secondary market mandatory disclosure, but it nevertheless appears necessary in the discussion of proposals to improve the operations of the Canadian Dealing Network to examine the

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181 Supra notes and related text.

182 CDN Policy. s. F.6. On the risk of manipulation during distribution supra Chapter II notes and related text.

183 Ibid. s. F.7.

role that such an organised exchange can play in the mandatory disclosure régime. Thus, this section presents an overview of the existing regulatory framework governing continuous disclosure in the secondary market, and then examines the role CDN should seek to play in the disclosure régime.

a) The Existing Continuous Disclosure Regime

The Securities Act imposes continuous disclosure obligations on all reporting issuers. The legislation enacts two types of continuous disclosure requirements: timely disclosure and periodic disclosure.

i) Periodic Disclosure

The periodic disclosure requirements compel reporting issuers to prepare quarterly and annual financial statements that are filed with the securities commission and delivered to investors. The interim financial statements must be filed within 60 days of the end of each fiscal quarter. They must include an income statement and a statement of changes in financial position and do not have to be audited. Annual financial statements must be audited and filed within 140 days from the end of the fiscal year. They must include an income statement, statement of surplus, statement of change in financial position and a balance sheet.

Since 1989, under OSC Policy 5.10, reporting issuers must file an Annual Information Form (AIF) compiling “relevant background material essential to a proper understanding of the nature of the issuer, its operations and prospects.” The issuers must also prepare a Management

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385 O.S.A., ss. 1(1) (reporting issuer), 77-79.
386 O.S.A., s. 77(1); 78.
387 O.S.A., s. 77; O.S.R., s. 7-9.
388 O.S.A., s. 78, O.S.R., s. 10-11.
Discussion and Analysis Report (MDAR) which is repeated in, or incorporated by reference into, the AIF. The MDAR purports to “give the investor the ability to look at the Issuer through the eyes of management by providing both a historical and prospective analysis of the business”. While the MDAR must be sent to all shareholders, the AIF, which contains equally essential information for understanding the issuer’s situation, is available to shareholders only upon request.

Recognising that the costs associated with the preparation of past-oriented disclosure documents required by the AIF and MDAR would represent a significant burden for small issuers, the OSC has introduced one of the rare size-based exemptions of the securities regulation in Policy 5.10. Thus, the policy applies to all reporting issuers with the exception of issuers with shareholders’ equity or revenues of $10 million or less. When an issuer exceeds the $10 million threshold, it must prepare and file an AIF and MDAR in respect of the fiscal year immediately following that in which it exceeds the threshold. It is argued here that the current exemption for small issuers should be maintained until the whole disclosure régime is modified to implement an integrated disclosure system.

While the periodic disclosure requirements reflect a willingness to design a cost-effective regime for small issuers, the Ontario Task Force on Small Business Financing expresses concerns in its Proposal for Comment with respect to some aspects of the periodic disclosure requirements. In particular, the Task Force questions the wisdom of mandating the disclosure of interim financial statements for the first and third quarter of each fiscal year.

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390 Policy 5.10, ibid. at 962.
391 Ibid. at 959.
392 N. Campbell, supra note 389, at 344-345.
393 Policy 5.10, supra note 389, at 944, para. 5.
394 See however Toronto Stock Exchange Committee on Corporate Disclosure, Responsible Corporate Disclosure (Toronto: Final Report. Toronto Stock Exchange, 1997) at 74-75 (suggesting mandating the production of an AIF for all issuers as a move towards the integration of transactional and continuous disclosure) [hereinafter Allen Report].
Presently, OSC Policy 2.6 establishes guidelines under which the commission will grant relief to reporting issuers from the duty to file and distribute interim financial statements. Specifically, the exemption will be granted under the policy "where the issuer demonstrates that the preparation and distribution of such statements would not be of significant benefits to investors and would not be of significant benefit to investors and would represent a material financial burden to the issuer." As a general threshold, the policy states that financial statements disclosure will be of little benefit for issuers with working capital of less than $50,000 and provides that the Commission is prepared to grant an exemption on a routine basis for those issuers with such a modest level of working capital.

Where it does not consider a full exemption to be appropriate, the OSC will consider, under Policy 2.6, granting a partial exemption from the requirements with respect to the first and third quarters of each financial year. According to the Task Force, this discretionary exemption should be codified and made available for any SME that meets the $10 million threshold. In support of its proposal, the Task Force notes that not all SMEs are aware of the routine nature of these exemptions. Furthermore, it states that the codification of the exemption would reduce the costs for issuers and the regulator of processing the application.

As many commentators have stressed, this proposal of the Task Force is misguided. Indeed, the preparation of interim financial statements impose little costs on issuers that they would not incur otherwise in the management of their businesses. Most modern businesses prepare financial statements on a monthly basis or at least on a quarterly basis. Thus, the direct cost and the opportunity cost of preparing the disclosure documents should not be too high.

396 Policy 2.6, supra note part. 1.A.

397 Task Force Proposals, supra note 395, at 62.

More importantly, the disclosure requirements provide relevant information on the performance of new issuers with limited track record that is subject to significant variation in the first year following the IPO.399 Financial information will be particularly useful to ensure that securities prices adjust rapidly to reflect the prospects of issuers and prevent founders and major shareholders from selling their securities at inflated prices after satisfying escrow requirements.400

Although the requirement to deliver interim financial statements to investors arguably imposes additional costs on issuers, there currently exists a mechanism that addresses this concern. Pursuant to National Policy No. 41, reporting issuers that deliver proxy-related materials to non-registered holders and establish and maintain a supplemental mailing list of security holders — registered and unregistered — who wish to receive interim financial statements are exempted from the delivery requirement. Thus, those issuers need only file the interim financial statements with the securities commission and distribute them to security holders who make a request.

The recent implementation of SEDAR should further decrease the cost of delivering financial statements to investors.401 Under the SEDAR National Instrument, reporting issuers are required to file interim and annual financial statements in electronic format.402 These disclosure documents are now generally available to the public through an Internet Web site and through various information service providers and sellers. Undoubtedly, the availability of financial information documents in

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399 Supra Chapter IV notes and related text. However, a survey conducted for the Toronto Stock Exchange Committee on Corporate Disclosure found that analysts ranked quarterly financial statements as somewhat less useful than annual financial statements and annual reports. The quality of disclosure in quarterly financial statements was ranked as “good” as opposed to “very good” for annual financial statements and annual reports. Toronto Stock Exchange Committee on Corporate Disclosure, “Toward Improved Disclosure – Interim Report”, (1996) 19 O.S.C.B. 8 at 25.

400 Supra Chapter notes and related text. The recent example of YMB highlights the importance of interim financial statements. Directors of YMB, a TSE 300, company allegedly sold more than $2 million worth of shares that may have been subject to escrow in the weeks before the company’s auditors raised concerns about its operations. See K. Howlett & P. Waldie, supra note; K. Howlett, “Funds hold almost 40% of troubled YBM”, The Globe and Mail, May 20, 1998 at B3.


electronic format will reduce the need and the demand for issuers to distribute such information to investors. In the long term, the cost of delivering financial statements to investors should therefore become insignificant for issuers.

**ii) Timely Disclosure**

The timely disclosure obligations aim at ensuring the immediate dissemination to the public of information that could reasonably be expected to be important for investors' investment decisions. Under the Securities Act, reporting issuers must disclose any "material change" occurring in their affairs by issuing and filing a press release disclosing the nature and substance of the change. Material change is currently defined as a change in the business, operations or capital of an issuer that would reasonably be expected to have a significant effect on the market price or value of any of the issuer’s securities. Following the Act, the reporting issuer must subsequently file with the OSC a “material change report” no later than 10 days after the change occurs.

The disclosure requirement enacted by the Securities Act is extended by National Policy No. 40. The Policy, which applies to all issuers whose securities are publicly traded in Canada, expands the concept of “material change” to encompass the reporting of “material information” concerning the issuer. Material information is not restricted to changes in assets or the business

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404 O.S.A., s. 75. Where the disclosure of a material change would be unduly detrimental to the issuer’s interests, it may file with the OSC a confidential material change report instead of filing a press release and disclose to the OSC the reasons why it seeks confidentiality. O.S.A. ss. 75(3).

405 O.S.A., s. 1(1) (material change). In contrast, material fact means a fact that significantly affects, or would reasonably be expected to have a significant effect on, the market price or value of the issuer’s securities. Note that the concept of material change is undergoing some modifications to reflect the recommendations of the Allen Report. See “Civil Liability for Continuous Disclosure”, (1998) 21 O.S.C.B. 3367 [hereinafter Civil Liability for Continuous Disclosure]. See also infra notes and related text. Upon the adoption of the proposed modifications, material change will be defined as “a change in the business, operations, capital, assets of the issuer which would be substantially likely to be considered important to a reasonable investor in making an investment decision.” Alternatively, material change will also include a decision made to implement such a change, where the decision is made by “senior management of the issuer who believe that confirmation of the decision by the directors is probable, or the directors of the issuer.”

406 O.S.A., s. 75(1).


408 For an example of the limits of the material change reporting requirement, see Pezim v. Superintendent of Brokers (B.C.) [1994] 2 S.C.R. 557.
and affairs of the issuer. Indeed, it includes any “information relating to the business and affairs of the issuer that results in or could reasonably be expected to result in a significant change in the market price or value of any of the company’s securities.” Material information must be disclosed immediately upon becoming known to management or upon becoming apparent that it is material.

While the decision as to whether an event must be disclosed is left to the discretion and judgement of each issuer, the Policy provides guidelines to determine if an information is material and lists several developments likely to give rise to disclosure of material information. For instance, material information is deemed to include, inter alia: share ownership changes affecting the control of the issuer; the development of new products, developments affecting the issuer’s resources, technology or markets; significant discoveries by resource companies; firm evidence of significant increases or decreases in near-term earnings prospects; and significant changes in management.

Issuers whose securities are quoted on the CDN system are also subject to the timely disclosure requirements of the CDN Policy. Under the CDN Policy, where a material change is proposed in the affairs of an issuer quoted on CDN, the issuer or its market-maker must give notice to the Board of CDN. The Board may then terminate, suspend or temporarily halt quotation of the issuer’s securities on the trading system. However, currently, “the absence of clear legal obligations in relation to these matters can in certain cases present a significant impediment to CDN’s enforcement efforts.”

Surprisingly, the CDN Policy does not use the same definition of “material change” as the Securities Act. Rather than use only a market-based standard of materiality, the Policy, as National

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409 National Policy C-40, supra note 407, Part D.
410 Ibid.
411 Ibid.
412 CDN Policy, s. C.3.
413 K. Cowan, supra note 185, at 6.
Policy 40 adopted by the Canadian Securities Administrators, also defines materiality in light of the significance of the information to a reasonable investor. Thus material change includes, under the CDN Policy:

...any other developments relating to the business and affairs of the issuer that would reasonably be expected to affect the market price or value of any of the issuer’s securities or that would reasonably be expected to have an influence on a reasonable investor’s investment decision.

While both materiality standards are accepted in the Canadian securities market context, it is argued here that the dual use of the standards to define material change may unnecessarily confuse issuers and hinder compliance. Thus, CDN should review the definition to harmonise it with the prevailing standard used in the Securities Act.

b) The Enforcement of Disclosure Obligations

Concerns have regularly been voiced by regulators with respect to the degree of compliance by issuers with the current continuous disclosure requirements. For instance, the Toronto Stock Exchange Committee on Corporate Governance in Canada noted in its 1994 report, Where Were the Directors?:

We have the distinct sense that concerns exist about the ongoing disclosures of public companies. The concerns focus both on the timeliness of the release of information and upon the content of the releases.

In 1995, the Toronto Stock Exchange set up a Committee on Corporate Disclosure to examine this particular issue. As part of its work, the Committee, chaired by Mr. Thomas Allen, conducted a survey of market participants to assess the latter’s perception of mandatory disclosure

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410 Supra note 410.

414 CDN Policy, s. C.3.

415 It should be noted in this respect that the definition of material changes will likely be changed to follow the recommendation of the Allen Report.


417 Dey Report, ibid. at 49.
compliance. The Committee marshalled anecdotal evidence supporting the concerns expressed previously by the TSE Committee on Corporate Governance by conducting a survey of analysts and retail investors.\textsuperscript{418} While the analysts surveyed considered that issuers generally complied with the disclosure obligations, they stressed the existence of problems with respect to the sufficiency and timeliness of the information provided. The survey of retail investors supported this perception that information was not disclosed on a timely basis. Thus, almost 70 per cent of investors surveyed considered that positive information was released on a timely basis almost all or most of the time. However, more than 65 per cent believed that issuers released negative information in a timely manner only some of the time or almost never.

In its assessment of the degree of compliance of issuers to disclosure requirements, the TSE Committee on Corporate Disclosure identified junior issuers, particularly unlisted companies traded in the OTC market, as an area of special concern.\textsuperscript{419} The Committee referred to observations by CDN staff that quoted companies regularly issued press releases "designed more to promote purchase of the stock than to disclose material information."\textsuperscript{420}

The TSE Committee on Corporate Disclosure produced a report entitled \textit{Responsible Corporate Disclosure — A Search for Balance} (the "Allen Report") in 1997. In its report, the Committee upholds a deterrence model to ensure compliance with disclosure standards.\textsuperscript{421} Thus, the primary recommendation of the report is to increase the level of private enforcement of mandatory disclosure in order to enhance the quality and quantity of disclosure. More particularly, the Committee recommends the introduction of a statutory liability régime whereby issuers and

\begin{footnotes}
\begin{enumerate}
\item[418] \textit{Allen Report}, supra note 394, at 25.
\item[419] \textit{Ibid.} at 26.
\item[420] \textit{Ibid.} at 28.
\item[421] The Committee has favoured a deterrence model, which uses civil liability as the primary means of providing a disincentive to misleading continuous disclosure, rather than a compensation model. The Committee explains the difference between the two options: "A statutory civil liability model based on deterrence would try to open the door of civil liability only to the extent that the consequences of misleading disclosure would provide effective deterrence without exposing issuers to crippling damage awards, while the model based on compensation would try to compensate anyone who was injured by misleading disclosure." \textit{Ibid.} at 41.
\end{enumerate}
\end{footnotes}
others who are responsible for violation of disclosure obligations may be liable in civil actions brought by injured investors to recover their damages.422

In light of this pending reform, what role should CDN play to enhance disclosure standards in the OTC market?423 It is argued here that in the formulation of a comprehensive set of rules governing its quotation and trade reporting system, CDN should seek to adopt provisions that will provide a legal foundation for a more active role in the disclosure regime. More particularly, CDN should seek to enhance the quality and quantity of information available in the market. As a organised stock exchange, CDN has a direct economic interest in ensuring that listed issuers comply with disclosure obligations.424 Indeed, systematic violations of disclosure requirements on CDN will negatively affect the trading system’s reputation and will lead investors to shun the market.

Concurrently CDN should attempt to enhance the cost-effectiveness of the new regulatory regime. Although it is beyond the scope of this dissertation to analyse the justifications425 and the objections426 to a mandatory disclosure regime in the secondary market, it is important to

422 See Civil Liability for Continuous Disclosure, supra note 405.

423 CDN staff has manifested a willingness to enhance the role of the trading system in the disclosure régime. See K. Cowan, supra note 185, at 6-7.

424 Financing Innovative Enterprise, supra note 13, at 135-136. See however, Letter from Coopers & Lybrand to Mr. T.L.A. Allen, dated April 25, 1996, in Toronto Stock Exchange Committee on Corporate Disclosure, Comment Letters Received by the Committee on Corporate Disclosure (Toronto: Toronto Stock Exchange, 1997) 175 at 180 (stock exchange has a vested interest which undermines its oversight function).

425 Continuous disclosure regulation can be justified on similar grounds as mandatory prospectus disclosure. Thus, the principal objective of the disclosure requirements is to produce an equality of opportunity for all investors by making available on a timely basis all information the investor needs to make an informed investment decision. It aims at ensuring that the information disclosed in the prospectus is updated with some regularity in order for investors to have adequate means to evaluate the issuers. Continuous disclosure also enhances the accountability of management and discourages fraud. In sum, continuous disclosure pursues the broad objectives of creating and maintaining investor confidence, while also fostering market efficiency. M.R. Gillen, Securities Regulation in Canada (Toronto: Butterworths, 1992) at 144, 145 referring to the Report of the Committee of the Ontario Securities Commission on the Problems of Disclosure Raised for Investors by Business Combinations and Private Placements, at 15 (the Merger Report); Toward Improved Disclosure, supra note at 35. See also Securities and Exchange Commission v. Texas Gulf Sulphur Co. 401 F.2d 833 at 847-848 (1968); Basic c. Levinson, supra note 425.

426 In an efficient capital market, the case in favour of a mandatory system of disclosure in the secondary market appears fragile. Since in an efficient market securities prices fully reflect all available information, securities prices are fair, i.e. they reflect on average the actual value of the securities. This, in turn, will foster an efficient allocation of capital to the most profitable investments. In addition, investment efficiency enables investors to protect themselves against risk by holding diversified portfolios. Finally, because of the speed at which securities prices reflect any new piece of information in an efficient market, mandatory disclosure contains little new information relevant to investors’ judgements on risk and return. For an overview of the argument, see J.R. Macey, “Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty”, (1994) 15 Cardozo L. Rev. 909 at
emphasise that disclosure requirements are not costless for issuers.\textsuperscript{427} For this perspective, CDN should ensure that the disclosure regime is tailored to the particularities of smaller issuers and does not impose overly costly obligations to the latter.

To provide a basis for its interventions in the disclosure process, CDN should consider adopting specific disclosure provisions along the lines of the \textit{TSE Timely Disclosure Policies}.\textsuperscript{428} Thus, the rules should provide for a duty for issuers to advise CDN of the method of dissemination and the content of any material information in advance of its release.\textsuperscript{429} Upon reception of the disclosure document, CDN should have the power to accept or refuse its filing, or require corrections to the information disclosed. This would enable CDN to act as a check on disclosure quality by reviewing any material information prior to its release by issuers. Such review of disclosure documents would reduce the risk of misrepresentations arising from the inclusion of promotional language in the releases.\textsuperscript{430} Furthermore, it would enhance disclosure by allowing market surveillance staff to ensure that the statements issued are not incomplete or ambiguous.

\textsuperscript{927-937} N. Wolfson, “A Critique of the Securities and Exchange Commission”, (1981) 30 \textit{Emory L.J.} 119. The benefits of mandatory disclosure in an efficient market have been challenged on empirical grounds by a series of studies undertaken by George Benston. Benston examined the reaction of the market following the enactment of the \textit{Securities and Exchange Act of 1934} and concluded that the disclosure requirements did not aid investors. G. Benston, “Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934”, (1973) 63 \textit{Am. Econ. Rev.} 132. However, the segment of the secondary market dominated by SMEs arguably does not possess the attributes of a semi-strong form efficient market. Particularly lacking in this segment of the secondary market is the presence of a critical mass of sophisticated market professionals as suggested by one of the most satisfying explanations of the small firm effect. The dearth of sophisticated market participants in the small firm securities market has important consequences for market efficiency since the rivalrous competition of such investors to identify overvalued or undervalued securities is instrumental in driving securities to their correct prices. R.J. Daniels & J.G. Maclntosh, “Toward a Distinctive Canadian Corporate Law Regime”, (1991) 29 \textit{Osgoode Hall L.J.} 863 at 878. To the extent that this segment of the securities market is characterised by a lower level of informational efficiency, there may be a stronger case in favour of a mandatory disclosure regime. More specifically, mandatory rules may be necessary to complement the insufficient incentives of firms to disclose an optimal amount of information and to overcome the problem posed by the public goods aspect of information. R.J. Dennis, “Mandatory Disclosure Theory and Management Projections: A Law and Economics Perspective”, (1987) 46 \textit{Md. L. Rev.} 1197 at 1210 n. 75

\textsuperscript{427} \textit{Financing Innovative Enterprise}, supra note 13, at 47.


\textsuperscript{429} Currently, the CDN Policy does not mandate pre-clearance with CDN authorities. See \textit{CDN Policy}, s. C.3.

\textsuperscript{430} \textit{Allen Report}, supra note 394, at 57.
Likewise, CDN should have the requisite power to work proactively to obtain disclosure in situations where the issuers may not be aware of the need to disclose material information. This would allow market surveillance staff to compel issuers to disclose information in reaction to rumours, unusual trading activity, media stories, or analyst reports.\textsuperscript{431} Moreover, market surveillance staff could effectively intervene where selective disclosure is suspected to ensure that material information is widely disseminated.

To ensure enforcement of its disclosure requirements, CDN should have the power to sanction any violation of the requirements by warning letters, suspension of trading, or filing a complaint with the Ontario Securities Commission. In addition, where material information is disclosed and might significantly affect the market price of the issuer's securities, CDN should have the power to halt trading in the securities in order for the information to be widely disseminated.

While the proposed rules may be interpreted as essentially curative, CDN should seek to adopt a preventive approach where dealing with disclosure issues. Thus, the trading system's authorities should use its powers to provide guidance to issuers on whether an event or development is material and requires disclosure. This assistance of CDN would be particularly important in light of the high degree of uncertainty which surrounds the concept of materiality, especially as it applies to pending developments.\textsuperscript{432}

In this perspective, where issuers do not comply with the exchanges' disclosure policies, CDN should favour warning letters advising the issuer of its failure to comply with its disclosure obligations. According to the TSE, "these warnings are mostly effective...due simply to moral suasion and the generally responsible attitude with which companies approach their disclosure obligations".\textsuperscript{433} Furthermore, it is worth stressing that delisting or suspension from trading is a drastic measure which penalises the shareholders at large, rather than just those responsible for the

\textsuperscript{431} Ibid. at 56-57; "TSE Company Manual", supra note 71, s. 414. CDN conducts market surveillance to detect unusual trading activity. In such a case, it requires the issuer, through moral suasion, to confirm or deny the existence of any corporate developments accounting for the trading activity. Conversation with Kevin Cowan and Roy Hill, Canadian Dealing Network, Toronto, March 11, 1998. CDN Policy, s. D.5.

\textsuperscript{432} Ibid.

\textsuperscript{433} Ibid.
inadequate disclosure. Thus, for more serious continuous disclosure violations, CDN should alert the securities commission and ask for its assistance in an investigation that will lead, if necessary, to sanctions under the securities legislation.

**SECTION D: SUMMARY**

The existence of an active and liquid secondary market is critical to the vitality of the initial public offering market. While there are a variety of stock exchanges in Canada, it appears that issuers making small initial public offerings in Ontario have difficulty accessing an organised stock market. This gap in the financing of SMEs in Ontario is particularly worrisome in light of the proposed reform to the regulatory framework governing IPOs to facilitate public equity financing for smaller enterprises.

From this perspective, the present chapter discussed the possibility of filling this gap in secondary markets. More particularly, it emphasised the potential of the Canadian Dealing Network, which operates the over-the-counter market in Ontario, in providing an accessible secondary market for smaller issuers. Thus, the chapter presented proposals to enhance the effectiveness of CDN in order for the trading system to become a viable secondary market for junior issuers securities.
GENERAL CONCLUSION

Small and medium-sized enterprises play a vital role in the Canadian economy. While the growth and success of these enterprises do not depend solely on financial support, access to financing is critical for their expansion. In this respect, public equity financing performs a crucial function among the various sources of capital in the funding of growing SMES. Accordingly, it is essential that smaller enterprises for which going public is justified are able to access the public equity market.

The accessibility of the securities market for SMES implicates directly securities legislation which enacts the regulatory framework governing initial public offerings in order to protect investors and enhance market efficiency. Unfortunately, as this dissertation shows, the regulatory framework is not adequate for the purpose of ensuring the access of small and medium-sized enterprises to public equity financing. This inadequacy stems from the fact that very little attention seems to have been paid by the legislator to the cost-effectiveness of the regulatory regime as well as to the characteristics of the institutional features of the market regulated. This has lead to the enactment of regulatory requirements that are not adapted to the segment of the market that is composed of SMES.

From this perspective, the dissertation discussed the reforms that should be undertaken in order to enhance the accessibility of public equity financing for SMES, taking as a starting point the work of the Ontario Securities Commission Task Force on Small Business Financing. Emphasizing the importance of implementing a cost-effective regulatory regime, the foregoing study examined closely the institutional setting of the small firm IPO market in order to identify the specific modifications to the regulatory requirements that should be performed.

While they are diverse, the modifications proposed all result from a recognition of the potential of the private information networks of this segment of the initial public offering market. Thus, their common goal is to redirect IPO regulation at strengthening and complementing these private mechanisms, rather than superseding them. A similar concern
guides as well the analysis of the development of an active and viable secondary market for SMES securities. Admittedly, the proposals for reform considered in this dissertation are not exhaustive. Therefore, further research is undoubtedly needed to enhance the efficiency and accessibility of the public equity market for small and medium-sized enterprises.
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