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VOLUNTARY CORPORATE GOVERNANCE, PROPORTIONATE REGULATION AND SMALL FIRMS: EVIDENCE FROM VENTURE ISSUERS*

Anita Anand, Wayne Charles and Lynnette Purda*

Following the implementation of the Sarbanes-Oxley Act, scholars argued that one-size-fits-all corporate governance imposed disproportionately high compliance costs on small businesses, weakening their competitiveness vis-à-vis larger firms. As an alternative, these critics contended that “proportionate regulation,” in the form of regulatory exemptions for small firms, is an appropriate means of minimizing disclosure obligations. While at first glance it may seem that small firms would seek to comply with less costly governance standards, is it possible that they would nonetheless voluntarily adhere to stricter standards? Our empirical findings suggest that proportionate regulation is a misguided regulatory approach given the voluntary adoption of corporate governance mechanisms among small firms.

I. INTRODUCTION

Following the implementation of the Sarbanes-Oxley Act, many scholars and business leaders argued that one-size-fits-all corporate governance imposed disproportionately high compliance costs on small businesses, weakening their competitiveness vis-à-vis larger firms.† As an alternative, these

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critics contended that “proportionate regulation,” in the form of regulatory exemptions for small firms, is an appropriate means of minimizing disclosure obligations. While at first glance it may seem that small firms would seek to comply with less costly governance standards, is it possible that they would nonetheless voluntarily adhere to stricter standards?

The notion that proportionate regulation can provide investor protection while nonetheless minimizing the regulatory burden for small firms has been debated in both the United States and Canada. In 2011, for example, President Obama called for a review of existing regulation to reduce “the burden regulations may place on small business.”2 Subsequently, in 2012 the Jumpstart Our Business Startups (JOBS) Act was signed into law on the basis of the belief that “cost-effective access to capital for companies of all sizes plays a critical role in our national economy.”3 Similarly, in 2015 the head of the Canadian Securities Administrators (CSA) suggested that their proposed changes would “alleviate the disclosure burden imposed on venture issuers without compromising investor protection.”4 Despite the regulatory attention given to proportionate regulation, there is little empirical evidence to either support or dismiss it. This article aids in closing this gap by delving deeply into a specific instance of proportionate regulation to shed light on venture issuers’ corporate governance preferences and their voluntary behaviour.

Our contribution to the literature is twofold. First, we provide specific insights on voluntary corporate governance and the perceived benefits for investors and firms of a particular exemption in the context of venture issuers. Second, our empirical findings suggest that many of the arguments in support


of implementing proportionate regulation were not relevant given voluntary adoption of corporate governance mechanisms among small firms. These findings lead us to stress the importance of empirical legal scholarship in this area of securities regulation. We call for more empirical work on the costs and benefits of regulatory exemptions for small firms prior to further exemptions being granted for these firms.

Our particular setting involves Canadian venture issuers trading on the TSX Venture Exchange. We employ an event study to examine the stock price response of these firms to announcements related to regulatory requirements pertaining to audit committee composition and subsequent exemptions from these requirements. These announcements provide a natural experiment on the response of investors to proportionate regulation. In addition, we examine the actions of the firms themselves to infer firm perspectives on the costs and benefits of the proposed audit committee requirements and the exemptions. Exemptions for small firms effectively change mandatory legal requirements applicable to all public companies into voluntary ones for the select few. In the particular example that we analyze, venture firms are free to adopt any audit committee composition they choose, as long as they adequately disclose member characteristics.

But if venture issuers perceive there to be value in the mandatory legal requirements, either for improving the quality of governance or implementing practices consistent with larger peers, they may choose to comply with the recommended audit committee guidelines, irrespective of any formal requirement to do so. Using hand-collected data regarding the characteristics of venture issuer boards, we examine whether these firms chose to comply with the requirements. In so doing, we can infer that a subset of these firms perceive there to be advantages in complying with stricter board committee standards. By contrast, if venture issuers chose not to adjust their audit committee composition, their inaction may support the use of proportionate regulation in this setting.

Examining the reaction of venture issuer stocks to regulatory announcements involves several challenges. First, the stocks of

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these firms are thinly traded so that observed closing prices are based on very little turnover. As a result, many stocks do not trade on a daily basis. Second, the ownership of these firms is quite concentrated as insiders, founders, or specialized investment funds hold large blocks of shares for relatively long time periods. This further exacerbates the low liquidity levels of the stocks. Finally, the prices of many of these shares are extremely low and thus movements of a few cents, say from $0.10 to $0.12, may result in extremely high percentage returns, thereby skewing the overall return distribution.

Despite these challenges, we conduct an event study around two announcement dates related to audit committee requirements for all firms and the subsequent venture issuer exemption. We experiment with several formats for our tests and use a variety of event windows to compensate for thin trading in these stocks. Our findings suggest limited statistically or economically significant stock price reactions to the proposed audit committee changes, leading us to further probe the governance mechanisms employed by these firms. Using data from the System for Electronic Document Analysis and Retrieval (SEDAR), we find that a large proportion of venture firm audit committees already complied with the proposed standards. This finding undermines arguments that the requirements were particularly onerous for these firms since, when left to their own devices, many of these firms voluntarily chose to comply. As a result, the announcement was viewed by investors as a non-event. This finding is consistent with previous research on voluntary compliance, as it demonstrates that firms will often adopt governance recommendations in the absence of any legal requirement to do so.

We begin in Part II by examining previous studies on proportionate regulation, highlighting available empirical work in this setting. We note that many scholars do not employ the term “proportionate regulation,” though they examine the regulation of small firms broadly speaking and thus fall into this article’s area of study. While many researchers have provided theoretical arguments both for and against treating small firms differently in the regulation, a testing ground for empirical cost-benefit

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8 For example, see Jarkko Harju, Tuomas Matika & Timo Rauhanen, *The Effects of Sized-Based Regulations on Small Firms: Evidence*
analyses arose in the U.S. context following the implementation of the Sarbanes-Oxley Act (SOX).\(^9\) The Securities and Exchange Commission (SEC) exempts small companies (i.e. firms with a market capitalization of less than US $75 million) from complying with SOX’s section 404(b), which requires firms to include an attestation report from their registered public accounting firm in the firm’s annual report.\(^{10}\) Outside of this particular example (and beyond the work related to the JOBS Act), little has been done to inform investors and policy makers about the implications of proportionate regulation on a broader basis.\(^{11}\) This gap in empirical evidence is disconcerting given the increasing use of proportionate regulation on an international scale. The underlying assumption, of course, is that proportionate regulation is a useful regulatory approach.

We then provide the contextual background required to understand our study by reviewing the different legal approaches to corporate governance in various jurisdictions. These legal approaches include statutory obligations, voluntary comply-or-explain regimes, and proportionate regulation. We highlight the implications of these approaches for both small and large firms. The CSA allows venture firms some leniency with respect to the rules regarding the disclosure of corporate governance practices. This is consistent with the approach to proportionate regulation policymakers have taken in the United Kingdom\(^{12}\) and Australia.\(^{13}\)

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\(^{12}\) Hogan Lovells, *Equity Capital Markets: Proportionate Disclosure Checklist*, online:
The issue of proportionate regulation became relevant in the Canadian context following the implementation of SOX in the United States. At that time, the Canadian government and provincial securities regulators contemplated whether to imitate the SOX approach or to craft a uniquely Canadian approach suitable to Canadian markets. When the CSA chose the latter alternative, they then analyzed whether all firms within Canada should be regulated in the same manner, especially given the preponderance of small to medium size issuers operating in the public markets.

As we discuss in Part III, in December 2002, the CSA proposed a rule under which all reporting issuers were required to have audit committees that were both financially literate and independent. In May 2003, venture issuers were exempted from this requirement and required instead to simply disclose the financial literacy and independence of each individual audit

committee member. In Parts IV and V, we present our data and the results on the share price reactions of 519 venture issuers to these announcements and using our original data, identify the existing audit committee composition of these firms. Our article concludes in Part VI with a discussion of the policy implications of our findings and calls for additional empirical research on legal approaches to governance requirements.

II. UNDERSTANDING PROPORTIONATE REGULATION

Proportionate regulation is based on the idea that less regulation should apply to certain corporations because of their smaller size relative to other corporations. The notion that securities regulation should take into account distinctive characteristics of corporations and other capital market participants is not novel. Daniels and MacIntosh argue that regulatory initiatives should distinguish between large, intensely-traded companies and smaller, thinly-traded companies. Cohn and Yadley claim that if policymakers enact non-proportional securities laws, which, in turn, impose similar compliance costs on all businesses, small businesses will generally refuse to “go public.” However, Sarra notes that while proportionate regulation is a valuable tool, it must balance firms’ access to capital with the goal of ensuring the long-term sustainability of capital markets.

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18 Ronald J. Daniels and Jeffrey G. MacIntosh, “Towards a Distinctive Canadian Corporate Law Regime” (1991) 29 Osgoode Hall L.J. 863. Daniels and MacIntosh also discuss the possibility of distinguishing between different types of shareholders (for example, retail vs. institutional shareholders) because of their size and sophistication.


20 Sarra, supra note 1.
To help inform our research, we review empirical studies that weigh the effects of exempting small firms from mandatory requirements through the use of proportionate regulation. This research is based on US data, collected in the wake of SOX, given the paucity of data from other jurisdictions including Canada. In particular, Iliev finds that announcements preceding the implementation of SOX had significant short-term negative effects on the value of small firms that were not exempt from SOX. While such events led to significant decreases in these firms’ stock returns, announcements of delays in the implementation of SOX led to significant positive returns. Iliev argues that, as a result, the costs of complying with SOX outweighed the benefits for small firms. This conclusion is common in the academic literature, which generally supports the view that exempting small firms from securities regulation leads to net benefits.

Some studies focus on the relationship between the implementation of SOX and decisions by small firms to deregister their stock, so as to avoid being subject to U.S. securities law. Generally, these analyses find a significant increase in small firm deregistration in the months after SOX was enacted. Further analysis demonstrates that the primary reason firms chose to deregister during the post-SOX period was due to the costs of participating in public capital markets. Block suggests that a small firm’s average cost of remaining public rose from $900,000 to $1.9 million following enactment of SOX. Moreover, auditing costs were also found to significantly increase. These findings imply that SOX imposed higher costs on small firms, causing them to exit the market for public capital, since the costs of adhering to SOX were perceived to outweigh the benefits. This suggestion is supported by the fact that U.S. firms often

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25 Iliev, supra note 21; Kamar, supra note 22.
intentionally limit their size, public float or market value to exempt themselves from SOX.\textsuperscript{26} Such practices can harm both a firm and its shareholders.

Additional evidence pointing to the negative effects of regulation on small firms is beginning to emerge on the heels of the JOBS Act of 2012, although this research is in its infancy. Dambra \textit{et al.} suggest that the Act was successful in reducing barriers to capital raising for small firms.\textsuperscript{27} They find evidence of significantly greater IPO activity for emerging growth companies in the two years following implementation of the Act. Decreasing the regulatory burden, however, may mean costs for firms and investors. Barth \textit{et al.} find that these IPOs had high levels of information uncertainty, as evidenced by larger IPO underpricing and greater return volatility.\textsuperscript{28}

We can surmise from the literature that there are definite tradeoffs that flow from requiring small firms to comply with mandatory regulation applicable to all firms rather than allowing them to be exempt because of their relative smaller size. Along these lines, Iliev discovers a statistically significant relationship between whether a small firm is exempt from SOX and its ability to report positive earnings.\textsuperscript{29} He explains these results by arguing that compliance with SOX requires a firm to take greater care in accurately reporting its earnings, so that it becomes less feasible for these firms to inflate their earnings.\textsuperscript{30} By improving the accuracy of earnings reports, the regulation of small firms through SOX could offer greater protection to investors and result in long-term benefits for firm performance overall.

\textsuperscript{26} Iliev, \textit{ibid}; Feng Gao, Joanna Shuang Wu & Jerold Zimmerman, “Unintended Consequences of Granting Small Firms Exemptions from Securities Regulation: Evidence from the Sarbanes-Oxley Act” (2009) 47 J. Account. Res. 459-506. As mentioned above, firms with a public float of less than US$75 million are exempt from some of the provisions of SOX: Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203 (124 Stat. 1376–2223) at § 989G [“Dodd-Frank Act”]. Section 404(b) of SOX, supra note 9, provides a requirement for auditor attestation of internal control over financial reporting. Section 989G of the Dodd-Frank Act effectively exempts issuers with a public float of less than US$75 million from this requirement.


\textsuperscript{29} Iliev, \textit{supra} note 21.

\textsuperscript{30} \textit{Ibid}. 

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Our review of the empirical literature suggests that empirical examinations of proportionate regulation initiatives are limited and relate primarily to SOX. Although there appear to be benefits to exempting small firms from specific securities regulations in order to assist them in raising capital and participating in public markets, such an approach may come at the cost of increased information uncertainty and poor disclosure quality. This is particularly relevant to our research because the proportionate regulation that we examine specifically refers to audit committee composition and, correspondingly, to oversight over companies’ financial reporting. We turn now to examine the Canadian context which unlike many of the previous studies is not based on the actions of U.S. firms following SOX.

III. CANADIAN AUDIT COMMITTEE RULES

In this section, we examine Canada’s approach to regulating audit committees. We then study the costs and benefits of proportionate regulation in this context.

While the approach in SOX is largely mandatory (in that companies, even foreign companies cross-listed on a U.S. exchange, are required to follow specified governance practices) other countries have implemented less stringent, more flexible, regimes. In particular, Canada, Australia and the United Kingdom have implemented comply-or-explain regimes in which public companies comply with recommended best practices or explain their rationales for doing otherwise. This disclosure is made in companies’ annual disclosure documents. For example, Canadian securities regulators recommend that firms separate the positions of CEO and Chair of the board, that they have a majority of independent directors on the board, and that they have a code of ethics in place.

These are recommendations or guidelines—they are not mandatory. Yet, the approach is not completely voluntary, as firms face mandatory disclosure obligations regarding their governance structures. From a practical perspective, this means

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that firms have differing governance structures depending on which recommended best practices they choose to follow. The caveat is that they must describe their governance choices in their annual required disclosures.

Proportionate regulation differs from mandatory governance by allowing wholesale exemptions from regulation for a subset of issuers (venture issuers). In Canada, venture firms are exempt from specific requirements imposed on non-venture firms in a number of areas, including certification of firms’ financial statements, evaluations of disclosure controls and procedures, and disclosure of corporate governance practices. They are also permitted longer periods within which to file interim and annual financial statements.

National Instrument 52-110, the subject of our inquiry, requires all members of non-venture issuer audit committees to be financially literate and independent. This policy was announced on December 5, 2002. At the time, the policy was intended to be relatively comprehensive. While venture issuers received some accommodation (in that the proposed guidance regarding financial literacy did not extend to all members of the audit committee), venture issuers still had to ensure at least a majority of committee members were financially literate and independent. Subsequently, on May 23, 2003, the CSA provided venture issuers with additional accommodations, exempting them from audit committee requirements altogether. Venture issuers simply had (and continue to have) to disclose whether their audit committee members are independent and financially literate; there is no requirement for them to ensure that their audit committees exhibit these characteristics.

The rationale for exempting venture issuers from the audit committee requirements is grounded in proportionate regulation: smaller firms have fewer resources and thus they bear a

34 For example, National Instruments 52-110, Audit Committees, discussed below, and 41-101, General Prospectus Requirements.
38 Audit Committees, OSC NI 52-110, 27 OSCB 3252 (March 26 2004).
39 National Instrument 52-110, supra note 34; Form 52-110F2, Disclosure by Venture Issuers, online: <https://www.bcsc.bc.ca/Securities_Law/Policies/Policy5/PDF/52-110F2__F___June_30__2015/>. 
disproportionate burden in recruiting top talent.\textsuperscript{40} Internal management costs to execute a search for individuals who meet these qualifications would be disproportionately borne by venture issuers. Yet, it is possible that voluntary compliance with the audit committee requirements benefits venture firms; when venture firms choose to populate their audit committees with independent financial experts, they may benefit from improved disclosure quality and stronger internal controls.\textsuperscript{41} This, in turn, may appeal to investors, making them more willing to provide capital to the firm.

It is unclear, however, whether these benefits are great enough to compensate for the higher search costs involved in finding qualified audit committee members.\textsuperscript{42} If costs of compliance are perceived as excessive, we would expect the following stock price responses to the announcements:

\textbf{H.1. Venture issuer stock prices respond negatively to the December 5, 2002 announcement mandating a majority independent audit committee.}
\textbf{H.2. Venture issuer stock prices responded positively to the May 23, 2003 announcement exempting venture issuers from audit committee requirements.}

The new disclosure requirements for venture issuers ensured that investors would be able to easily determine which firms had majority independent, financially literate audit committees. We use this enhanced disclosure to further explore the cost-benefit tradeoff of voluntary compliance with the audit committee proposals. We identify firms that chose to voluntarily appoint independent, financially literate audit committees versus those that did not. We provide additional cross-sectional analysis on investor reactions to the announcements conditional on the firms’ existing audit committee composition. If investors believe that the benefits of compliance outweigh the costs, the stock prices of non-compliant firms may have been negatively impacted on May 23\textsuperscript{43}, when it became clear that these firms would not be required to alter their audit committee composition as a result of

\textsuperscript{41} For an example in the emerging economy context, see Vighneswara Swamy, \textit{Corporate Governance in Family Owned Small Firms}, (2012), online: <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2126756>.
the exemption for venture issuers. We turn now to discussing the
data requirements needed to undertake this analysis.

IV. DATA DESCRIPTION

To understand how announcements surrounding firm
composition and audit committee governance affect venture
issuers, we consulted the Bloomberg Professional Service for an
inventory of firms listed on the TSX Venture Exchange as of the
two announcement dates. We obtained security price
information on daily returns and trading volume from
DataStream in order to establish investors’ response to the
regulatory announcements. In addition, we accessed Annual
Information Forms (AIFs), proxy circulars and annual reports
that were released by these firms between January 1, 2001 and
January 1, 2005 through the SEDAR website.43 In these
documents, we find information regarding the composition of a
firm’s board of directors, its audit committee, and the
distribution of its shares. Variability in data availability led us to
a sample size of 517 firms for the December, 2002 announcement
and 496 in May of 2003. As a result, our sample represents a
subset of firms on the TSX Venture Exchange.

In order to examine stock price response to the regulatory
announcements conditional on the firm’s audit committee
characteristics, we need to establish the committee’s level of
independence and financial literacy. Generally, AIFs provide the
most reliable information on the composition and independence
of a firm’s board of directors or audit committee, given that AIFs
are mandated documents.44 However some of the sample firms
did not release an AIF during the search period in question.
Thus, where necessary, we supplement information disclosed in a
firm’s most current AIF through investigation of its annual report
and/or proxy circular.45

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43 We are interested in investigating the composition of firms’ audit
committees, board of directors’, and the distribution of their shares
as of May 23, 2003. A search window of roughly two years before
and after this date will provide us optimal access to this information.
44 NI 51-102, supra note 37, Part 6.
45 Our research involved an examination of firms’ annual reports or
proxy circulars. We supplemented this examination with an analysis
of firms’ AIF where necessary. For instance, some firms will, in
addition to listing nominees for directors, disclose the current
number of directors, and the date that each director assumed their
respective position. In some instances, such disclosure on behalf of
firms provides us with sufficient information to conclude that a
specific group of proposed directors form the firm’s board of
directors as of May 23, 2003 as well. By reviewing the information
pertaining to these individuals, as it is disclosed in firms’ proxy
circulars, we can thereby measure independence and financial
expertise.
To measure the independence of a firm’s audit committee, we looked at whether a given firm disclosed whether its audit committee members were “related” or “unrelated”. Only “unrelated” audit committee members were classified (in the context of this study) as “independent”. For firms that did not disclose this information, members’ independence was measured by determining if members were “inside” or “outside” directors.\textsuperscript{46} Again, we only consider the latter to be “independent”. To be classified as an “outside” director, an audit committee member must not be part of the firm’s executive management team and must also not be the firm’s legal counsel or auditor.\textsuperscript{47} We measure the independence of a firm’s board of directors by employing the same method used to measure the independence of audit committee members.

To categorize audit committee members as financial experts, we first consult firms’ AIFs and proxy circulars, which generally provide extensive information on members’ occupational histories. We use the term “financial expertise” in accordance with its usage in SOX.\textsuperscript{48} According to this legislation a “financial expert” is a person who has: an understanding of generally accepted accounting principles and financial statements; the ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves; experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant’s financial statements, or experience actively supervising one or more persons engaged in

\begin{footnotes}
\item[46] To determine whether a firm included this information in its corporate disclosure, we ran a text-based search for the terms “unrelated”, “related”, “inside” and “outside”.
\item[48] We employ this definition because, as of May 23, 2003, there was no official definition of “financial expertise” in Canadian securities law, including in the aforementioned TSX Governance Guidelines. NI 52-110 had not yet been formally proposed and even if it had been, the definition of “financial expertise” in SOX is more robust than that found in NI 52-110. See, for instance, Joseph V. Carcello, Carl W. Hollingsworth, April Klein & Terry L. Neal, \textit{Audit Committee Financial Expertise, Competing Corporate Governance Mechanisms, and Earnings Management in a Post-SOX World}, (2014), online: \href{https://archive.nyu.edu/bitstream/2451/27455/2/SSRN-id887512.pdf}{<https://archive.nyu.edu/bitstream/2451/27455/2/SSRN-id887512.pdf>}.\end{footnotes}
such activities; an understanding of internal controls and procedures for financial reporting and, an understanding of audit committee functions.\(^{49}\)

We distinguish “accounting financial experts” from “non-accounting financial experts” despite the fact that both groups qualify as having “financial expertise.” However, we note that the former can be considered \textit{more} financially literate than the latter.\(^{50}\) Audit committee members who are neither accounting nor non-accounting financial experts are coded as “non-financially literate.”

We build on the work of Chen and Li who examine the audit committee composition of Canadian firms listed on both the Toronto Stock Exchange (TSX) and TSX Venture Exchange.\(^{51}\) Chen and Li study the longer-term consequences of more stringent governance requirements. They suggest that the requirements can increase firm value and investment efficiency for both large and small firms, but that only small firms with low compliance costs were likely to meet the audit committee requirements voluntarily. By contrast, we study short-term investor reaction to regulatory announcements and analyze the costs and benefits of comply-or-explain regimes for small firms. We draw conclusions about the importance of voluntary governance for these firms.

\section*{V. \textbf{EMPIRICAL RESULTS}}

\subsection*{1. Event Study Results at Announcement Dates}

We first examine investors’ responses to the first announced proposal on December 5, 2002, which mandated that all venture firms have independent and financially literate audit committees. We also consider the subsequent announcement on May 23, 2003, which provided venture firms an exemption from this requirement. Due to the low volume of trading in the venture market (and the resulting difficulties in identifying a “normal” return for these firms), we use a variety of event study techniques

\(^{49}\) These attributes can be acquired through: education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor, or position with similar functions; experience actively supervising individuals; experience overseeing or assessing the performance of companies or public accountants’ preparation, auditing or evaluation of financial statements; or, other relevant experience (SOX, §§ 406 and 407).


including constant mean return, market adjusted return, a single factor market model, and the non-parametric sign test. The estimation window used throughout all tests is 100 days prior to the event window, which we consider to be either 1 day (Day 0) or 3 days (Day – 1 to Day +1) where Day 0 corresponds to the announcement date.

To illustrate the trading characteristics of sample firms, Table 1 presents a summary of statistics indicating share prices, trading volume, and shares outstanding during the estimation period prior to the first announcement date. The table indicates that average share price for venture firms is only $2.63 and the average number of shares outstanding is 29.5 million. There is significant variation in these characteristics within our sample and our averages are skewed upwards by a few large outliers. The corresponding median values are much lower; the median share price is only $0.51 and the median number of shares outstanding is 21 million. The low price of most firms implies that a price movement of only a few cents can result in a very large percentage return.

Our first approach to defining abnormal returns is through the use of the constant mean return model where we establish the average daily return for the security during the previous 100-day estimation window. Abnormal returns on an announcement day are defined as the actual return minus the mean level of return during the estimation period.

Our second approach, the market-adjusted model, uses the return on the S&P/TSX venture index as a benchmark and defines a security’s abnormal return on an event day as its actual return minus the index return. This index is designed to be a broad market-weighted figure representing the performance of the venture exchange. In order to be included in the index, a security must represent at least 0.05% of the market capitalization of the exchange and be listed for a minimum of 12 months prior to its inclusion.52

A complication in using this index is that the index level itself may be influenced by the announcement of governance requirements for its composite firms. We note that the index return is driven primarily by its largest members due to its construction using market weighting. However, we aggregate on an equal basis when establishing the overall response of our firms to regulatory announcements. Since there is significant

52 An exception is made to include securities after only 6 months of listing history, if these securities are ranked in the top 100 of the current S&P/TSX Venture Composite Securities on a market value basis: McGraw Hill Financial, S&P/TSX Venture Composite Methodology, online: <http://ca.spindices.com/indices/equity/sp-tsx-venture-composite-index>.
variability in venture firm size (as of April 2016) ranging from a market cap value of $1 million to $500 million, our aggregate sample returns will not completely mirror those of the index. Moreover, we address this issue in more detail in the cross sectional analysis that follows. We rely on a variety of event study methods, some of which do not require benchmarking against the index.

Our third approach defines normal return as predicted by a single factor market model for stock $i$ at time $t$ with alpha and beta coefficients from equation (1) below. Within this equation $r_{mt}$ represents the return on the market index at time $t$ and $\epsilon_{it}$ represents noise arising from the lack of fit with the model. This approach may also be biased by its reliance on the index. Further issues may arise due to the incongruence between venture firms and their high levels of illiquidity and frequent days of non-trade.

\[ r_{it} = \alpha_i + \beta_i r_{mt} + \epsilon_{it} \quad (1) \]

Despite these drawbacks, this model allows us to deal with an additional possibility in our analysis—that the event is “clustered” in calendar time so that the announcement date is the same for each of our sample firms. To address this issue using the market model, we follow the typical practice of aggregating the individual stocks into a portfolio and evaluating the return at the portfolio level as suggested by Campbell et al.\(^53\) The single factor model is augmented to include an event dummy variable that is equal to one on the event day and zero throughout the estimation window. The estimated coefficient for this variable captures the abnormal return in response to the announcement.

For the sake of completeness, we measure, report, and test for statistically significant abnormal returns using all three approaches described above, in addition to the non-parametric sign test. Like the constant mean model, this approach does not rely on benchmarking individual security returns against the index. Instead, the test is based on the proportion of observed positive returns in the sample (denoted as $N^+/N$) compared to an expected value of 50%. The specific test statistic we use is provided in equation 2 and follows Campbell et al.\(^54\) $N$ denotes the total sample of possible firms. The statistic has a standard normal distribution.

\[ Test\ Stat = \left[ \frac{N^+}{N} - 0.5 \right] \frac{\sqrt{N}}{0.5} \quad (2) \]


\(^{54}\) Campbell, supra note 53.
Tables 2 and 3 provide results analyzing the venture firms’ stock price in response to the announcements related to audit committee requirements. In both cases, Panel A provides the stock price reaction to the December 2002 announcement while Panel B provides results for the May 2003 announcement. Table 2 presents results of the parametric tests defining abnormal return on the basis of the constant mean, market adjusted and market models. Table 3 provides results for the non-parametric sign test.

Our data for both announcement days is extremely sensitive to the method used to define “abnormal returns”. The constant mean approach provides a positive average abnormal return of 0.22% on the first date (December 2002), when it was announced that venture firms would be required to have financially literate and independent audit committees (with respect to the majority of members serving on these committees). The three day returns using the constant mean and market adjusted models also support positive returns in response to the announcement, however none are statistically significant. In contrast, the single factor market model and one-day return measured using the market adjusted approach suggest negative returns on announcement day, although, again, these are not statistically significant. These differences lead us to examine the index return on the day of the first announcement. We find it to be positive at 0.73%. When compared to the average daily return for the index for the previous 100 days, which was -0.14%, this level of return is significantly greater than average. Applying the constant mean model to the index itself, and testing for abnormal returns on that day, generates a test statistic in excess of 10, suggesting that the venture index experienced atypically large returns on December 5, 2002.

A high level of index return has several possible implications. The first is that the announcement was viewed positively by investors and that, as a result, many of the stocks in the index experienced positive returns. This of course results in a high level of return for the index, making it challenging for any individual security to generate abnormal returns when these returns are benchmarked against the index’s performance on that day. This would explain why we see positive one and three day abnormal returns under the constant mean approach, where securities are benchmarked against their own past performance, but not under the market adjusted and market model methods.

To explore further the number of securities within the sample that experienced positive returns at the time of the 2002 announcement, we turn to our non-parametric sign test. We provide two versions of this test in Table 3. The first includes all observed returns for the sample firms during the event windows. As is typical of venture issuers, this includes a high number of
zero returns, primarily driven by the absence of trading for the securities. For instance, on the announcement date in 2002, over half of the 519 securities examined had zero returns. Even if all remaining stocks that traded experienced positive returns, the test statistic would not be positive since the proportion of positive returns would not exceed half. As a result, we generate the sign test excluding all zero returns in the next column of the table. Now, for both one day and three-day event windows we see that more securities experienced positive returns than negative ones. Similar to what we witness for three day returns using the constant mean approach, the sign test using a three-day window from Day – 1 to Day +1 is positive and statistically significant.

The challenges of using venture issuer data weaken our ability to make statistical inferences. Nonetheless, the large positive index return and statistically significant three day tests under the constant mean and sign tests suggest that, overall, news of the audit committee requirements was positively received by investors. In contrast to hypothesis one, which suggests that investors view the cost of compliance by venture firms to be excessive, benefits accruing from these more stringent governance requirements may have been perceived to outweigh their costs or were, at a minimum, viewed neutrally.

We perform a similar analysis for our second announcement date of May 23, 2003 in Panel B of Tables 2 and 3. Again we see a high level of sensitivity to the method of measuring abnormal returns, however none of the one or three day returns centered on the announcement day are statistically significant. We further probe the securities’ returns by examining the proportion with positive returns, both including and excluding zero returns. Even when zero returns are excluded, the proportion of positive returns is relatively balanced at 53% for one day returns and 51% for three day returns. We cannot conclude that the announcement was informationally meaningful to investors. As a result, we turn to examine the companies’ choices themselves to see what we can infer from their chosen audit committee structure.

2. Cross Sectional Analysis Based on Audit Committee Composition

In this subsection, we further analyze firm board and audit committee composition at the time of the May 2003 announcement to exempt venture firms from the audit committee composition requirements. It is possible that investors did not react to news of the exemption if venture issuers already had audit committees that were closely aligned with the new requirements. Venture firms may have ensured their committees met the proposed recommendations either in anticipation of the impending rule or because they viewed them
to be beneficial and therefore undertook such measures voluntarily.

The cross sectional analysis reduces some of the issues associated with benchmarking returns against the index when the index itself may be influenced by the announcement. Presumably investors’ responses to the announcement would vary by security depending on their existing audit committee structure. If costs of compliance were perceived to be excessive, the exemption would be viewed more positively for those who had not yet complied with its requirements.

We summarize the structure of our sample firms’ board of directors and audit committees in Table 4. Since there is tremendous variability in firms’ life stage, from those in the process of early capital raising to others that are fully operational, we see significant variation in board structure. Boards range in size from 3 to 12 directors with the average size being just over 5. The average number of independent directors on a board is 3.5 and we find that the vast majority of these firms (78%) have a majority of independent directors on their board.

Turning to the audit committee, we find that almost all firms disclose that they have an audit committee (98%) and that on average it consists of 3 members. Using the guidelines discussed in our previous section on data description, we identify whether each committee member is independent and financially literate. We find that, on average, 2.2 members of the audit committee are independent. Furthermore, 88% of audit committees that we examine maintain a majority of independent members. While venture issuers were not required to ensure majority independent audit committees, it appears that many have voluntarily appointed outside committee members who qualify as independent. Venture issuers appear to be behaving in a way that would suggest that maintaining independent audit committees is beneficial.

We next examine the level of financial literacy among the venture issuers’ audit committees. Again, we see a high level of voluntary compliance. On average, 2.3 members per audit committee are financially literate; the highest number of these come from an accounting background. Firms that have chosen to appoint an audit committee where the majority of members are financially literate represent 85% of our sample. While proportionate regulation was motivated by excessive costs and regulatory burden for these firms, we see almost all firms voluntarily coming in close to compliance with the proposed requirements.

As a final examination of investors’ response to the 2003 announcement exempting venture issuers from audit committee
requirements, we conduct a cross sectional analysis on the firms’ stock response to the news, differentiating between those who had and had not met the proposed guidelines. Using one day abnormal returns defined by the market adjusted model, we use dummy variables to identify whether or not each firm had a majority independent audit committee, a majority financially literate audit committee, and a majority of independent directors on its board.

Regression results using these dummy variables are presented in Table 5. We see from the table that stock price reaction to the announcement did not significantly differ for firms with a majority independent board or audit committee, or those with high levels of financial literacy on their audit committee. The announcement was largely a non-event for these firms. Exempting venture firms from audit committee requirements does not appear to have elicited significant investor response, perhaps since, as we have shown, these firms were already largely compliant with the proposed requirements. This suggests that the debate surrounding the “excessive cost” of these requirements for venture issuers was (at least somewhat) irrelevant and could have been avoided through a simple analysis of existing board and audit committee structure.

We cannot, however, rule out an alternative possibility—that audit committee composition is simply not a relevant governance mechanism for these firms and is therefore viewed to be unimportant by investors. One possible reason for this perception is that audit committees are generally designed to protect the interests of minority shareholders in widely held firms. The shares of venture issuers, however, are typically held by a small number of institutional investors or insiders whose large proportionate ownership may provide them with additional access to management or monitoring capabilities. On average, our sample firms have 37.5% of their stock held by insiders with 29% of firms having over 50% of their shares held by insiders.

VI. CONCLUSIONS AND IMPLICATIONS

This article has provided an overview of the various legal approaches used to oversee firms’ corporate governance practices. The focus has been on increasing the use of proportionate regulation as a means for finding middle ground between the dual objectives of investor protection and calibrated regulatory oversight of small firms. Despite the ongoing debate about the merits of proportionate regulation, little empirical analysis has been done to help inform the debate. We point to

this gap in the literature and, using an example of proportionate regulation from Canada, illustrate how the debate may be misguided.

Using the case of Canadian venture issuers’ audit committee composition, we find weak evidence that investors responded positively to the initial announcement requiring majority independent and financially literate audit committees for these firms. Our analysis is limited by the difficulties in working with a clustered event for infrequently traded stock. Despite these limitations, however, there is no evidence that investors responded negatively to the news of the proposed requirements – we cannot infer that investors perceived the rules to impose an excessive regulatory burden on firms. In fact, three day abnormal returns are positive and statistically significant when measured without benchmarking to the S&P/TSX Venture Index, which itself experienced large returns on that day. A second announcement exempting venture issuers from these requirements was largely met with investor indifference.

After closely examining the board and audit committee composition of our sample firms, it is clear that most boards exhibit a high level of audit committee independence and financial literacy. This suggests that venture issuers voluntarily chose to comply with the proposed guidelines either in anticipation of the guidelines’ impending enactment, or because they viewed adoption and compliance as truly beneficial. These actions seem inconsistent with small firms’ frequent complaints of regulatory burden. While the controversy and discussion surrounding the rules occurred during the time at which the Sarbanes-Oxley Act was adopted, the discussion remains relevant. For instance, more recently (in light of proposed changes to small firm disclosure), McFarland notes that “companies complained they were too overwhelmed by economic hard times to adapt to new rules.”

Our findings lead us to call for additional empirical work that examines legal approaches to governance oversight, and the implications of these approaches for large and small firms. We suggest that policy makers may be ill-informed with respect to the potential benefits of these approaches due to the lack of empirical evidence. While data collection and analysis of this information is difficult, especially with respect to small firms, our study illustrates that basic data collection and summary statistics can provide regulators and policymakers with additional (and necessary) insights to reduce unproductive debate.

57 A Wall Street Journal article “Regulatory ‘Burden’ Tough to Quantify” criticizes the lack of information in this realm and echoes these sentiments. See Bialik, supra note 2.
Table 1: Trading Summary Statics
The table provides summary statistics for the trading and stock characteristics of the sample firms in the 100-day estimation period and 3-day event window (i.e. 103 days) related to the first announcement date on December 5, 2002. The sample includes 517 firms listed on the TSX Venture Exchange.

<table>
<thead>
<tr>
<th></th>
<th>Price ($Cdn)</th>
<th>Returns (% daily)</th>
<th># Shares (1,000s)</th>
<th>Volume (1,000s per day)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean</td>
<td>$2.63</td>
<td>0.28%</td>
<td>29,496</td>
<td>20.02</td>
</tr>
<tr>
<td>Standard Deviation</td>
<td>$14.01</td>
<td>9.54%</td>
<td>36,737</td>
<td>64.45</td>
</tr>
<tr>
<td>Min.</td>
<td>$0.01</td>
<td>-76.15%</td>
<td>67</td>
<td>0</td>
</tr>
<tr>
<td>Median</td>
<td>$0.51</td>
<td>0.00%</td>
<td>21,057</td>
<td>5.5</td>
</tr>
<tr>
<td>Max</td>
<td>$400.00</td>
<td>400.00%</td>
<td>608,953</td>
<td>6,416</td>
</tr>
<tr>
<td>N (517 firms x 103 days)</td>
<td>53,271</td>
<td>53,271</td>
<td>53,271</td>
<td>53,271</td>
</tr>
</tbody>
</table>
Table 2: Parametric Tests of Announcement Day Abnormal Returns

The table presents one day abnormal returns (AR) for the announcement day (Day 0) and three day cumulative abnormal returns (CAR) from Day -1 to Day +1 for two event dates. Panel A provides results for December 5, 2002, when venture issuers were proposed to have majority independent and financially literate audit committees. Panel B provides results for May 23, 2003, when venture issuers were made exempt from these requirements. Three alternative methods are used to define alternative returns for the sample of 517 firms. Column 1 uses the constant mean approach, Column 2, the market adjusted method and Column 3 estimates a single factor market model for the sample firms combined into a single portfolio. The market model is estimated over a 103-day period which includes 100 days prior to the 3-day event window from Day -1 to Day +1. A dummy variable is included in the market model which is equal to one on event days and zero otherwise.

Panel A: Abnormal Stock Returns Centered on December 5, 2002

<table>
<thead>
<tr>
<th></th>
<th>Constant Mean (1)</th>
<th>Market Adjusted (2)</th>
<th>Market Model (3)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1 Day</td>
<td>3 Day</td>
<td>1 Day</td>
</tr>
<tr>
<td>Average AR/CAR</td>
<td>0.221%</td>
<td>1.448%</td>
<td>-0.247%</td>
</tr>
<tr>
<td>Std. Error</td>
<td>0.398</td>
<td>0.554</td>
<td>0.397</td>
</tr>
<tr>
<td>t-stat</td>
<td>0.555</td>
<td>2.613***</td>
<td>-0.621</td>
</tr>
<tr>
<td>P-Value (2 tail test)</td>
<td>0.579</td>
<td>0.009</td>
<td>0.535</td>
</tr>
<tr>
<td>N</td>
<td>517</td>
<td>517</td>
<td>517</td>
</tr>
</tbody>
</table>

Panel B: Abnormal Stock Returns Centered on May 23, 2003

<table>
<thead>
<tr>
<th></th>
<th>Constant Mean (1)</th>
<th>Market Adjusted (2)</th>
<th>Market Model (3)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1 Day</td>
<td>3 Day</td>
<td>1 Day</td>
</tr>
<tr>
<td>Average AR/CAR</td>
<td>0.072%</td>
<td>-0.389%</td>
<td>-0.423%</td>
</tr>
<tr>
<td>Std. Error</td>
<td>0.307</td>
<td>0.469</td>
<td>0.305</td>
</tr>
<tr>
<td>t-stat</td>
<td>0.233</td>
<td>-0.828</td>
<td>-1.385</td>
</tr>
<tr>
<td>P-Value (2 tail test)</td>
<td>0.816</td>
<td>0.408</td>
<td>0.167</td>
</tr>
<tr>
<td>N</td>
<td>496</td>
<td>496</td>
<td>496</td>
</tr>
</tbody>
</table>

*** Indicates significance at the one percent level or better.
Table 3: Analysis of Abnormal Stock Returns – Non-Parametric Sign Test

Returns are examined for one and three day periods surrounding the two announcement dates of December 5, 2002 and May 23, 2003. The number of positive, zero and negative returns experienced by the sample firms are provided. Panel A of the table examines returns centered on December 5, 2002, while Panel B examines returns on May 23, 2003. The test statistic is the non-parametric sign test which has a standard normal distribution. We provide corresponding values of the cumulative distribution function for each calculated test statistic.

Panel A: Abnormal Stock Returns Centered on December 5, 2002

<table>
<thead>
<tr>
<th></th>
<th>Full Sample</th>
<th>Drop Zero Returns</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1 Day</td>
<td>3 Day</td>
</tr>
<tr>
<td># Positive Returns</td>
<td>118</td>
<td>380</td>
</tr>
<tr>
<td># Zero Returns</td>
<td>288</td>
<td>838</td>
</tr>
<tr>
<td># Negative Returns</td>
<td>111</td>
<td>333</td>
</tr>
<tr>
<td>Test Statistic</td>
<td>-12.358***</td>
<td>-20.085***</td>
</tr>
<tr>
<td>Cum. Dist. Function</td>
<td>0.000</td>
<td>0.000</td>
</tr>
<tr>
<td>N</td>
<td>517</td>
<td>1551</td>
</tr>
</tbody>
</table>

Panel B: Abnormal Stock Returns Centered on May 23, 2003

<table>
<thead>
<tr>
<th></th>
<th>Full Sample</th>
<th>Drop Zero Returns</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1 Day</td>
<td>3 Day</td>
</tr>
<tr>
<td># Positive Returns</td>
<td>132</td>
<td>353</td>
</tr>
<tr>
<td># Zero Returns</td>
<td>247</td>
<td>792</td>
</tr>
<tr>
<td># Negative Returns</td>
<td>117</td>
<td>343</td>
</tr>
<tr>
<td>Test Statistic</td>
<td>-10.42***</td>
<td>-20.27***</td>
</tr>
<tr>
<td>Cum. Dist. Function</td>
<td>0.000</td>
<td>0.000</td>
</tr>
<tr>
<td>N</td>
<td>496</td>
<td>1488</td>
</tr>
</tbody>
</table>

** and *** indicate significance at the five and one percent levels respectively.
Table 4: Summary Statistics for Board and Audit Committee Characteristics

Using hand collected data for the firms in our sample, we establish characteristics of the board of directors and audit committees at the time of the May 23, 2003 announcement. Most variables provide counts reflecting the number of directors with the characteristics described. Exceptions are the variables: audit committee present, majority of audit committee independent, majority of board members independent, and majority of audit committee members that are financially literate. These are dummy variables that take on a value of 1 if the characteristic is true. As a result, mean values for these variables can be interpreted to represent the proportion of the sample that complies with the characteristic. For example, 98% of our sample firms disclose the presence of an audit committee.

<table>
<thead>
<tr>
<th></th>
<th>Mean</th>
<th>Std. Dev.</th>
<th>Min.</th>
<th>Median</th>
<th>Max</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Directors</td>
<td>5.32</td>
<td>1.53</td>
<td>3</td>
<td>5</td>
<td>12</td>
</tr>
<tr>
<td>Number of Independent Directors</td>
<td>3.52</td>
<td>1.53</td>
<td>0</td>
<td>3</td>
<td>9</td>
</tr>
<tr>
<td>Audit Committee Present (dummy)</td>
<td>0.98</td>
<td>0.14</td>
<td>0</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Audit Committee Size</td>
<td>2.97</td>
<td>0.51</td>
<td>1</td>
<td>3</td>
<td>8</td>
</tr>
<tr>
<td>Independent Audit Committee Members</td>
<td>2.20</td>
<td>0.72</td>
<td>0</td>
<td>2</td>
<td>5</td>
</tr>
<tr>
<td>Financially Literate Audit Committee Members</td>
<td>2.29</td>
<td>0.79</td>
<td>0</td>
<td>2</td>
<td>5</td>
</tr>
<tr>
<td>Accounting Experts</td>
<td>0.69</td>
<td>0.74</td>
<td>0</td>
<td>1</td>
<td>3</td>
</tr>
<tr>
<td>Non-Accounting Experts</td>
<td>1.61</td>
<td>0.90</td>
<td>0</td>
<td>2</td>
<td>4</td>
</tr>
<tr>
<td>Non-Financially Literate</td>
<td>0.67</td>
<td>0.78</td>
<td>0</td>
<td>1</td>
<td>6</td>
</tr>
<tr>
<td>Majority of Audit Committee Members Independent (dummy)</td>
<td>0.88</td>
<td>0.32</td>
<td>0</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Majority of Board Members Independent (dummy)</td>
<td>0.78</td>
<td>0.41</td>
<td>0</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Majority of Audit Committee Financially Literate (dummy)</td>
<td>0.85</td>
<td>0.35</td>
<td>0</td>
<td>1</td>
<td>1</td>
</tr>
</tbody>
</table>
Table 5: Cross Sectional Analysis of Security Returns May 23, 2003
We examine whether board and audit committee characteristics influence the stock price reaction to the May 23, 2003 announcement. We conduct ordinary least squares regressions, in which the dependent variable is the one-day abnormal return measured using the market adjusted model. The models include a constant and a variety of dummy variables indicating whether the firm had a majority of independent audit committee members, a majority of financially literate audit committee members, or a majority of independent board members. Coefficients for the dummy variables are provided in the table with p-values in parenthesis.

<table>
<thead>
<tr>
<th></th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
<th>(4)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Majority Independent Audit Committee</td>
<td>0.628</td>
<td>0.740</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.520)</td>
<td>(0.491)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Majority Financially Literate Audit Committee</td>
<td>-0.067</td>
<td>-0.160</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.938)</td>
<td>(0.857)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Majority Independent Board</td>
<td>0.0519</td>
<td>-0.173</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.945)</td>
<td>(0.834)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Constant</td>
<td>-0.987</td>
<td>-0.374</td>
<td>-0.472</td>
<td>-0.814</td>
</tr>
<tr>
<td></td>
<td>(0.283)</td>
<td>(0.642)</td>
<td>(0.481)</td>
<td>(0.483)</td>
</tr>
<tr>
<td>N</td>
<td>485</td>
<td>485</td>
<td>485</td>
<td>485</td>
</tr>
</tbody>
</table>