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The Future of Capital Formation for Small and Medium-sized Enterprises: Rethinking Initial Public Offering Regulation after the Restructuring of Canadian Stock Exchanges*

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Résumé

Les petites et moyennes entreprises (PME) jouent un rôle central dans l'activité économique canadienne. Bien que la croissance des PME ne dépende pas exclusivement du financement, l'accessibilité des capitaux constitue une condition essentielle pour le développement de ces entreprises. À cet égard, il est bien connu que le financement public occupe une place de choix parmi les différentes sources de capitaux propres.

Dans cette perspective, la création d'une bourse pour entreprises junior au Canada constitue une bonne

Summary

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.

From this perspective, the recent restructuring of Canadian stock exchanges which has lead to the creation of a junior stock exchange is commendable. Appropriately

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nouvelle. Dotée d'un régime de fonctionnement adéquat, cette bourse peut améliorer l'accessibilité du financement public pour les PME en fournissant un marché secondaire liquide pour leurs titres.

Toutefois, pour que la création de cette bourse améliore véritablement les conditions de financement des PME, il paraît nécessaire de réviser les règles qui régissent actuellement l'appel public à l'épargne. Comme l'indique la présente étude, la réglementation exerce une influence certaine sur l'accessibilité du financement public pour les PME. D'une part, elle édicte des exigences qui sont particulièrement onéreuses pour les petits émetteurs. D'autre part, elle n'arrive pas à corriger les défaillances du marché qui tendent à augmenter le coût de cette source de financement pour ces entreprises. Dans ce contexte, l'étude présente des réformes réglementaires qui paraissent souhaitables afin d'adopter un régime d'appel public à l'épargne qui réponde de manière efficace aux besoins et aux caractéristiques des petits émetteurs.

designed, a junior stock market can enhance the accessibility of public equity financing for SMEs by giving them access to a liquid secondary market.

However, if it is to significantly improve the financing conditions of SMEs, the creation of a junior exchange must be accompanied by a revision of the current regulatory framework governing initial public offerings. As this paper shows, current securities regulation impacts on SMEs' ability to raise public equity capital. On the one hand, regulation enacts requirements which tend to burden excessively small issuers. On the other hand, it fails to correct market imperfections which raise the cost of capital for SMEs. In this context, this paper argues for reforms that will contribute to the implementation of a cost-effective regulatory regime adapted to the needs and characteristics of smaller issuers.

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Small and medium-sized enterprises (SMEs) play a pivotal role in the Canadian economy[1]. They constitute the vast majority of firms in the country, are vital to employment, and contribute to a significant portion of economic activity[2]. 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 [3]. The capacity of SMEs to innovate, their flexibility in adjusting to changes in technology and their ability to adapt to current needs give them a competitive advantage over larger rivals in this new economic setting, and is likely to be instrumental in improving Canada's competitiveness[4].

The significant role, which small and medium-sized firms can play in the economy, depends to a great extent on their ability to grow. While the growth and success of these enterprises do not

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1 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. SMALL BUSINESS WORKING COMMITTEE, *Breaking Through Barriers - Forging Our Future*, Ottawa, Supply and Services, 1994, p. 5; STANDING COMMITTEE ON INDUSTRY, *Taking Care of Small Business*, Ottawa, Supply and Services, 1994, p. 71 and 72.

2 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. SMEs have increased their share of employment in the last decade and now account for almost two-thirds of private-sector employment. ENTREPRENEURSHIP AND SMALL BUSINESS OFFICE, *Small Business in Canada: A Statistical Overview*, Ottawa, Supply and Services, 1994, p. 2; INDUSTRY CANADA, *Small Business: A Progress Report*, Ottawa, Supply and Services, 1994, p. 1.

3 Nuala BECK, *Shifting Gears: Thriving in the New Economy*, Toronto, Harper Collins, 1992.

4 ORGANISATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, *Small and Medium-sized Enterprises: Technology and Competitiveness*, Paris, OECD, 1992. See generally: George SLAN, "The Future of Small Business in the New Economy", *Canadian Manager*, September 1994, 22; "The Fall of Big Business", *The Economist*, April 17, 1993, 13; "The Rise and Rise of America's Small Firms", *The Economist*, January 21, 1989, 67; Andrew MORGAN, "Small Business: Canada's Strategic Sector for the 1990s", (Spring 1994) *Canadian Business Review* 13.

depend solely on financial support, access to appropriate financing is critical for their expansion[5]. 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.

At a general level, equity capital appears to be more adapted to SMEs, especially those that operate in knowledge-based industries[6]. SMEs tend to have limited or erratic cash flows which make the fixed payment schedule of debt financing inappropriate or unmanageable[7]. 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[8]. 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[9].

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5 John BALDWIN, *Strategies for Success – A Profile of Growing Small and Medium-Sized Enterprises in Canada*, Ottawa, Supply and Services, Statistics Canada, no. 61-523R E, 1994, p. 11-15; Graham HALL, "Lack of Finance as a Constraint on the Expansion of Innovatory Small Firms", in John BARBER, J. Stanley METCALFE and Mike PORTEOUS (ed.), *Barriers to Growth in Small Firms*, London, Routledge, 1989, p. 39; Tony BOVAIRD, Les HENS and Mike TRICKER, "Market Failures in the Provisions of Finance and Business Services for Small and Medium-Sized Enterprises", in Roger BUCKLAND and Edward W. DAVIS (ed.), *Finance for Growing Enterprises*, London, Routledge, 1995, p. 13, 17-31; B. MOORE, "Financial Constraints to the Growth and Development of Small High-Technology Firms", in Andrew HUGHES and David J. STOREY (ed.), *Finance and the Small Firm*, London, Routledge, 1994, p. 112.

6 Barbara EICHENLAUB, *Publicly Traded Canadian Software Product Firms*, Ottawa, Industry Canada, 1996; Jeffrey G. MACINTOSH, *Legal and Institutional Barriers to Financing Innovative Enterprise in Canada*, Discussion Paper 94-10, School of Policy Studies, Kingston, Queen's University, 1994, p. 44-89 (hereinafter "*Financing Innovative Enterprise*").

7 *Financing Innovative Enterprise*, *op. cit.*, note 6, p. 87; J.A. WELSH and J.A. WHITE, "A Small Business Is Not a Little Big Business", 59 *Harv. Bus. Rev.* 18 (1981).

8 *Financing Innovative Enterprise*, *op. cit.*, note 6, p. 57 and 58; Vijay M. JOG, "The Climate for Canadian Initial Public Offerings", in Paul J.N. HALPERN, *Financing Growth in Canada*, Calgary, University of Calgary Press, Industry Canada Research Series, 1997, p. 357, at page 358; Larry WYNANT and James HATCH, *Banks and Small Business Borrowers*, London, Western Business School, 1991, p. 349-351.

9 The level of gearing refers to the ratio of borrowings to equity or risk capital: Graham BANNOCK and Alan DORAN, *Going Public – The Markets in Unlisted Securities*, London, Harper & Row, 1987, p. 3 and 4.

More specifically, two additional factors justify the importance of the public equity market. The first emphasises the motivational aspect of going public for entrepreneurs. According to professor Vijay Jog, going public provides entrepreneurs "with an additional impetus to start a business" in that it gives them "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"[10]. The second factor refers to the influence of the initial public offering (IPO) market as an exit mechanism on the investment strategies on venture capitalists. Exit plays a critical function in the operation of an efficient venture capital market by giving venture capital firms the opportunity to realise their investments[11]. Although there exists a variety of methods venture capitalists can use to exit their investments, IPOs are on average the most profitable exit option[12]. Thus, a vibrant IPO market provides venture capitalists the incentives to engage in small firm financing[13]. Furthermore, the high returns generated by successful investee firms that go public that enable venture capital firms to undertake new investments.

From this perspective, the restructuring of the Canadian stock exchanges, which has lead to the creation of a junior stock exchange, is commendable[14]. Following the restructuring, the Toronto Stock Exchange has taken over all trading of senior securities. The Montreal Exchange handles exclusively all exchange-traded derivative products, while continuing to service junior Quebec-based SMEs[15]. The Alberta Stock Exchange and the

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10 V.M. JOG, *loc. cit.*, note 8, 358.

11 B.S. BLACK and R.J. GILSON, "Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets", 47 *J. Fin. Econ.* 243 (1998).

12 Jeffrey G. MACINTOSH, "Venture Capital Exits in Canada and the United States", in P.J.N. HALPERN, *op. cit.*, note 8, p. 279.

13 J. LERNER, "Venture Capitalists and the Decision to Go Public", 35 *J. Fin. Econ.* 293 (1994).

14 See: "Memorandum of Agreement between the Alberta Stock Exchange, the Montreal Exchange, the Toronto Stock Exchange and the Vancouver Stock Exchange, March 15, 1999", [http://www.cvmq.com/fr/publi/dossier_doc/entente.doc].

15 The Quebec government was more cautious in its response to the project. See: Konrad YAKABUSKI, "Quebec reacts warily to ME's plan to abandon stock trading", *The Globe and Mail*, March 16, 1999, B1. The Finance Minister commissioned an advisory committee to examine the proposed changes which issued a favorable recommendation in support of the restructuration. See: *Report of the Advisory Committee – Proposed Specialization of Canadian Exchanges*,

Vancouver Stock Exchange made arrangements for the rationalization of their activities, the result of which has been the creation of the Canadian Venture Exchange[16].

Appropriately designed, the proposed junior stock market can enhance the accessibility of public equity financing for SMEs by giving them access to a liquid secondary market[17]. However, if it is to significantly improve the financing conditions of SMEs, the creation of a junior exchange must be accompanied by a revision of the current regulatory framework governing IPOs. As this paper shows, current securities regulation impacts on SMEs' ability to raise public equity capital. On the one hand, regulation enacts requirements which tend to burden excessively small issuers. On the other hand, it fails to correct market imperfections which raise the cost of capital for SMEs. In this context, this paper argues for reforms that will contribute to the implementation of a cost-effective regulatory regime adapted to the needs and characteristics of smaller issuers.

The paper is divided in three parts. The first part presents the regulatory- and market-induced costs that SMEs must incur when raising equity capital on the primary market. The next part examines the private information networks of the IPO market to identify the nature and source of the imperfections which impede market efficiency. Finally, the third part, taking as a starting point the work of the Ontario Securities Commission Task Force on Small

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Québec, 1999. The restructuration was approved by Quebec Securities Commission after hearings on the project. See: "In The Matter of the Restructuring of Canadian Stock Exchanges", (1999) *C.V.M.Q. Bull.* While the Minister of Finance has required that the Montreal Exchange continues listing junior issuers, it remains uncertain whether the Exchange will keeps this function. See: "Restructuring of exchanges – the Deputy Prime Minister agrees with the essentials but wants a review of the junior listings component", *Canadian News Wire*, October 7, 1999; CANADIAN PRESS, « La Bourse de Montréal s'apprêterait à transférer ses titres à la CDNX », *La Presse*, Montréal, 13 février 2001.

16 The Canadian Venture Exchange also encompasses issuers of the Canadian Dealing Network, party to the restructuration agreement, and of the Winnipeg Stock Exchange. See: Janet MCFARLAND, "Winnipeg plans to join junior exchange", *The Globe and Mail*, March 16, 1999, B7.

17 The creation of a junior stock exchange remains a challenge as show the failures of many European junior stock exchanges in the 1980s and 1990s. See: Mario ANOLLI, Roger BUCKLAND and Michel DUBOIS, "Second-tier Markets in Europe", in R. BUCKLAND and E.W. DAVIS (ed.), *op. cit.*, note 5, p. 223; Graham BANNOCK, *European Second-tier Markets for NTBFs*, London, Commission of the European Communities, 1994.

Business Financing, discusses specific measures to improve the accessibility of public equity markets for SMEs.

I. The Costs of Raising Equity Capital on the Initial Public Offering Market

Small and medium-sized enterprises must incur significant costs when raising public equity capital. Firstly, they must assume the cost of complying with securities regulation requirements governing initial public offerings. Secondly, aside from this regulatory-induced cost, SMEs must incur the direct cost of compensating the underwriter conducting the offering. Finally, SMEs must bear the indirect cost of the underpricing of their IPO securities. As this section shows, all of those three costs of going public affect more severely SMEs and can inhibit their ability to raise equity capital.

A. The Costs Associated with Disclosure Requirements

1. 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[18]. 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[19]. The concept of trade is defined broadly in the Act to

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[18] The paper refers to the Ontario *Securities Act*, R.S.O. 1990, c. S-5 (hereinafter "O.S.A."). Nevertheless, the analysis remains relevant to the other securities acts which enact similar requirements as the Ontario Act. For a more detailed analysis of the regulation of the prospectus process, see: George R.D. GOULET, *Public Share Offerings and Stock Exchange Listings in Canada*, North York, CCH Canadian Ltd., 1994; David L. JOHNSTON and Kathleen D. ROCKWELL, *Canadian Securities Regulation*, 2nd ed., Toronto, Butterworths, 1998, c. 5 and 6.

[19] O.S.A., *supra*, note 18, 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. O.S.A., *supra*, note 18, s. 1(1) "control".

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[20].

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"[21]. More precisely, this requirement translates into an obligation to present the information in a straightforward narrative and plain language style[22], 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[23].

Aside from the general requirement to provide full, true and plain disclosure, the regulatory framework sets out specific disclosure requirements[24]. 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 three 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

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20 O.S.A., *supra*, note 18, s. 1(1) "trade". Mark R. GILLEN, *Securities Regulation in Canada*, Toronto, Carswell, 1992, p. 100 and 101; D.L. JOHNSTON and K.D. ROCKWELL, *op. cit.*, note 18, p. 35-39. Since courts have taken a liberal approach in interpreting the meaning of "trade", they probably would not require a completion of the sale or of the other activities, in order to found a furtherance. See: *R.* v. *Dalley*, [1957] O.W.N. 123 (C.A.); *R.* v. *Langs*, [1965] 1 O.R. 692 (C.A.); *Sanderson* v. *O.S.C.*, [1972] 3 O.R. 329 (C.A.).

21 O.S.A., *supra*, note 18, s. 58(1).

22 *Ontario Securities Regulation*, s. 46 and 49 (hereinafter "O.S.R."), to be reformulated in Rule 41-501. See: "National Policy 41-501 – Prospectus Disclosure Requirements", (2000) 23 O.S.C.B. (Supp.) 623, s. 2.2 and 2.4 (hereinafter "*Rule 41-501*").

23 See: O.S.A., *supra*, note 18, s. 1(1) "material fact"; *Pezim* v. *B.C. (Superintendent of Brokers)*, [1994] 2 R.C.S. 557.

24 *Rule 41-501, supra*, note 22; ONTARIO SECURITIES COMMISSION, "Companion Policy 41-501CP", (2000) 23 O.S.C.B. (Supp.) 728 (hereinafter "*Policy 41-501CP*"); G.R.D. GOULET, *op. cit.*, note 18, par. 6300-6335.

holders of more than 10 per cent of the issuer's voting securities including the number and percentage of securities held[25].

In addition, there are requirements with respect to financial statements. Issuers must provide audited financial statements for the three 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)[26]. If they find it relevant, issuers may also include future-oriented financial information.

Under the prevailing regime, issuers must file a preliminary prospectus that will be followed by a final version of the prospectus[27]. 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[28]. Once the preliminary prospectus is filed with the relevant securities commissions and a receipt has been issued, issuers may conduct limited marketing activities[29]. 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[30]. 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[31]. Once the receipt for the final prospectus is issued, the issuers may begin the actual sale of their offering.

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25 *Rule 41-501*, *supra*, note 22, Item 15.1.

26 O.S.R., *supra*, note 22, s. 1(3) and 2, to be complemented by *Rule 41-501*, *supra*, note 22.

27 O.S.A., *supra*, note 18, s. 53 and 54.

28 G.R.D. GOULET, *op. cit.*, note 18, par. 7000; Joan C. SMART and Patricia L. OLASKER, "Disclosure Standards in Canada", (1996) 19 *O.S.C.B.* 221, 229.

29 O.S.A., *supra*, note 18, s. 65(2).

30 *Id.*, s. 61(1).

31 *Id.*, s. 61(2).

2. The Costs of Preparing the Prospectus

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, the printing expenditures, the filing fees for the securities commissions, and other related expenses[32]. The costs of assembling the prospectus are 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[33].

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[34]. 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 efforts by regulators to facilitate and accelerate multi-province offerings[35]. 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[36].

The costs of preparing the prospectus are enormous when viewed in the context of a small enterprise. Indeed, they have a large fixed-cost component and represent, therefore, a higher percentage

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32 John HIGGINS, *Canada and U.S. Cost Comparisons of Initial Public Offerings (IPOs)*, Ottawa, The Conference Board of Canada, 1994, p. 5.

33 *Financing Innovative Enterprise*, *op. cit.*, note 6, p. 44 and 45.

34 Grant V. SAWIAK, Cameron W. FERRIS, William J. BRATHWAITE, John WALKER, Patricia OLASKER and F. John DURDAN, *The Transaction Costs of a Decentralized System of Securities Regulation*, Ottawa, Report to the Standing Senate Committee on Banking, Trade and Commerce, 1996.

35 "Notice of National Policy 43-201 – Mutual Reliance Review System for Prospectuses and Annual Information Forms", (1999) 22 *O.S.C.B.* 7308.

36 G.V. SAWIAK, C.W. FERRIS, W.J. BRATHWAITE and others, *op. cit.*, note 34, p. 9.

of proceeds for small issues than for larger issues[37]. For example, the non-underwriter costs for offerings of less than $1 million (U.S.) represent about 8.5 per cent of issue price, while they represent only 0.9 per cent of issue price for offerings of $100 to 200 millions (U.S.).

In addition to these direct expenses, the costs of preparing the prospectus include the opportunity cost of complying with regulatory requirements. Opportunity cost 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[38]. 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[39]. In this respect, it is interesting to note that the cost of the management time has a high fixed-cost component and declines, as a percentage of the amount raised, as the size of issues increases[40].

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 an information for their own operating needs[41]. 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[42]. However, it is likely that firms would not disclose the

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37 *Id.*, p. 15; Theresa SHUTT and Hugh WILLIAMS, *Going to Market – The Cost of IPOs in Canada and the United States*, The Conference Board of Canada, Members' Briefing 296-00, 2000, p. 2; see also: B.D. BAYSINGER, R.E. MEINERS and C.P. ZEITHAML, *Barriers to Corporate Growth*, p. 90-93 (1981).

38 Michael ANDREWS, *Initial Public Offerings – The Experience of Eight Canadian Growth Companies*, Ottawa, Conference Board of Canada, 1995, p. 9 and 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.

39 *Financing Innovative Enterprise*, *op. cit.*, note 6, p. 45 and 46.

40 M. ANDREWS, *op. cit.*, note 38, p. 10; *Financing Innovative Enterprise*, *op. cit.*, note 6, p. 45 and 46.

41 R.K. ELLIOTT and P.D. JACOBSON, "Costs and Benefits of Business Information Disclosure", 8 *Acct. Hor.* 80, 83 (1994).

42 F.H. EASTERBROOK and D.R. FISCHEL, "Mandatory Disclosure and the Protection of Investors", 70 *Va. L. Rev.* 669, 709 (1984).

same level of information that current mandatory disclosure rules require, given the continuous increase of disclosure requirements[43].

3. The Cost of Delays

Another cost that must incur issuers results from the delays associated with the prospectus approval process. An average period of three months elapses 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[44], 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[45]. 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.

4. The Loss of Competitive Advantage

The mandatory disclosure of information in the prospectus involves non-operational costs which result from the loss of confidentiality for issuers[46]. 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 at their advantages. 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*

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43 *Financing Innovative Enterprise*, *op. cit.*, note 6, p. 50 and 51.

44 G.V. SAWIAK, C.W. FERRIS, W.J. BRATHWAITE and others, *op. cit.*, note 34, p. 8. Sixty-seven 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 have a strong deterrent on small issuers. *Id.*, p. 11.

45 *Id.*, p. 8 and 9; *Financing Innovative Enterprise*, *loc. cit.*, note 6, p. 47.

46 F.H. EASTERBROOK and D.R. FISCHEL, *loc. cit.*, note 42, 708; E.W. KITCH, "The Theory and Practice of Securities Disclosure", 61 *Brook. L. Rev.* 763, 846 and 857 (1995).

them a better idea of the size of the potential surplus created by their deals with the issuer.[47]

It is important to emphasise that the cost at the firm level which can result from the loss of confidentiality are essentially born by investors: "Investors can have the information, but at a price: their investment will be worth less."[48] Thus, mandatory disclosure of confidential information may actually compel managers to disregard the best interest of the corporation, in contravention with their fiduciary duties[49].

The competitive losses resulting from disclosure of confidential information are difficult to assess[50]. In a mandatory disclosure system, issuers will gain advantages from knowing more about their competitors as every issuer have to disclose such information[51]. Thus, it remains unclear whether disclosure of proprietary information will consistently generate net competitive disadvantages for issuers[52].

B. The Underpricing of Initial Public Offerings

Research by financial economists on the pricing of IPOs has uncovered a troubling anomaly: initial public offerings are, on average, underpriced. The underpricing of IPOs is problematic since it raises the cost of capital for firms by reducing the amount of funds they obtain for their securities. This section presents the empirical evidence on the underpricing of IPO market and presents the most convincing theoretical model put forward to explain this systematic mispricing.

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47 M.B. FOX, "Securities Disclosure in a Globalizing Market: Who Should Regulate Whom", 95 *Mich. L. Rev.* 2498, 2551 (1997).

48 E.W. KITCH, *loc. cit.*, note 46, 848.

49 D.C. LANGEVOORT, "Information Technology and the Structure of Securities Regulation", 98 *Harv. L. Rev.* 747, 791 (1985).

50 L. LOWENSTEIN, "Financial Transparency and Corporate Governance: You Manage What You Measure", 96 *Col. L. Rev.* 1335, 1356 and 1357 (1996).

51 M.B. FOX, *loc. cit.*, note 47, 2551.

52 C.S. BRADFORD, "Transaction Exemption in the Securities Act of 1933: An Economic Analysis", 45 *Emory L.J.* 591, 608 (1996) (emphasising the difficulty of quantifying the loss of competitive advantage).

1. Empirical Evidence of Underpricing

It is now well recognised by the finance literature that IPOs are, on average, underpriced[53]. 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[54]. This anomaly of the IPO market exists in every country that has a stock market[55].

Early studies in Canada based on data from periods prior to 1970 indicated a degree of IPO underpricing in excess of 40 per cent[56]. However, more recent research suggests 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[57]. 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[58]. 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.

Following these results, the degree of underpricing in Canada is much lower than in most industrialised countries. They lead Jog to

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53 S.C. ANDERSON, T. Randolf BEARD and Jeffery A. BORN, *Initial Public Offerings – Findings and Theories* (1994); R.G. IBBOTSON, J. SINDELAR and J.R. RITTER, "The Market's Problem with the Pricing of Initial Public Offerings", *J. Ap. Corp. Fin.* 66 (1994).

54 R.G. IBBOTSON, J. SINDELAR and J.R. RITTER, *loc. cit.*, note 53, 67; see also: C.S. CHEUNG and I. KRINSKY, "Information Asymmetry and the Underpricing of Initial Public Offerings: Further Empirical Evidence", 21 *J. Bus. Fin. & Acct.* 739 (1994); J.S. RUUD, "Underwriter Price Support and the IPO Underpricing Puzzle", 34 *J. Fin. Econ.* 135 (1993).

55 See: T. LOUGHRAN, J.R. RITTER and K. RYDGVIST, "Initial Public Offerings: International Insights", 2 *Pacific-Basin Fin. J.* 3 (1994).

56 For a summary: Vijam M. JOG and Allan Lance RIDING, "Underpricing in Canadian IPOs", *Fin. Anal. J.* 48, 49 (Nov.-Dec. 1987).

57 *Id.*, 51 .

58 V.M. JOG, *loc. cit.*, note 8, 363, 394 and 395.

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"[59]. 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[60]. 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 Canadian exchanges.

Accordingly, 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 firm IPOs[61]. Given the existing relationship between firm quality 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. This argument seems to be confirmed by a recent study of the Conference Board of Canada using IPO data from 1998 and 1999[62]. The study examined the costs of going public on the TSE by measuring namely the degree of underpricing of new issues. The results showed clearly that the degree of underpricing varies negatively with the size of the issue. Thus, issues of $1-9.9 millions were underpriced by 23% on average. Issues of $10-49.9 millions experienced underpricing of 10%, on average, while those of $50-99.9 millions of 15.6%. The largest issues of the sample ($100-199.9 millions) were underpriced by a mere 4.2% on average.

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59 *Id.*, 392-395.

60 J. HIGGINS, *op. cit.,* note 32, p. 3.

61 In fairness, Jog does acknowledge that his study "may reflect the experience of somewhat larger firms": V.M. JOG, *loc. cit.,* note 8, 394 and 395. Elizabeth Maynes also makes this point in her comment of the Jog study: Elizabeth MAYNES, "Comment", in P.J.N. HALPERN, *op. cit.,* note 8, p. 411.

62 T. SHUTT and H. WILLIAMS, *loc. cit.,* note 37; see also: TORONTO STOCK EXCHANGE, "The Costs of Going Public Advantage: TSE", TSE Research Bulletins, March 2000: (http://tse.com/news/bulletins/bull_2000_03.htm).

2. The Winner's Curse Model of Underpricing

The winner's curse model of underpricing, first formally proposed by Kevin Rock, is the most convincing theory put forward to explain the underpricing of IPOs[63]. The theory is based on the existence of information asymmetries among potential investors[64]. 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. 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.

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[65].

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63 For an overview of the studies, see: Stéphane ROUSSEAU, *Designing an Efficient Securities Market for Small and Medium-Sized Enterprises (SMEs): Perspectives for Reform*, Doctoral dissertation, Toronto, Faculty of Law, University of Toronto, 1999, p. 51-77.

64 K. ROCK, "Why New Issues Are Underpriced", 15 *J. Fin. Econ.* 187 (1986).

65 C.B. BARRY and R.H. JENNINGS, "The Opening Price Performance of Initial Public Offerings of Common Stock", 22:1 *Fin. Mgmt.* 54 (1993). 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.

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[66]. 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"[67]. 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.

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"[68]. However, it is not possible to test the model directly in Canada or the United States because it is not possible to observe information on the rationing process adopted by underwriters and issuers[69]. Hence, empirical studies in the two countries have tested the winner's curse model using indirect evidence on the relationship between proxies for *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[70]. Relying on the gross proceeds from the offering as a proxy for uncertainty, the authors found a significant correlation between *ex ante* uncertainty and the degree of underpricing[71].

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66 R.P. BEATTY and J.R. RITTER, "Investment Banking, Reputation, and the Underpricing of Initial Public Offerings", 15 *J. Fin. Econ.* 213, 216 (1986).

67 S.C. ANDERSON, *op. cit.,* note 53, p. 36.

68 K. ROCK, *loc. cit.,* note 64, 205.

69 F. KOH and T. WALTER, "A Direct Test of Rock's Model of the Pricing of Unseasoned Issues", 23 *J. Fin. Econ.* 251, 266 (1989).

70 R.E. MILLER and F.K. REILLY, "An Examination of Mispricing, Returns, and Uncertainty for Initial Public Offerings", 16 *Fin. Mgmt.* 33 (1987).

71 The results of Miller and Reilly confirm the findings of Beatty and Ritter that indicate the existence of a positive relation between underpricing and the gross proceeds of the offering: R.P. BEATTY and J.R. RITTER, *loc. cit.,* note 66, 227.

In Canada, Clarkson and Merkley analysed the underpricing phenomenon using various proxies for *ex ante* uncertainty identified by the literature[72]. The results of their study supported the existence of a relation between most of the proxies for *ex ante* uncertainty and the degree of underpricing, as the authors explain:

> *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.*[73]

Finally 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[74]. These authors tested the proposition that underpricing should decrease as information asymmetry across investor groups decreases, 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. Michealey and Shaw found that regular IPOs experience

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72 Peter M. CLARKSON and Jack MERKLEY, "Ex Ante Uncertainty and the Underpricing of Initial Public Offerings: Further Canadian Evidence", (1994) 11 *Can. J. Admin. Sci.* 54. 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 *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 from the offering, they failed to find a relation between underpricing and aftermarket variance, or the level of ownership retention by the original owners. V.M. JOG and A.L. RIDING, *loc. cit.*, note 56.

73 *Id.*, 66.

74 R. MICHAELY and W.H. SHAW, "The Pricing of Initial Public Offerings: Tests of Adverse-Selection and Signalling Theories", 7 *Rev. Fin. St.* 279, 287-294 (1994).

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 investors who possess superior information"[75].

C. 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[76]. 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 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 the apparent 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. In this respect, 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[77]. This can be explained by classic price competition. Competition between

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75 *Id.*, 281.

76 M. ANDREWS, *op. cit.*, note 38, p. 11.

77 M.R.K. CHISHTY, I. HASAN and S.D. SMITH, "A Note on Underwriter Competition and Initial Public Offerings", 23 *J. Bus. Fin. & Acct.* 905 (1996).

dealers on the compensation they are willing to accept leads to a level of commission that reflects the cost of supplying underwriting services[78]. 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.

II. The Private Information Networks of the Initial Public Offering Market

Securities regulation imposes obligations to market participants in the IPO market to protect investors and enhance efficiency. The current regulatory requirements are designed to apply to the primary market as a whole, without any specific treatment for different kind of issuers. The foregoing section suggests that this one size fits all approach to regulation does not serve well market efficiency. On the one hand, securities regulation enacts rules which tend to burden excessively smaller issuers. On the other hand, market imperfections, which impede the accurate pricing of IPO securities, raise the cost of capital for SMEs by forcing the underpricing of their shares.

To enhance the accessibility of public equity financing for SMEs, the regulatory framework must be more responsive to the particularities of the market regulated. Hence, it appears appropriate, before making any reform proposals, to examine the 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 insights into the appropriate role of regulation in enhancing market efficiency.

From this perspective, this section examines the amount of privately generated information which is available on small issuers in the IPO market. The section starts 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

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78 K. GARBADE, *Securities Markets*, p. 478 (1982).

ability of issuers to rely on information intermediaries' services to convey information to investors with respect to firm value. The sections concludes by discussing the importance of institutional investors for market efficiency.

A. Voluntary Disclosure by Issuers

Issuers have significant incentives to voluntarily disclose information to investors. The incentives of issuers to disclose information comes more particularly from the impact of disclosure on firm value[79]. 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[80]. 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[81]. 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. 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"[82]. Hence, by reducing the cost of information production

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79 See, for example: G. BENSTON, "Required Disclosure and the Stock Market", 63 *Am. Econ. Rev.* 132 (1973); G. BENSTON, "The Effectiveness and Effects of the SEC's Accounting Disclosure Requirements", in H.G. MANNE (ed.), *Economic Policy and the Regulation of Corporate Securities* 23, 24 (1969); F.H. EASTERBROOK and D.R. FISCHEL, *loc. cit.,* note 42, 673-677.

80 G. BENSTON, "Required Periodic Disclosure Under the Securities Acts and the Proposed Federal Securities Code", 33 *U. Miami L. Rev.* 1471, 1473 (1979); A. Richard RODIER, "Prospectus Disclosure Under the Proposed Securities Act in Ontario: Problems in a Changing Environment", (1985) 23 *U.W.O. L. Rev.* 21, 23.

81 J.F. BARRY, "The Economics of Outside Information and Rule 10b-5", 129 *U. Pa. L. Rev.* 1307, 1323 (1981).

82 G. BENSTON, *loc. cit.,* note 80, 1473 and 1474.

incurred by prospective investors, firms can maximise the value of their shares.

Secondly, voluntary disclosure tends to reduce the agency costs of equity that depress firm value[83]. 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[84]. 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[85]. 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[86]. Firms with "good news" or good investment projects have nothing to hide since the disclosure of information will raise their value 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"[87].

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83 P.G. MAHONEY, "Mandatory Disclosure as a Solution to Agency Problem", 62 *U. Chi. L. Rev.* 1047 (1995).

84 M.C. JENSENand W.H. MECKLING, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure", 3 *J. Fin. Econ.* 305, 323 (1976).

85 G. BENSTON, *loc. cit.,* note 80, 1475; F.H. EASTERBROOK and D.R. FISCHEL, *loc. cit.*, note 42, 675-677.

86 H.E. LELAND and D.H. PYLE, "Informational Asymmetries, Financial Structure, and Financial Intermediation", 32 *J. Fin.* 371 (1977).

87 G. BENSTON, *loc. cit.,* note 80, 1476.

However powerful, the incentives of issuers to disclose information remain questionable. Indeed, issuers have countervailing incentives to refrain from disclosing information where doing so will decrease rather than increase firm value, such as with confidential information[88]. This "good reason" not to disclose information is likely to exercise an important 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[89].

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[90]. 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.*[91]

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.

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

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88 E.W. KITCH, *loc. cit.*, note 46, 848-855; D.J. SCHULTE, "The Debatable Case for Securities Disclosure Regulation", *J. Corp. L.* 535, 538 and 539 (1988); J. SELIGMAN, "The Historical Need for a Mandatory Corporate Disclosure System", 9 *J. Corp. L.* 1, 8, note 24 (1983).

89 A.R. PETTIT and R.F. SINGER, "Small Business Finance: A Research Agenda", 14 *Fin. Mgmt.* 48, 57 (1985).

90 E.W. KITCH, *loc. cit.*, note 46, 853.

91 R.K. ELLIOTT and P.D. JACOBSON, *loc. cit.*, note 41, 85.

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[92]. 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[93]. 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[94]. In particular, owner-managers can use mechanisms involving endogenous factors to the firm to convey information to outside investors about financial situation and prospects. For instance, information transfer can occur through the willingness of insiders, such as owner-managers, to invest in the firm[95]. The higher the level of equity retained by insiders, the greater the risk the latter face by holding less fully diversified portfolios. Since this increased risk costs less for good quality firms that promise higher returns than for poor quality firms with lower expected returns, investors can consider the percentage of equity retained by the latter as a signal of the true expected returns[96].

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92 R.A. DYE, "Disclosure of Nonproprietary Information", 23 *J. Acct. Res.* 123 (1985).

93 F.H. EASTERBROOK and D.R. FISCHEL, *loc. cit.*, note 42, 674-677; R.J. GILSON and R.H. KRAAKMAN, "The Mechanisms of Market Efficiency", 70 *Va. L. Rev.* 549, 594 and 595 (1984); S.J. GROSSMAN, "The Informational Role of Warranties and Private Disclosure about Product Quality", 24 *J. Law & Econ.* 461 (1981).

94 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.

95 H.E. LELAND and D.H. PYLE, *loc. cit.*, note 86; see also: F.H. EASTERBROOK and D.R. FISCHEL, *loc. cit.*, note 42, 676; N. STRONG and M. WALKER, *Information and Capital Markets*, p. 151-156 (1987).

96 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 *ex ante* uncertainty in the IPO market: P.M. CLARKSON, A. DONTOH, G. RICHARDSON and S.E. SEFCIK, "Retained Ownership and the Valuation of Initial Public Offerings: Canadian Evidence", 8 *Cont. Acct. Res.* 115 (1992); P.M. CLARKSONand J. MERKLEY, *loc. cit.*, note 72. (The average initial returns for the high and low ownership retention partitions were 4.1% and 8.7%, respectively.)

The choice made by firms between debt and equity financing can also constitute a signal of their quality[97]. The use of debt finance increases the probability of financial distress that can lead to bankruptcy[98]. 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[99]. In this respect, there is strong evidence that investors react positively to announcements of debt issue, and negatively to announcements of common stock issues that decrease financial leverage, suggesting that investors take larger debt level as signal of firm quality[100].

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[101]. 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, these 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.

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97 S. MYERS and N. MAJLUF, "Corporate Financing and Investment Decisions When Firms Have Information That Investors Do Not Have", 13 *J. Fin. Econ.* 187 (1984); S. ROSS, "The Determination of Financial Structure: The Incentive Signalling Approach", 8 *Bell. J. Econ.* 23 (1977); N. STRONG and M. WALKER, *op. cit.*, note 95, p. 151-155.

98 Richard A. BREALEY, Stewart C. MYERS, Gordon SICK and Ronald GIAMMARINO, *Principles of Corporate Finance*, 2nd Can. ed., Toronto, McGraw-Hill Ryerson, 1992, p. 466.

99 N. STRONG and M. WALKER, *op. cit.*, note 95, p. 146.

100 C.W. SMITH, "Raising Capital: Theory and Evidence", *J. Ap. Corp. Fin.* 6, 7 (1986).

101 E. NORTON, "Capital Structure and Small Public Firms", 6 *J. Bus. Vent.* 287, 300 (1991). (Major factor motivating the IPO is the management's desire to diversify their personal holdings.)

In addition, there are several reasons indicating that SMEs should be inclined to use less debt than larger enterprises[102]. Firstly, the general lower tax rates for small firms in Canada diminish the tax shield associated with debt financing for larger firms and the attractiveness of this source of financing[103]. Secondly, smaller firms face higher bankruptcy and reorganisation costs, irrespective of their quality[104]. 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[105]. Therefore, the cost of signalling with debt will tend to be very high for small enterprises, making it an inappropriate mechanism.

As the foregoing discussion suggests, constraints on voluntary disclosure reduce the amount of information that would be available on the market absent disclosure regulation. However, the presence of these constraints does not inevitably imply that there is a need for mandatory disclosure, or for the current level of disclosure for that matter[106]. The need for disclosure regulation must be assessed in light of the other market mechanisms which serve as independent source of information on issuers[107].

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102 J.J. McCONNELL and R.R. PETTIT, "Application of the Modern Theory of Finance to Small Business Firms", in E.I. ALTMAN and I. WALTER (ed.), *Small Business Finance – Problems in the Financing of Small Businesses,* Contemporary Studies in Economic and Financial Analysis, vol. 42, p. 97, at pages 110-116 (1982); *Financing Innovative Enterprise, op. cit.,* note 6, p. 88.

103 *Income Tax Act*, R.S.C. (1985), c. 1 (5th Supp.), s. 125; Vijay M. JOG and Heather SCHALLER, "Sources of Financing for Small and Medium-Sized Companies in Canada", in Roy D. HOGG and Jack M. MINTZ (ed.), *Tax Effects on the Financing of Medium and Small Public Corporations*, Kingston, John Deutsch Institute, 1991, p. 11, at page 12; Vern KRISHNA, *The Fundamentals of Canadian Income Tax*, 4th ed., Scarborough, Carswell, 1993, p. 791-793.

104 J.J. McCONNELL and R.R. PETTIT, *loc. cit.,* note 102, 114 and 115.

105 *Financing Innovative Enterprise*, *op. cit.,* note 6, p. 88; P.A. GOMPERS, "Optimal Investment, Monitoring, and the Staging of the Venture Capital", 50 *J. Fin.* 1461, 1466 and 1467 (1995).

106 J.C. COFFEE, "Market Failure and the Economic Case for a Mandatory Disclosure System", 70 *Va. L. Rev.* 717, 739 and 740 (1984).

107 F.H. EASTERBROOK and D.R. FISCHEL, *loc. cit.,* note 42, 687-692; R.J. GILSON and R.H. KRAAKMAN, *loc. cit.,* note 93, 597-609.

B. Securities Research by Professional Analysts

The research activities of securities analysts are essential to the informational efficiency of the market[108]. Analysts from brokerage firms and independent research services 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[109]. 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[110].

The information that analysts uncover, assess and verify, generally helps investors value securities, and make their own decisions as to buy or sell them[111]. Analysts research and verify information at a lower cost than investors because of the economies of scale associated with these activities[112]. Their presence tends therefore to reduce the information costs of investors and fosters a wider distribution of information in the market[113]. This contributes to ensuring ultimately that prices reflect all available information.

Economic theory holds that analysts should 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. However, according to some commentators securities research resembles a

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108 J.C. COFFEE, *loc. cit.*, note 106, 723; R.J. GILSON and R.H. KRAAKMAN, *loc. cit.*, note 93, 598-600; D.C. LANGEVOORT, "Investment Analysts and the Law of Insider Trading", 76 *Va. L. Rev.* 1023, 1028 (1990); Note, "The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry", 29 *Stan. L. Rev.* 1031, 1055 (1977).

109 J.C. COFFEE, *loc. cit.*, note 106, 724; R.J. GILSON and R.H. KRAAKMAN, *loc. cit.*, note 93, 600. This is a form of certification of information quality. D.C. LANGEVOORT, *loc. cit.*, note 108, 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 Bankrupcy Issues Under the Securities Laws", 57 *Ohio St. L.J.* 731, 754 and 755 (1996).

110 L. LOWENSTEIN, *loc. cit.*, note 50, 1354.

111 P.M. HEALEY and K.G. PALEPU, "The Effect of Firms' Financial Disclosure Strategies on Stock Prices", 7 *Acct. Hor.* 1 (1993).

112 R.J. GILSON and R.H. KRAAKMAN, *loc. cit.*, note 93, 601.

113 A.R. RODIER, *loc. cit.*, note 80, 36 and 37.

public good since investors can consume securities research without paying for it[114]. Thus, an unregulated market will underprovide securities research because of the impossibility for analysts to realise the full value of their research activities. 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[115]. 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[116]. 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[117]. Similarly, there is no incentive for an investor to propagate securities research information indicating that the issue is accurately priced or overpriced.

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

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114 K.J. ARROW, "Economic Welfare and the Allocation of Resources for Invention", in NATIONAL BUREAU OF ECONOMIC RESEARCH, *The Rate and Direction of Inventive Activity: Economic and Social Factors*, p. 609 (1962); J.C. COFFEE, *loc. cit.*, note 106, 723-737; M. MENDELSON, "Economics and the Assessment of Disclosure Requirements", 1 *J. Comp. Corp. L. & Sec. Reg.* 49, 53 and 54 (1978).

115 J.F. BARRY, *loc. cit.*, note 81, 1327 and 1328; Gregory HERDER, "Corporate Finance Theory and the Australian Prospectus Legislation", (1995) *Comp. & Sec. L.J.* 181, 187.

116 L.M. BENVENISTE and P.A. SPINDT, "How Investment Bankers Determine the Offer Price and Allocation of New Issues", 24 *J. Fin. Econ.* 343, 344 (1989); G. HERDER, *loc. cit.*, note 115, 188.

117 This is central to the winner's curse model. K. ROCK, *loc. cit.*, note 64, 188: "the investor with the highest valuation need not obtain the shares, even if the valuation exceeds the issuer's reservation (offer) price."

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[118]. 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"[119].

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[120]. 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[121]. 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[122].

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 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[123]. This redundant production of

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118 K. ROCK, *loc. cit.,* note 64, 188.

119 L.M. BENVENISTE and P.A. SPINDT, *loc. cit.,* note 116, 358.

120 B. CHOWDHRY and A. SHERMAN, "International Differences in Oversubscription and Underpricing of IPOs", 2 *J. Corp. Fin.* 359 (1996); I. WELCH, "Sequential Sales, Learning and Cascades", 47 *J. Fin.* 695 (1992).

121 In Canada, this period is of at least 10 days; see: B. CHOWDHRY and A. SHERMAN, *loc. cit.*, note 120, 361, 363 and 364 (10 days); Mark WEISDORF, *Going Public and The Public Equity Market*, Toronto, Wood Gundy, 1996, p. 18 and 19 (14 days).

122 I. WELCH, *loc. cit.,* note 120, 695.

123 G. HERDER, *loc. cit.,* note 115, 188.

information will happen when analysts search and expend resources for the same information[124].

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[125]. 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[126]. In this respect, evidence shows that analyst supply increases with the number of institutions holding firms' securities[127]. However, institutional investors are not active purchasers of small firm IPOs for reasons that will be examined further below[128]. Therefore, the low degree of institutional ownership will influence negatively the demand and supply of analysts for small IPOs.

Secondly, firm size influences the demand for analysts' services[129]. The demand for analyst's information is related to the potential economic value of the information generated[130]. Information on larger firms is likely to be more valuable to investors than information on smaller firms because the profits generated

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124 F.H. EASTERBROOK and D.R. FISCHEL, *loc. cit.*, note 42, 681.

125 Institutional investors are the most active traders on the market, accounting for about 70 per cent of all transactions: "Agency Volume Business", (December 1995) *Toronto Stock Exchange Review* 3.

126 J.C. COFFEE, *loc. cit.*, note 106, 732.

127 A. ARBEL, S. CARRELL and P. STREBEL, "Giraffes, Institutions and Neglected Firms", *Fin. Anal. J.* 57 (May-June 1983).

128 *Infra*, notes 210-219 and corresponding text.

129 K.H. CHUNG and others, "Production of Information, Information Asymmetry, and the Bid-Ask Spread: Empirical Evidence from Analysts' Forecast", 19 *J. Bank. & Fin.* 1025, 1042 (1995); P.C. O'BRIEN and R. BHUSHAN, "Analyst Following and Institutional Ownership", 28 *J. Acct. Res.* 55 (1990).

130 K.H. CHUNG and others, *loc. cit.*, note 129, 1028.

by trading on the basis of this information are likely to be higher[131]. 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[132]. This problem is magnified by the lower volume of transactions in the IPO market in comparison with in the secondary market. This lower volume of transactions limits considerably the potential compensation that generates research for analysts and reduces their incentives to supply research[133]. 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"[134].

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 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.

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

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131 R.C. MOYER and others, "Security Analyst Monitoring Activity: Agency Costs and Information Demands", 24 *J.F.Q.A.* 503 (1989).

132 K.H. CHUNG and others, *loc. cit.*, note 129, 1031, 1042.

133 B.M. BARBER and others, "The Fraud-on-the-Market Theory and the Indicators of Common Stocks' Efficiency", 20 *J. Corp. L.* 285, 291 (1994).

134 L. LOWENSTEIN, "Shareholder Voting Rights: A Response to SEC Rule 19c-4 and to Professor Gilson", 89 *Col. L. Rev.* 979, 995 (1989).

by the dearth of securities research. 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[135]. These information intermediaries enhance investor confidence by providing an independent check on information accuracy by offering their reputation in lieu of the issuers' as a guarantee of quality.

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 met[136]. 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"[137]. This section presents the most important certifying agents in the IPO process and discusses their accessibility for SMEs.

1. Venture Capital Firms

Venture capitalists are investors who provide long-term financing and expertise to high-growth, high-risk promising firms, often in the high technology sector[138]. Venture capitalists take

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135 G.J. BENSTON, *loc. cit.*, note 80, 1475 and 1476; F.H. EASTERBROOK and D.R. FISCHEL, *loc. cit.*, note 42, 675; R.J. GILSON and R.H. KRAAKMAN, *loc. cit.*, note 93, 604.

136 R.P. BEATTY and J.R. RITTER, *loc. cit.*, note 66, 217; J. BOOTH and R. SMITH, "The Certification Role of the Investment Banker in New Issue", *J. Ap. Corp. Fin.* 56, 57 (1986); W.L. MEGGINSON and K.A. WEISS, "Venture Capitalist Certification in Initial Public Offerings", 46 *J. Fin.* 879, 881 (1991).

137 W.L. MEGGINSON and K.A. WEISS, *loc. cit.*, note 136.

138 B.S. BLACK and R.J. GILSON, *loc. cit.*, note 11, 245; INDUSTRY SCIENCE AND TECHNOLOGY, *Venture Capital – Industry Profile*, Ottawa, Supply and Services, 1991, p. 2; C.J. MILHAUPT, "The Market for Innovation in the United States and Japan: Venture Capital and the Comparative Corporate Governance Debate", 91 *Nw. U.L.Rev.* 865, 871 and 876 (1997).

concentrated equity positions in such firms and assume an active role in management to add value[139]. While venture capitalists play a variety of roles in their portfolio firms, this section emphasises their ability to reduce the information asymmetry between corporate insiders and prospective investors, and to facilitate the access of their portfolio firms to the public equity market[140].

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[141]. 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.

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 strategies, and structuring transactions[142].

The monitoring of portfolio firms by venture capitalists is further ensured by the staging of their capital infusions[143]. Venture

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139 B.J. ANDERSON, "Venture Capital and Securities Market in Malaysia: The Search for a Functioning Exit Mechanism", 12 *Wis. Int'l L.J.* 1, 4 (1993); C.B. BARRY, "New Directions in Research on Venture Capital Finance", 23:3 *Fin. Mgmt.* 3, 4 and 5 (1993); B.S. BLACK and R.J. GILSON, *loc. cit.*, note 11, 252 and 253.

140 See: Y. CHAN, "On the Positive Role of Financial Intermediation in Allocations of Venture Capital in a Market with Imperfect Information", 33 *J. Fin.* 1543 (1983).

141 C.B. BARRY, *loc. cit.,* note 139, 5; V.H. FRIED and R.D. HISRICH, "Towards a Model of Venture Capital Investment Decision Making", 23:3 *Fin. Mgmt.* 28 (1994); W.A. SAHLMAN, "The Structure and Governance of Venture Capital Organizations", 27 *J. Fin. Econ.* 473, 506 (1990).

142 C.B. BARRY, C.J. MUSCARELLA, J.W. PEAVY and M.R. VETSUYPENS, "The Role of Venture Capital in the Creation of Public Companies", 27 *J. Fin. Econ.* 447, 449 and 450 (1990); W.A. SAHLMAN, *loc. cit.,* note 141, 508; J. LERNER, "Venture Capital and the Oversight of Private Firms", 50 *J. Fin.* 301 (1995).

143 B.S. BLACK and R.J. GILSON, *loc. cit.,* note 11, 253.

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[144]. 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. 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"[145]. 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 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.

In the IPO market, the presence of venture capitalists further reduces the information asymmetry between insiders and other market participants through its certification effect[146]. Megginson and Weiss remark that there are strong reasons to believe that venture capitalists are effective certifying agents[147]. Firstly, since they are repeat players in the IPO market, venture capitalists have incentives to establish and maintain a trustworthy reputation that will ensure them continuous access to the market on favourable terms. Secondly, the value of their reputation exceeds the benefit that can yield false certification for four reasons:

> *(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*

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144 C.B. BARRY, C.J. MUSCARELLA, J.W. PEAVY and M.R. VETSUYPENS, *loc. cit.*, note 142, 450; BUSINESS DEVELOPMENT BANK OF CANADA, *Economic Impact of Venture Capital*, Montreal, Venture Capital Division, 1996, p. 11; P.A. GOMPERS, *loc. cit.*, note 105, 1461; W.A. SAHLMAN, *loc. cit.*, note 141, 506 and 507.

145 W.A. SAHLMAN, *loc. cit.*, note 141, 507.

146 B.S. BLACK and R.J. GILSON, *loc. cit.*, note 11, 254 and 255.

147 W.L. MEGGINSON and K.A. WEISS, *loc. cit.*, note 136, 881.

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.[148]

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 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[149]. This makes it very difficult for poor quality firms to imitate good quality firms by purchasing the services of venture capitalists.

In accordance with these theoretical insights, there is strong evidence that capital markets recognise the value of venture capitalists' monitoring and certification functions. Most noteworthy, Barry and others, 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"[150]. 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 as they found that venture capital backing resulted in significantly lower underpricing[151].

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[152]. This can be explained by the fact that the past experience

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148 *Id.*, 882 and 883.

149 See: W.A. SAHLMAN, *loc. cit.*, note 141, 509 and 510.

150 C.B. BARRY, C.J. MUSCARELLA, J.W. PEAVY and M.R. VETSUYPENS, *loc. cit.*, note 142, 469.

151 W.L. MEGGINSON and K.A. WEISS, *loc. cit.*, note 136; see also: T.H. LIN, "The Certification Role of Large Block Shareholders in IPOs: The Case of Venture Capitalists", 35:2 *Q.J.B.E.* 55 (1996).

152 T.H. LIN, *loc. cit.*, note 151, 62; W.L. MEGGINSON and K.A. WEISS, *loc. cit.*, note 136, 887-891.

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[153]. 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 facilitate 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[154]. The reputation of venture capitalist will also diminish the underwriters' and auditors' cost of due diligence by making it easier for these intermediaries to acquire and verify information about issuers, thereby lowering their compensation[155].

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[156]. 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[157]. Besides,

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153 *Id.*

154 W.L. MEGGINSON and K.A. WEISS, *loc. cit.*, note 136, 887.

155 T.H. LIN, *loc. cit.,* note 151, 63.

156 MACDONALD AND ASS., *Technology Exposure Continues to Grow – Venture Capital Investment by Sector*, Toronto, CVCA, 1997; see also: Raphael AMIT, James BRANDER and Christoph ZOTT, "Venture Capital Financing and Entrepreneurship in Canada", in P.J.N. HALPERN, *op. cit.,* note 8, p. 244 and 245; *Financing Innovative Enterprise*, *op. cit.,* note 6, p. 35.

157 MACDONALD AND ASS., *op. cit.*, note 156.

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[158]. Venture capitalists tend to concentrate their investments in early stage firms and technology firms where information asymmetries are likely to be severe because the value of their monitoring is considerable for these firms[159].

As the foregoing discussion suggests, 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[160]. In this respect, the IPO market plays a critical role in the venture capital process since IPOs are the most profitable means of exit. 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[161].

2. Underwriters

In the offering process, investment dealers perform four economic functions which may be of value for issuers[162]. Firstly, they can advise issuers on their financial situation and provide information on the various alternatives to raise capital and the ways

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158 *Id.*

159 P.A. GOMPERS, *loc. cit.*, note 105, 1462 and 1463; see also: R. AMIT, J. BRANDER and C. ZOTT, *loc. cit.*, note 156, 255 and 256; R.A. WINTER, "Comments", in P.J.N. HALPERN, *op. cit.*, note 8, p. 405.

160 See, for example: J.G. MACINTOSH, *loc. cit.*, note 12; B.S. BLACK and R.J GILSON, *loc. cit.*, note 11.

161 This was suggested, among others in: *Quinquennial Report on the Application of the Québec Securities Act*, Québec, Ministère des Finances, 1993, p. 64 and 65; Louise ROBIC, *L'appui au secteur financier: des dividendes pour le Québec*, Québec, Ministère des Finances, 1993, p. 38 and 39; see also: C.J. MILHAUPT, *loc. cit.*, note 138, 895 and 896.

162 For an overview of the functions of investment dealers, see: M. MENDELSON, "Underwriting Compensation", in I. FRIEND and others, *Investment Banking and the New Issues Market*, p. 394 (1969).

to structure the transactions. Secondly, 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 offerings that will convey information on firm value to prospective investors. This section discusses the certification function of underwriters.

The ability of underwriters to certify the quality of offerings comes from their reputation for pricing issues and assessing market conditions accurately[163]. Reputation is valuable for investment dealers since it allows them to charge higher fees for their services. The value of this reputation is magnified by the fact that it can be used over time in investment dealers' repeat underwriting business. 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[164]. 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[165]. For this reason, reputable underwriters have incentives to screen closely prospective offerings and issue those only that will not adversely affect their reputation. 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

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163 J.R. BOOTH and R.L. SMITH, "Capital Raising, Underwriting and the Certification Hypothesis", 15 *J. Fin. Econ.* 261 (1986). For an early view of the certification hypothesis, see: D.P. BARON, "A Model of the Demand for Investment Bank Advising and Distribution Services for New Issues", 37 *J. Fin.* 955 (1982).

164 R.P. BEATTY and J.R. RITTER, *loc. cit.*, note 66, 217, 227; J. BOOTH and R. SMITH, *loc. cit.*, note 136, 63 (Underwriters' most valuable asset is their reputation); R.J. GILSON and R.H. KRAAKMAN, *loc. cit.*, note 93, 618-621.

165 R.P. BEATTY and J.R. RITTER, *loc. cit.*, note 66, 217, 227; V. NANDA and Y. YUN, "Reputation and Financial Intermediation: An Empirical Investigation of the Impact of IPO Mispricing on Underwriter Market Value", 6 *J. Fin. Intermediation* 39 (1997).

they have more to lose if their reputation gets damaged by false certification[166].

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[167]. Hence, the presence of prestigious underwriters seems to reduce the *ex ante* uncertainty that drives the winner's curse that is responsible, in part, for underpricing.

To the extent that reputable underwriters reduce the *ex ante* uncertainty that induces underpricing, firms with greater level of *ex ante* uncertainty, such as SMEs, should employ higher quality underwriters because of the higher benefits of the certification services. However, empirical studies indicate that reputable underwriters tend to issue larger-size offerings while less reputable underwriters are associated with smaller-size IPOs[168]. This finding is particularly troubling since it implies that underwriter certification may not be available for SMEs.

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

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166 J.M. JOHNSON and R.E. MILLER, "Investment Banker Prestige and the Underpricing of Initial Public Offerings", *Fin. Mgmt.* 19 (Summer 1988).

167 R.B. CARTER, F.H. DARK and A.K. SINGH, "Underwriter Reputation, Initial Returns, and the Long-Run Performance of Initial Public Offerings", 53 *J. Fin.* 285 (1998); P.M. CLARKSON and J. MERKLEY, *loc. cit.,* note 72. The average initial returns for the high and low underwriter prestige partitions were 4.4% and 13.0% respectively; J.M. JOHNSON and R.E. MILLER, *loc. cit.*, note 166; I. KRINSKY and W. ROTENBERG, "The Valuation of Initial Public Offerings", 5 *Cont. Acct. Res.* 501 (1989); R. MICHAELEY and W.H. SHAW, *loc. cit.,* note 74, 294-301.

168 S.P. FERRIS, J.S. HILLER, G.A. WOLFE and E.S. COOPERMAN, "An Analysis and Recommendation for Prestigious Underwriter Participation in IPOs", 17 *J. Corp. L.* 581, 597 and 598 (1992); R. MICHAELY and W.H. SHAW, *loc. cit.*, note 74, 297 and 298; S.M. TINIC, "Anatomy of Initial Public Offerings of Common Stock", 43 *J. Fin.* 789, 813 (1988); see also: J.R. BOOTH and R.L. SMITH, *loc. cit.,* note 163, 274-277.

that are inherently more risky[169]. Being associated with poorly performing IPOs is likely to have a negative effect on the reputation and wealth of underwriters. 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[170]. 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.

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[171]. The expected loss element includes the litigation costs and the cost of reputation loss. Both of these costs

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169 C.B. BARRY, C.J. MUSCARELLA and M.R. VETSUYPENS, "Underwriter Warrants, Underwriter Compensation, and the Costs of Going Public", 29 *J. Fin. Econ.* 113, 121 and 122 (1991). Smaller IPOs have high aftermarket standard deviation; R. CARTER and S. MANASTER, "Initial Public Offerings and Underwriter Reputation", 45 *J. Fin.* 1045, 1062 (1990). Prestigious underwriters tend to market low risk IPOs to maintain their reputation; R.B. CARTER, F.H. DARK and A.K. SINGH, *loc. cit.*, note 167 (same).

170 S.P. FERRIS, J.S. HILLER, G.A. WOLFE and E.S. COOPERMAN, *loc. cit.*, note 168, 598; P.M. CLARKSON and J. MECKLEY, *loc. cit.*, note 72, 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 and W. ROTENBERG, *loc. cit.*, note 167. Higher quality underwriters can charge a higher fees notwithstanding the cost of performing information Intermediation services; R.P. BEATTY and I. WELCH, "Issuer Expenses and Legal Liability in Initial Public Offerings", 39 *J. Law & Econ.* 545, 576 (1996). Underwriters earn a return on their reputational capital primarily from large less risky firms.

171 See, for example: P.M. CLARKSON and J. MECKLEY, *loc. cit.*, note 72, 66 (noting that smaller firms are more underpriced).

are affected positively by *ex ante* uncertainty which is conducive of mispricing and increases the probability of damages to underwriter reputation[172].

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[173]. Furthermore, evidence shows that firm-specific risk, a proxy for inside information, is significantly related to underwriter compensation[174]. 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.

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.

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172 S.P. FERRIS, J.S. HILLER, G.A. WOLFE and E.S. COOPERMAN, *loc. cit.*, note 168, 598 and 599; S.M. TINIC, *loc. cit.*, note 168, 799.

173 J.R. BOOTH and R.L. SMITH, *loc. cit.*, note 163, 272-274; I. KRINSKY and W. ROTENBERG, *loc. cit.*, note 167, 507-509; see also: C. JAMES, "Relationship-Specific Assets and the Pricing of Underwriter Services", 47 *J. Fin.* 1865 (1992).

174 J.R. BOOTH and R.L. SMITH, *loc. cit.*, note 163, 273 and 274; see also: R. CARTER and S. MANASTER, *loc. cit.*, note 169.

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[175]. 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[176]. Since the exercise price of warrants is tied to the price of the offering[177], 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"[178]. Accordingly, warrants can be seen as a mechanism that enhances the certification provided by less reputable underwriters and best efforts offerings[179].

One risk raised by the use of warrants arises out of the principal-agent relationship existing between underwriters and

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175 C.B. BARRY, C.J. MUSCARELLA and M.R. VETSUYPENS, *loc. cit.,* note 169, 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", 38 *J. Fin. Econ.* 59, 64 (1995). Almost all best efforts IPOs use warrants as underwriter compensation.

176 R.A. BREALEY, S. MYERS, G. SICK and R. GIAMMARINO, *op. cit.,* note 98, c. 22.

177 G.R.D. GOULET, *op. cit.,* note 18, 219.

178 C.G. DUNBAR, *loc. cit.,* note 175, 62.

179 C.B. BARRY, C.J. MUSCARELLA and M.R. VETSUYPENS, *loc. cit.*, note 169, 131; J. BOOTH and R. SMITH, *loc. cit.,* note 136, 62 and 63; C.G. DUNBAR, *loc. cit.*, note 175, 62; C.K. NG and R.L. SMITH, "Determinants of Contract Choice: The Use of Warrants to Compensate Underwriters of Seasoned Equity Issues", 51 *J. Fin.* 363 (1996). (Finding direct evidence that warrant compensation functions as a bond that can substitute for reputational capital.) 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. C.G. DUNBAR, *loc. cit.*, note 175, 76; C.K. NG and R.L. SMITH, *id.*, 361. Seasoned issuers using warrants experience less underpricing; see however: C.B. BARRY, C.J. MUSCARELLA and M.R. VETSUYPENS, *loc. cit.*, note 169, 124 and 125. IPOs with underwriter warrants are more underpriced. Note that these studies were only examining firm commitment offerings.

issuers[180]. 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 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, no empirical evidence supports either the principal-agent theory of underpricing nor the monopsony power hypothesis. Furthermore, more specific evidence "indicates that underwriters do not force issuers to accept costlier compensation contracts"[181].

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.

3. Auditors

Audit service is used to add credibility to the financial information of issuers. Auditors scrutinise the financial statements of issuers to reduce the risk of misrepresentations and report any deviations of accounting principles[182]. Thus, auditing makes the information disclosed in financial statements more accurate and this allows investors to estimate more precisely firm value[183].

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180 This possibility is proposed and rejected by C.G. DUNBAR, *loc. cit.*, note 175, 63 and 64.

181 C.G. DUNBAR, *loc. cit.,* note 175, 76.

182 R.P. BEATTY, "Auditor Reputation and the Pricing of Initial Public Offerings", 64 *Acct. Rev.* 683, 695 and 696 (1989).

183 *Id.*; Dan A. SIMUNIC and Michael T. STEIN, *Product Differentiation: Auditor Choice in the Market for Unseasoned New Issues*, Vancouver, Canadian Certified General Accountants' Research Foundation, 1987, p. 16.

The credibility conferred by the audit service to financial statements depends on the reputation of the auditing firms[184]. Indeed, prestigious auditing firms have substantial investments in reputation capital to protect. For this reason, they avoid getting associated with lower-quality issuers because of the adverse effect it may have on their reputation in the IPO business and on their entire activities[185]. 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[186]. Thus, audit quality reduces the probability that financial statements contain material omissions or statements[187].

Besides, prestigious auditors charge higher fees to issuers renting their reputational capital. High quality firms benefits 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[188].

The foregoing discussion suggests that the reputation of auditors selected by issuers has the potential to convey information about firm quality and reduce *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[189]. Accordingly, when

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184 K. MENON and D.D. WILLIAMS, "Auditor Credibility and Initial Public Offerings", 66 *Acct. Rev.* 313, 314 (1991).

185 R. MICHAELY and W.H. SHAW, "Does the Choice of Auditor Convey Quality in an Initial Public Offering?", 24:4 *Fin. Mgmt.* 15, 16 (1995).

186 D.A. SIMUNIC and M.T. STEIN, *op. cit.,* note 183, p. 19.

187 Z.-V. PALMROSE, "An Analysis of Auditor Litigation and Audit Service Quality", 63 *Acct. Rev.* 55, 56 and 57 (1988); see, for example: K. HOWLETT and P. WALDIE, "YBM chief, directors unloaded stock", *The Globe and Mail*, May 16, 1998, B1 (auditors raised concerns about the possibility of illegal acts involving audited company).

188 R.P. BEATTY, *loc. cit.,* note 182, 696.

189 R.J. BALVERS, B. McDONALD and R.E. MILLER, "Underpricing of New Issues and the Choice of Auditors as a Signal of Investment Banker Reputation", (1988) 63 *Acct. Rev.* 605, 620; R.P. BEATTY, *loc. cit.*, note 182, 708; P.M. CLARKSON and J. MERCKLEY, *loc. cit.,* note 72, 66; R. MICHAELEY and W.H. SHAW, *loc. cit.,* note 185, 16.

selecting auditors, issuers should attempt 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[190]. From this it follows that firms with greater *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"[191]. Such a prediction assumes that the cost of higher auditor quality is relatively fixed and independent of *ex ante* uncertainty. However, there may be reasons to believe that the cost of hiring a high quality auditor will increase with *ex ante* uncertainty about firm value.

The cost of audit service is made up of two elements: a production element and an expected loss element[192]. The production cost element will increase with the size of the issuer and the complexity of its operations[193]. 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[194]. These costs increase with the degree of uncertainty surrounding firms' financial conditions that affects the probability for auditors of being sued[195].

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

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190 R.P. BEATTY, *loc. cit.*, note 182, 696; C.E. HOGAN, "Costs and Benefits of Audit Quality in the IPO Market: A Self-Selection Analysis", 72 *Acct. Rev.* 67 (1997).

191 G.A. FELTHAM, J.S. HUGUES and D.A. SIMUNIC, "Empirical Assessment of the Impact of Auditor Quality on the Valuation of New Issues", 14 *J. Acct. & Econ.* 375, 376 (1991).

192 C.E. HOGAN, *loc. cit.*, note 190, 69.

193 R.P. BEATTY, *loc. cit.*, note 182, 703.

194 D.A. SIMUNIC and M.T. STEIN, *op. cit.*, note 183, p. 61. Potential liability losses seem to be a significant component of auditor costs.

195 See generally: R.P. BEATTY, "The Economic Determinants of Auditor Compensation in the Initial Public Offerings Market", 31 *J. Acct. Res.* 294 (1993); S.M. TINIC, *loc. cit.*, note 168.

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[196]. 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 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[197].

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[198]. Clarkson and Simunic argue that this difference can be attributed to the lower liability risk facing auditors in Canada compared to the United States[199]. The differences in the litigation environment in the two countries reduce the potential liability losses for Canadian auditors. 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"[200].

In sum, the services of reputable auditors appear to be accessible for SMEs in Canada. However, the contrast between the

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196 P.M. CLARKSON and D.A. SIMUNIC, "The Association Between Audit Quality, Retained Ownership, and Firm-Specific Risk in U.S. vs. Canadian IPO Market", 17 *J. Acct. & Econ.* 207 (1994).

197 C.E. HOGAN, *loc. cit.*, note 190, 84. Issuers associated with lower-tier underwriters select the auditor which minimises the costs of underpricing and auditor compensation.

198 R.P. BEATTY, *loc. cit.*, note 195; G.A. FELTHAM, J.S. HUGUES and D.A. SIMUNIC, *loc. cit.*, note 191; D.A. SIMUNIC and M.T. STEIN, *op. cit.*, note 183.

199 P.M. CLARKSON and D.A. SIMUNIC, *loc. cit.*, note 196, 210 and 211; see also: D.A. SIMUNIC et M.T. STEIN, *op. cit.*, note 183, p. 61: the "legal liability provisions of the *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."

200 P.M. CLARKSON and D.A. SIMUNIC, *loc. cit.*, note 196, 211.

Canadian and American situations indicates that regulators should proceed with caution before imposing new liability to auditors.

D. Sophisticated Investors

The presence of institutional investors exercises a significant influence on the pricing efficiency of the IPO market[201]. Firstly, the participation of institutional investors affects the amount and quality of information available on the market. Institutional investors have the expertise and the resources to analyse the information disclosed by issuers, verify its accuracy and supplement it with additional 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[202].

Besides, the expertise and economic clout of institutional investors lead underwriters to give them special access to information from issuers during the marketing activities preceding the offering. Thus, institutions are usually invited to attend road shows that promote offerings and where important details about the firms and the deals are disclosed[203]. 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[204].

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201 J.N. GORDON and L.A. KORNHAUSER, "Efficient Markets, Costly Information, and Securities Research", 60 *NYU L. Rev.* 761, 802 (1985); R. ROBINSON, "Fraud-on-the-Market Theory and Thinly Traded Securities Under Rule 10b-5: How Does a Court Decide if a Stock Market Is Efficient?", 25 *Wake For. L. Rev.* 223, 250 (1990); see also: R.J. GILSON and R.H. KRAAMAN, *loc. cit.*, note 93; Jeffrey G. MACINTOSH, "The Role of Institutional and Retail Investors in Canadian Capital Markets", (1993) 31 *Osgoode Hall L.J.* 371, 433-443 and 450-458.

202 M. KAHAN, "The Qualified Case Against Mandatory Terms in Bonds", 89 *Northwestern U. L. Rev.* 565, 585 and 586 (1995). Sophisticated investors price bonds more accurately.

203 S.J. SCHULTE, "IPO Road Shows: A Primer for the Practitioner", in *26th Annual Institute on Securities Regulation*, vol. 2, 525, 529 (1994). For a critique of this situation: P.L. ZWEIG and L.N. SPIRO, "Beware the IPO market", *Business Week*, April 4, 1994, 84.

204 S.J. SCHULTE, *loc. cit.*, note 203, 540-542; M.A. WEISDORF, *op. cit.*, note 121, 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[205]. Given the fact that institutional investors are less likely to be noise traders than unsophisticated retail investors[206], their presence ensures 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[207]. 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[208]. 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"[209].

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

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205 J.G. MACINTOSH, *loc. cit.,* note 201, 451; see also: C. SPATT and S. SRIVASTAVA, "Preplay Communication, Participation Restrictions, and Efficiency in Initial Public Offerings", 4 *Rev. Fin. St.* 708 (1991).

206 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", 41 *J. Fin.* 529 (1986); D.C. LANGEVOORT, "Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited", 140 *U. Pa. L. Rev.* 851 (1992); R.J. SHILLER, *Market Volatility*, Cambridge, MIT Press, 1990.

207 A. BRAV and P.A. GOMPERS, "Myth or Reality? The Long-Run Underperformance of Initial Public Offerings: Evidence from the Venture and Nonventure Capital-backed Companies", 52 *J. Fin.* 1791 (1997); C.M.C. LEE, A. SCHLEIFER and R.H. THALER, "Investor Sentiment and the Close-End Fund Puzzle", 46 *J. Fin.* 75 (1991).

208 See: J.C. COFFEE, "Re-Engineering Corporate Disclosure: The Coming Debate Over Company Registration", 52 *Wash. & Lee L. Rev.* 1143, 1182-1185 (1995).

209 Ronald J. DANIELS and Jeffrey G. MACINTOSH, "Toward a Distinctive Canadian Corporate Law Regime", (1991) 29 *Osgoode Hall L.J.* 863, 870.

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. 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.

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[210]. This disinterest of institutional investors in small IPOs may stem from their conservative investment policies, which are induced by legal restrictions that limit the percentage of the equity of a single company that they can hold[211]. Those ceilings allow institutions to make substantial investments in large enterprises. However, they compel institutional investors to make very small investments in SMEs which may not be cost-effective to hold.

Still, 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

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210 G. BANNOCK, *op. cit.,* note 17, p. 20 and 21; R.J. DANIELS and J.G. MACINTOSH, *loc. cit.,* note 209, 877; J.G. MACINTOSH, *loc. cit.,* note 201, 435; C.A. HESSEL and M. NORMAN, "Financial Characteristics of Neglected and Institutionally Held Stocks", 7 *J. Acct. Aud. & Fin.* 313 (1992); J. LAKONISHOK and others, "The Impact of Institutional Trading on Stock Prices", 32 *J. Fin.* 23 (1992); F. REILLY, "A Three-Tier Stock Market and Corporate Finance", 4 *Fin. Mgmt.* 7 (Autumn 1975).

211 See, for example: *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 Instrument – Mutual Funds 81-102", (1999) 22 *O.S.C.B.* (Supp. 2) 105, s. 2.2 (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.

cultural factors, following more conservative investment policies[212]. 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[213].

Furthermore, the securities of small issuers tend to have a relatively low liquidity[214]. The low liquidity of small firm securities imposes an implicit trading tax that raises the cost of investing in small firms and influences negatively the level of institutional ownership[215]. 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

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212 Raymonde CRÊTE et Stéphane ROUSSEAU, "De la passivité à l'activisme des investisseurs institutionnels au sein des corporations: le reflet de la diversité des facteurs d'influence", (1997) 42 *McGill L.J.* 863, 937-939.

213 A. BRAV and P.A. GOMPERS, *loc. cit.,* note 207, 1809, 1819 and 1820; R. BUCKLAND and E.W. DAVIS, *The Unlisted Market*, Oxford, Clarendon Press, 1989, p. 14 and 15; J.G. MACINTOSH, *loc. cit.,* note 201, 435.

214 See in general: K.H. CHUNG and others, "Production of Information, Information Asymmetry, and the Bid-Ask Spread: Empirical Evidence from Analysts' Forecasts", 19 *J. Bank. & Fin.* 1025 (1995); E.W. DAVIS, "The Stock Exchange and the Unlisted Securities Market", in R. BUCKLAND and E.W. DAVIS, *op. cit.,* note 5, p. 134-136; J.G. MACINTOSH, *loc. cit.*, note 201, 435.

215 Paul Alan GOMPERS and Andrew METRICK, *How Are Large Institutions Different from Other Investors? Why Do These Differences Matter?*, Cambridge, Harvard University and National Bureau of Economic Research, Working Paper, 1998, p. 16 and 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, for example: Y. AMIHUD and H. MENDELSON, "Liquidity and Asset Prices: Financial Management Implications", 17 *Fin. Mgmt.* 5 (1988); J. HASBROUCK and R.A. SCHWARTZ, "Liquidity and Execution Costs in the Equity Markets", *J. Port. Mgmt.* 10 (1986).

costs[216]. 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[217].

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[218]. 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 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"[219]. Accordingly, while it is true that institutions favour securities that are marketable, *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. Given the failure of tax incentives such as Québec Stock Savings Plan in

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216 P.A. GOMPERS and A. METRICK, *op. cit.*, note 215, p. 10 and 11. On the turnover of institutional portfolios, see: K.A. FROOT and others, "Shareholder Trading Practices and Corporate Investment Horizons", 5:2 *J. Ap. Corp. Fin.* 42 (1992).

217 G. BANNOCK, *op. cit.*, note 17, p. 20 and 21; C.A. HESSEL and M. NORMAN, "Financial Characteristics of Neglected and Institutionally Held Stocks", 7 *J. Acct. Aud. & Fin.* 313 (1992); J. LAKONISHOCK and others, *loc. cit.*, note 210 (97 per cent of institutional purchases confined to the largest quintiles of the NYSE, AMEX and OTC firms); F. REILLY, *loc. cit.*, note 210.

218 W.L. MEGGINSON and K.A. WEISS, *loc. cit.*, note 136, 892.

219 J. MACEY and H. KANDA, "The Stock Exchange as a Firm: The Emergence of Close Substitutes for the New York and Tokyo Stock Exchanges", 75 *Corn. L. Rev.* 1007, 1017 and 1018 (1990).

this respect[220], 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.

E. Summation

The foregoing analysis reveals the existence of disincentives preventing issuers 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 which 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, 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, and rather focus on ensuring that there are no legal hurdles to the operations of information intermediaries.

A final feature of the small firm IPO market uncovered by the above analysis is the low level of institutional investments in smaller issuers. The reluctance of institutional investors to purchase

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220 The use of tax incentives has been proposed by various commentators; see: P. JOHNSTON, *Nothing Ventured – Investing in Canada's Winners*, Toronto, Toronto Stock Exchange, 1980, p. 62; G. BANNOCK, *op. cit.*, note 17, p. 137. On the failure of the Quebec Stock Savings Plan, see: Jean-Marc SURET and Élise CORMIER, "The Quebec Stock Savings Plan: Overview and Assessment", in P.J.N. HALPERN, *op. cit.*, note 8, p. 525.

securities in smaller offerings, which partly explains the disinterest of securities analysts toward SMEs securities, 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 ensure that SMEs going public have access to a liquid secondary market for trading their securities, rather than attempt to subsidise institutional investments.

III. Re-engineering Initial Public Offering Regulation for Small and Medium-sized Enterprises

The regulatory framework governing IPOs can impose significant compliance costs on issuers. The expenses generated by regulation can be especially burdensome for SMEs because of their high fixed-cost component. The combination of the regulatory costs with the costs arising out of 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.

The guiding principle underlying the revision of the regulatory regime should be cost-effectiveness, as recognised the Ontario Securities Commission Task Force on Small Business Financing in its 1996 Report:

> *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.*[221]

Thus, any case for policy intervention should 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. Likewise, given that the high cost of public equity is not only

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[221] ONTARIO SECURITIES COMMISSION, Task Force on Small Business Financing, *Final Report*, Toronto, 1996, p. 16 (hereinafter "*Task Force Report*").

the product of market imperfections, but also caused by regulation, the revision of the regulatory regime should seek to eliminate policies that impair market efficiency. This requires determining whether the benefits generated by the policies reviewed are greater than the costs they impose.

In this respect, it is worth underlying the uncertainty surrounding the effectiveness of mandatory disclosure regulation, which is the keystone of IPO legislation, in enhancing informational efficiency. According to the accuracy enhancement theory put forward to justify mandatory disclosure[222], the principal benefits of disclosure regulation accrue to investors in two ways[223]. Firstly, it may enable investors to assess more accurately the value of issuers and thereby increase their returns. Secondly, it may reduce the risks of investments by permitting investors to evaluate with greater certainty expected returns. However, empirical studies cast doubts on the significance of both of those alleged benefits. Research conducted in the United States shows that following the enactment of the *Securities Act of 1933*, there was no significant increase in securities prices, a finding that suggests that the introduction of mandatory disclosure requirements did not enhance investors' returns[224]. And while studies note that the variance of IPO securities prices declined significantly after the enactment of the 1933 Act, the most plausible interpretation of this result is that mandatory disclosure prevented higher risk issuers from accessing the public equity market[225].

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222 M.B. FOX, *loc. cit.,* note 47, 2544-2550; R.J. GILSON and R.H. KRAAKMAN, *loc. cit.*, note 93; M. KAHAN, "Securities Laws and the Social Costs of 'Inaccurate' Stock Prices", 41 *Duke L.J.* 977 (1992).

223 R. ROMANO, "Empowering Investors: A Market Approach to Securities Regulation", 107 *Yale L.J.* 2359, 2376 and 2377 (1998).

224 G.A. JARRELL, "The Economic Effects of Federal Regulation of the Market for New Security Issues", 24 *J. of Law & Econ.* 613 (1981); C.J. SIMON, "The Effect of the 1933 Securities Act on Investor Information and the Performance of New Issues", 79 *Amer. Econ. Rev.* 295 (1989); G.J. STIGLER, "Public Regulation of Securities Markets", 37 *J. Bus.* 117 (1964). These three studies are the subject of a flurry of criticism. Most notably, see: I. FRIEND and E.S. HERMAN, "The S.E.C. Through a Glass Darkly", 37 *J. Bus.* 406 (1964); I. FRIEND and R. WESTERFELD, "Required Disclosure and the Stock Market: Comment", 65 *Amer. Econ. Rev.* 467 (1975); F. OKCABOL and T. TINKER, "Dismantling Financial Disclosure Regulations: Testing the Stigler-Benston Hypothesis", 6 *Acct. Aud. & Accountability J.* 10 (1993).

225 G.A. JARRELL *loc. cit.*, note 224; C.J. SIMON, *loc. cit.*, note 224; G.J. STIGLER, *loc. cit.*, note 224; see also: R. ROMANO, *loc. cit.,* note 223, 2377.

In this context, this section 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 Ontario Securities Commission to review the legislative framework governing the raising of equity capital by SMEs. In its 1996 report, the Task Force proposed substantial modifications to the *Securities Act* to increase the accessibility of private and public equity financing to smaller enterprises[226]. This section presents, criticises and supplements the proposals contained in the Task Force Report, which address the most important aspects of the going public process, in light of the general goal to implement a cost-effective regulatory regime governing SMEs IPOs.

A. The Elaboration of a Small Business Prospectus to Simplify Disclosure

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[227]. 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[228]. While there are several criteria commonly used to define an SME, gross revenues remain the easiest criterion to use to measure the size of enterprise. Since this threshold is quite high, most SMEs should be able to meet it[229].

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226 *Task Force Report*, *op. cit.*, note 221, p. 16. Following the presentation of the Report, the Securities Commission decided not to implement the recommendations of the Task Force, preferring to follow a piecemeal approach to the question of SME financing; see: ONTARIO SECURITIES COMMISSION, *Annual Report 1997-1998*, Toronto, 1998, p. 12.

227 ONTARIO SECURITIES COMMISSION TASK FORCE ON SMALL BUSINESS FINANCING, *Proposal for Comment*, Toronto, Queen's Printer, 1995, p. 71 (hereinafter "*Task Force Proposals*").

228 *Id.*, p. 18-20.

229 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. HOUSE OF COMMONS STANDING

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"[230]. 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[231]. 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 *ex ante* uncertainty of an offering, is found to decrease with the size of the gross proceeds from the offering[232]. 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

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COMMITTEE ON INDUSTRY, *Taking Care of Small Business*, Ottawa, Supply and Services, 1994, Appendix A.

230 *Task Force Report*, *op. cit.*, note 221, p. 78.

231 Letter from Borden & Elliot, dated October 10, 1995, in response to request for comments, p. 4.

232 P.M. CLARKSON and J. MERKLEY, *loc. cit.*, note 72, 59 and 60.

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.

1. 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. 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[233]. The limited relevance of information 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 three years, the occupations of directors and officers over the past five years, and the financial statements of the last three financial years[234].

There is reason to believe that firms incur unnecessary costs to disclose historical information. This information is generally of limited relevance to investors – unsophisticated or sophisticated –

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233 H. KRIPKE, "A Search for a Meaningful Securities Disclosure Policy", 31 *Bus. Law.* 293 (1975); H. KRIPKE, "New Approaches to Disclosure in Registered Security Offerings – A Panel Discussion", 28 *Bus. Law.* 505 (1973); B.A. MANN, "Prospectuses Unreadable or Just Unread? – A Proposal to Reexamine Policies Against Permitting Projections", 40 *Geo. Wash. L. Rev.* 222 (1971); A.R. RODIER, *loc. cit.*, note 80; C.W. SCHNEIDER, "Nits, Grits, and Soft Information in SEC Filings", 121 *U. Pa. L. Rev.* 254 (1972).

234 *Supra*, notes 24 and 25 and related text.

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[235]. 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, the timing of cash transactions, and the risk that the return will be different than expected[236].

To the extent that it is suggestive of future performance, historical data arguably remain relevant to these inquiries[237]. 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[238]. 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.

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 requires 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 three financial years[239]. This would codify the waiver that the Director generally grants in similar circumstances[240]. Although issuers would still have to include in the prospectus an audited balance sheet for the most recently completed financial year, the

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235 T.J. FIFLIS, "Soft Information: The SEC's Former Exogenous Zone", 26 *UCLA L. Rev.* 95, 99-104 (1978).

236 Note, "Disclosure of Future-Oriented Information Under the Securities Laws", 88 *Yale L.J.* 338, 341 (1978); see also: B.A. MANN, *loc. cit.*, note 233, 223 and 224.

237 See however: H. KRIPKE, *loc. cit.*, note 233, 298. Historical information is totally irrelevant to a current or prospective investor.

238 Note, *loc. cit.*, note 236, 341-350.

239 *Task Force Report*, *op. cit.*, note 221, p. 74.

240 *Id.*; see: *O.S.R.*, *supra*, note 22, s. 53(6).

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[241]. Similarly, liberal requirements would apply to historical financial information pertaining to significant acquired businesses.

The Task Force proposes that historical information be replaced by more detailed disclosure concerning forward-looking information such as business plans, obstacles anticipated in realising business goals and overall strategy[242]. For example, small issuers should be compelled to disclose the intended use of all of their available capital rather than just the proceeds of the offering. 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 involve 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[243]. 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[244]. 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

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241 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, *op. cit.*, note 32, p. 5.

242 *Task Force Report*, *op. cit.*, note 221, p. 72 and 73.

243 G.M. STAKIAS and J.E. HARRIS, "Simplifying Registration of Small Corporate Offerings: Form U-7 'SCORs'", 6:7 *Insights* 13, 14 (1992).

244 *Task Force Report*, *op. cit.*, note 221, p. 74.

situation, as argued by the Task Force. Indeed, "there is little value in comparing information prepared using different standards"[245].

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 so when they consider it to be beneficial, that is when the financial statements will convey relevant information to investors.

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[246], adequate safeguards exist to protect investors from such abuse[247]. 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. 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.

2. Simplifying the Presentation of Information

The Task Force proposes that the Small Business Prospectus Form uses 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[248]. The central rationales, which underlie the

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245 Letter from D.M. Hyndman, Chair, British Columbia Securities Commission, dated September 26 1995 (on file with the author), Appendix A, p. 13.

246 *Id.*

247 P.M. CLARKSON, A. DONTOH, G. RICHARDSON and S.E. SEFCIK, "The Voluntary Inclusion of Earnings Forecasts in IPO Prospectuses", 8 *Contemp. Acct. Res.* 601 (1992). Investors are not misled by forecasts and discount the expected bias likely to taint forecasts.

248 *Task Force Report*, *op. cit.*, note 221, p. 76. On the Small Corporate Offering Registration Form, see: D.R. HARRIS, "Introduction to the Review of

development of this format, are the simplification of the disclosure process and the reduction of the costs of preparing the prospectus[249].

The new prospectus would be designed to be completed by an entrepreneur armed with a basic business plan and with only limited professional assistance. 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[250]. These instructions would allow entrepreneurs, attorneys and accountants, who are not experienced securities professionals, to structure the prospectus 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[251]. In the United States, this format has helped a large number of issuers to file their SCOR registrations without the benefit of counsel[252]. 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[253]. 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

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Developments in State Securities Regulation", 47 *Bus. Law.* 271 (1991); R.S. JANVEY, "The SEC's Small Business Initiatives: Regulatory Reform or Shabby Conduct?", 21:4 *Sec. Reg. L.J.* 4 (1993); H.H. MAKENS and J.E. HARRIS, "Blue Sky Practice Part II: Small Corporate Offering Registration-Form U-7", *ALI-ABA* 378 (1995); G.M. STAKIAS and J.E. HARRIS, *loc. cit.*, note 243, 14.

249 M.A. SARGENT, "Blue Sky Law: The SCOR Solution", 18 *Sec. Reg. L.J.* 93, 98 and 99 (1990).

250 *Task Force Report*, *op. cit.*, note 221, p. 76 and 77.

251 *Id.*, p. 55.

252 G. M. STAKIAS and J.E. HARRIS, *loc. cit.*, note 243, 13 and 14.

253 *Id.*, 14; Letter from D.J. Hudson, President and Chief Executive Officer, Vancouver Stock Exchange, dated September 25, 1995, in response to request for comments, p. 6.

some form of professional assistance[254]. Professional fees would be nevertheless reduced if securities professionals were involved as shown by the American experience where 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[255].

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[256]. This format, just by including questions, arguably provides information to the reader, regardless of whether the corresponding answer is affirmative or negative[257]. 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[258]. 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.

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[259]. Indeed, it is difficult for retail investors to comprehend the products or competitive position of

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254 Letter from Aird and Berlis, dated October 6, 1995, in response to request for comments, p. 5 and 6. Several U.S. jurisdictions have discouraged filings of SCOR registration without the help of securities professionals. G. M. STAKIAS and J.E. HARRIS, *loc. cit.*, note 243.

255 G. M. STAKIAS and J.E. HARRIS, *loc. cit.*, note 243, 14.

256 *Task Force Report*, *op. cit.*, note 221, p. 77.

257 G. M. STAKIAS and J.E. HARRIS, *loc. cit.*, note 243, 13.

258 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 and J.E. HARRIS, *loc. cit.*, note 248, 379.

259 J. AZZI, "Disclosure in Prospectus", 9 *Com. & Sec. L.J.* 205, 207-210 (1991); M. COHEN, "Truth in Securities Revisited", 79 *Harv. L. Rev.* 1352 and 1353 (1966); H. KRIPKE, *loc. cit.*, note 233, 1164-1170; A.R. RODIER, *loc. cit.*, note 80, 35-42.

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 of modern disclosure is accounting", investors can have some difficulties understanding the financial statements of issuers[260].

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"[261]. 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[262]. The brochure would also provide practical guides to analyse the information disclosed in the form.

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260 H. KRIPKE, "A Search for a Meaningful Securities Disclosure Policy", *loc. cit.*, note 233.

261 P.K. HOWARD, *Report of the Task Force on Disclosure Simplification*, Washington, Securities and Exchange Commission, 1996, p. 21 (hereinafter "*Task Force on Disclosure Simplification*").

262 H.H. MAKENS and J.E. HARRIS, *loc. cit.*, note 248, 384. The states of Arizona and Washington require that investors be provided with 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.

The standardisation of the content of the brochure would reduce its costs for the securities commissions and involve no cost for issuers.

Finally, it is worth emphasising that the changes proposed to the prospectus form could 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[263]. Indeed, much of the difficulty and the costs of preparing a prospectus stem from the necessity to avoid misrepresentations. This question will be examined further below[264].

3. 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[265]. The delivery of the prospectus to investors is considered to be necessary or beneficial to assure that information about the 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[266].

Compliance with this obligation imposes significant costs on companies that may not be justified according to several commentators who advocate the elimination of this requirement for small issuers[267]. For instance, professor MacIntosh argues that the benefits of delivering the prospectus to all buyers are limited since

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263 Letter from MM. Atlas, Baker and McKenzie, dated September 15, 1995, in response to request for comments, p. 13 and 14; Letter from Aird and Berlis, *op. cit.*, note 254, p. 7.

264 *Infra*, notes 312-324 and related text.

265 O.S.A., *supra*, note 18, s. 71(1); V.P. ALBOINI, *Securities Law and Practice*, Toronto, Carswell, loose leafs, § 16.7.1.

266 Note, "Comparing U.S. and Hong Kong Public Offering Regulation: How Cost-Effective Is China's Primary Capital Market", 69 *S. Cal. L. Rev.* 1821, 1873 (1996); L.C. QUINN, "Reforming The Securities Act of 1933: A Conceptual Framework", 10 *Insights* 25, 27 (1996).

267 *Financing Innovative Enterprise*, *op. cit.*, note 6, p. 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: *id.*, p. 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. WEISDORF, *Going Public and the Public Equity Market*, Toronto, CICB – Wood Gundy, 1996, p. 19.

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: "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"[268]. 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)[269]. 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[270]? 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

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268 *Financing Innovative Enterprise*, *op. cit.*, note 6, p. 125.

269 *Task Force Report*, *op. cit.*, note 221, p. 84. See: CANADIAN SECURITIES ADMINISTRATORS, "SEDAR Filer Manuel – Version 2.0", (1996) 19 OS.C.B. 39 (Supp.); J. Mark DESLAURIERS, "SEDAR: An Overview of the Canadian Securities Administrators' System for Electronic Document Analysis and Retrieval", in Lazar SARNA, *Corporate Structure, Finance and Operations*, vol. 10, Toronto, Carswell, 1997, p. 143.

270 L.C. QUINN, *loc. cit.*, note 266, 27 and 28.

of the prospectus. 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 *ex ante* uncertainty surrounding issuers and diminish the extent of underpricing.

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 over-pricing 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.

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 mandatedand of delivering the prospectuswould fall onunderwriters 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 asexempt purchasers under the private placement exemptions[271]. This obligation would reduce the costborn bysmall issuersby diminishing

[271] O.S.A., *supra*, note 18, s. 72(1)c).

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 SEDARand the developmentsof information technologywill however mandate close supervision to determine at what point a sufficient number of retail investors have access to the electronic information to mandate thedelivery of theprospectus only upon investor request.

B. The Need to Enhance Information Flows in the Initial Public Offering Market

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, 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.

1. 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 prior to 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 marketing activities, such as the solicitation of expressions of interest from potential investors, during the pre-filing period, since these activities can be considered to be in furtherance of a trade[272].

Two rationales support the rule prohibiting solicitation of expressions of interest from potential investors[273]. A first rationale

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[272] G.R.D. GOULET, *op. cit.*, note 18, par. 7700; J.C. SMART and P.L. OLASKER, *loc. cit.*, note 28, 229.

[273] For an exhaustive presentation of the evolution of the rule in the U.S., see: E.A. CHIAPPINELLI, "Gun Jumping: The Problem of Extraneous Offers of Securities", 50 *U. Pitt. L. Rev.* 457 (1989); see also: B. LONGSTRETH and J.B. PRAGER, "Gun Jumping Revisited: A Proposal to Prevent False Starts in Private Offerings", 21 *Sec. Reg. L.J.* 235 (1992).

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[274]. A second rationale is that the rule ensures that all investors have equal access to the new equity offerings[275].

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. 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[276]. If the issue fails due to lack of 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[277]. Permitting issuers to test the waters would also 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.

Finally, 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

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274 M.R. GILLEN, *op. cit.*, note 20, p. 100.

275 *Financing Innovative Enterprise*, *op. cit.*, note 6, p. 127 and 128.

276 P.S. JOHNSON, "The SEC's Small Business Initiatives and Regulation A : New Life for an Old Exemption?", 13 *J.L. & Com.* 157, 175 (1993); R.S. JANVEY, *loc. cit.*, note 248, 23.

277 J.F. DANIELS, "Comparing U.S. and Hong Kong Public Offering Regulation: How Cost-Effective is China's Primary Capital Market?", 69 *S. Cal. L. Rev.* 1821, 1851 (1996); *Financing Innovative Enterprise*, *op. cit.*, note 6, p. 128; see also: L.A. STOUT, "Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation", 81 *Va. L. Rev.* 611, 658, note 236 (1995). (Lengthening the distribution period would allow issuers to sell their IPOs at 'at-the-market' prices.)

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[278].

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[279]. 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[280]. 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[281]. Moreover, it is probable that the sophisticated investors in the market know more about factors that affect the price of an

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278 N.D. LOBELL, "Revision of the Securities Act", 48 *Col. L. Rev.* 313, 320-322 (1948); J.F. DANIELS, *loc. cit.*, note 277, 1859 and 1860 (making a similar argument for the Hong Kong regulation in the waiting period).

279 *Task Force Report*, *op. cit.*, note 221, p. 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, *loc. cit.*, note 248, 23 and 24; see also: "Solicitations of Interest Prior to an Initial Public Offering", Securities Act Release 7188 (June 27, 1995), 60 FR 35648 (July 10, 1995); NASAA, "Proposed Statement of Policy on Solicitation of Interest (Testing the Waters)", *NASAA Reports*, Chicago, CCH, 1994, par. 4141.

280 *Financing Innovative Enterprise*, *op. cit.*, note 6, p. 128.

281 L.M. BENVENISTE and W.J. WILHELM, "A Comparative Analysis of IPO Proceeds Under Alternative Regulatory Environments", 28 *J. Fin. Econ.* 173, 177 (1990).

offering[282]. By canvassing institutions, underwriters can therefore collect indication of interest and discover information that will influence the price of the securities[283]. 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 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[284]. This should make it easier for retail investors to identify good issues and could reduce the underpricing of new issues.

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"[285]. 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

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282 For example, institutional investors can have information about a competitor that could influence the value of a issuer's product. L.M. BENVENISTE and P.A. SPINDT, *loc. cit.*, note 116, 344-346; K. ROCK, *loc. cit.*, note 64, 190.

283 L.M. BENVENISTEand P.A. SPINDT, *loc. cit.*, note 116; L.M. BENVENISTE and W.J. WILHELM, *loc. cit.*, note 281; see also: C. SPATT and S. SRIVASTAVA, "Preplay Communication, Participation Restriction, and Efficiency in Initial Public Offerings", 4 *Rev. Fin. St.* 709 (1991).

284 K. ROCK, *loc. cit.*, note 64, 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."

285 *Financing Innovative Enterprise*, *op. cit.*, note 6, p. 128.

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[286]. 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 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. This would ensure that investors have access to adequate information before committing themselves. Furthermore, as the Task Force recommends, pre-marketing materials should be explicitly prohibited from being misleading[287]. Thus, although no statutory liability would attach to those materials, the distribution of misleading materials would be a factor considered by the Director in the exercise of the discretion pursuant to clause 61(2) of the *Securities Act* as to whether to issue a receipt for a prospectus.

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[286] This is proposed also in the *Task Force Report*, *op. cit.*, note 221, p. 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, *op. cit.*, note 245, Appendix A, p. 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*, *supra*, note 279; NASAA, *op. cit.*, note 279; R.S. JANVEY, *loc. cit.*, note 248, 20-27; see also: E.A. CHIAPPINELLI, *loc. cit.*, note 273, 492-496.

[287] *Task Force Report*, *op. cit.*, note 221, p. 83

2. Advertising Restrictions during the Waiting Period

The Task Force does not address in its proposals the strict limitations imposed by the *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[288]. 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[289].

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 restricts the possibility of issuers using the media to present relevant information about their offerings in salient form[290]. 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

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288 O.S.A., *supra*, note 18, ss. 65(2); "Uniform Act Policy Statement No. 2-13", in *Canadian Securities Law Reporter*, North York, CCH Canadian Ltd., loose leaf, par. 80-262; see generally: V.P. ALBOINI, *op. cit.,* note 265, § 16.1.1.

289 M.R. GILLEN, *op. cit.,* note 20, p. 108; J.C. SMART and P.L. OLASKER, *loc. cit.,* note 28, 229.

290 ONTARIO SECURITIES COMMISSION, "Notice – Advertising and Use of Marketing Material During the Waiting Period", in *Canadian Securities Law Reporter*, *op. cit.,* note 288, par. 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", 11 *O.S.C.B.* 1098 (1988). No views should be given to the financial media by management; see also: *Re Cambior*, (1986) 9 *O.S.C.B.* 3225, 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."

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[291]. In this respect, it is worth noting that while issuers are allowed to maintain their normal advertising and public relations activities[292], 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[293].

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[294]. Advances in information technology offer vast opportunities for issuers to reduce the information acquisition costs of prospective investors and improve thereby the information environment of the IPO market[295]. 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[296].

The restrictions may also have some adverse impact on investor confidence by contributing to the maintenance of an information grey market that fosters the unequal access of information between institutional and investors[297]. The unrestricted ability to engage in oral selling efforts once the preliminary prospectus is filed leads to

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291 E.A. CHIAPPINELLI, *loc. cit.,* note 273, 499; B.A. MANN, *loc. cit.,* note 233, 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", 12 *O.S.C.B.* 2641 (1989).

292 GOODMAN and GOODMAN, *The IPO Process*, Toronto, 1994, Appendix C, p. 17.

293 See: J. William HICKS, "Protection of Individual Investors Under U.S. Securities Laws: The Impact of International Regulatory Competition", 1 *Ind. J. Global L. Stud.* 431, 446 (1994).

294 See generally: R.J. GILSON and R.H. KRAAKMAN, *loc. cit.,* note 93, 597-609.

295 S.J. CHOI, "Gatekeepers and the Internet: Rethinking the Regulation of Small Business Capital Formation", 2 *J. Small & Emerging Bus. L.* 27, 43-54 (1998); J.E. FISCH, "Can Internet Offerings Bridge the Small Business Capital Barrier?", 2 *J. Small & Emerging Bus. L.* 57 (1998); A.C. GAVIS, "The Offering and Distribution of Securities in Cyberspace: A Review of Regulatory and Industry Initiatives", 52 *Bus. Law.* 317, 363-373 (1996).

296 D.C. LANGEVOORT, *loc. cit.,* note 49, 760 and 761.

297 P.L. ZWEIG and N.L. SPIRO, "Beware of the IPO market", *Business Week*, April 4, 1994, 84 (describing various forms of the information grey market).

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 questions are answered and management is fully evaluated"[298]. 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[299]. It is certainly ironic that for investor protection purposes, it is necessary to create unequal access 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[300]. 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 information more widely and instantaneously accessible[301]. Thus, information outside of the mandated disclosure package is readily available to and accessible

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298 M.A. WEISDORF, *Going Public and the Public Equity Market*, Toronto, CIBC – Wood Gundy, 1996, p. 15; see also: "Interim Report of the Committee on Corporate Disclosure", (1996) 19 *O.S.C.B.* 8, 25. Analysts indicate that discussion with management is a source of information when dealing with smaller companies.

299 S.N. ALLEN, "A Lawyer's Guide to the Operation of Underwriting Syndicates", 26 *New Eng. L. Rev*. 319, 340 and 341 (1991); *Task Force on Disclosure Simplification*, *op. cit.,* note 261, p. 26 and 27.

300 L.C. QUINN, *loc. cit.,* note 266, 27; see, for example: DOW JONES NEWSWIRE, "SEC gives nod to Internet Road Show", *The Globe and Mail*, September 9, 1997, B16.

301 *Task Force on Disclosure Simplification*, *op. cit.,* note 261, p. 33 and 34.

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[302]. The recent 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.

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[303]. 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[304].

It is suggested 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

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302 D.C. LANGEVOORT, *loc. cit.*, note 49, 757.

303 The Canadian Securities Administrator have published a Draft National Policy which would permit under certain conditions the use of advertising material. See: CANADIAN SECURITIES ADMINISTRATOR, "Draft National Policy Statement No. 43 – Advertisements of Securities and Related Sales Practices", 17 *O.S.C.B.* 5133 (1994) (hereinafter "*NP43*").

304 L.C. QUINN, *loc. cit.*, note 266, 26-28.

information that is not disclosed in the prospectus[305]. To ensure the enforcement of these principles, the Commission should have the authority to intervene to prohibit the dissemination of information that is misleading or prejudicial to the public interest[306].

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 investors. 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"[307]. 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"[308]. 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.

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305 *NP43*, *loc. cit.*, note 303, par. 4.4.
306 See the proposed *NP43*, *loc. cit.*, note 303, par. 4.1.
307 E.A. CHIAPPINELLI, *loc. cit.*, note 273, 510 and 511.
308 J.F. DANIELS, *loc. cit.*, note 277, 1871.

3. Liability Issues 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"[309]. This obligation is reinforced by a statutory civil action provided to purchasers of securities against certain persons for a misrepresentation in a prospectus[310]. 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 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.

Several commentators argue that the liability rule represents a powerful countervailing force to the simplification of the disclosure process[311]. 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. Likewise, they stress that liability concerns may lead underwriters to insist on disclosure beyond that required by the SBPF.

a. The Impact of Issuer Liability on the Simplification of Prospectus Disclosure

The liability rule complements the market-based incentives that work imperfectly in driving issuers to disclose full, true and plain information to the market. It 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[312]. In corollary, liability reduces the precaution costs that investors must

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309 O.S.A., *supra*, note 18, s. 56(1).

310 *Id.*, s. 130. 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.

311 See: Letter from MM. Atlas, Baker and McKenzie, *op. cit.*, note 263, p. 13 and 14; Letter from L.A. Manning, Canadian Bar Association – Ontario, dated October 2, 1995, in response to request for comments, p. 4.

312 F.H. EASTERBROOK and D.R. FISCHEL, *loc. cit.*, note 42, 677.

incur to "uncover fraud so as to avoid entering into bargains they would not have concluded in an honest market"[313].

The liability rule can however constitute a serious barrier to the simplification of disclosure contemplated by the implementation of the SBPF. In particular, if issuers are to 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 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. 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[314]. The seminal case of *TSC Industries Inc.* v. *Northway Inc.* established an important principle concerning the materiality of omitted facts[315]. In this case, the U.S. Supreme Court held that the determination of whether an omission concerns a material fact should not be made in isolation, but rather in light of all other information available to investors[316]. More particularly,

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313 P.G. MAHONEY, "Precaution Costs and the Law of Fraud in Impersonal Market", 78 *Va. L. Rev.* 623, 630 (1992).

314 O.S.A., *supra*, note 18, s. 1(1) "material fact".

315 A cursory examination of the materiality standard in the United States may suggest that it is different from the Canadian standard. Following *TSC Industries Inc.* v. *Northway Inc.*, 96 S. Ct. 2126 (1976), 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, as Anisman stresses: "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." Letter from Philip Anisman to Daniel P. Iggers, dated December 22 1997 in response to request for comment 51-901 [en ligne: www.tsers.com].

316 See also: S. DOLAN, "*United Paperworks International Union* v. *International Paper Company*: Environmental Disclosure and the Total Mix Concept of Materiality", 49 *Bus. Law.* 1225, 1228-1230 (1994); F.H. EASTERBROOK and D.R. FISCHEL, *loc. cit.*, note 42, 706.

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"[317]. In other words, the inquiry should seek to establish whether 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.

The standard developedin *TSCIndustries Inc.* would provide little protectionagainst liabilityforomissions for issuersusingtheproposed small business prospectusform.Indeed, unlikein *TSCIndustriesInc.* where thecourtfound that somuch information was containedin the Securities andExchangeCommission's forms and schedules that the omitted information could not have influenced the decision of a reasonable investor[318], 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.

The risk of liability for omissions in connexion with the SBPF would create strong incentives to continue to provide a level of disclosure similar to that provided under the standard prospectus, undermining thereby 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[319]. In this respect, the creation of a general

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317 *TSC Industries Inc.* v. *Northway Inc.*, *supra,* note 315, 448. For a recent application of the standard, see: *In re Apple Computer Sec. Litig.*, 886 F.2d 1109 (9th Cir. 1989).

318 *TSC Industries Inc.* v. *Northway Inc.*, *supra*, note 315, 452.

319 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, par. 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."

"safe harbour" for omissions constitutes an interesting form of protection.

The enactment of a safe harbour for omissions requires making a distinction between two broad categories of information that are subject to omissions by issuers: positive information and negative information. The first category concerns 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.

Given the uncertainty surrounding the benefits of mandating the disclosure of competition-sensitive information, many have argued that some level of discretion should be left to issuers to determine the opportunity of disclosing proprietary information[320]. 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. Professor Langevoort has proposed that such a safe harbour should 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 signalling the company's intentions to marketplace competitors"[321].

The second category of information subject to omissions encompasses information whose disclosure would result in depreciation in the price or value of the securities issued.[322] 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

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320 J.R. MACEY and G.P. MILLER, "Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory", 42 *Stan. L. Rev.* 1059 (1990); E.W. KITCH, *loc. cit.*, note 46, 846-874; D.C. LANGEVOORT, *loc. cit.*, note 49, 791.

321 D.C. LANGEVOORT, *loc. cit.*, note 49, 772.

322 See, for example: *In re Apple Computer Sec. Litig.*, *supra*, note 317.

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. 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 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[323]. 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 professor Edward Kitch has underlined[324]. 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.

b. The Liability of Underwriters

The *Securities Act* imposes liability upon the underwriter for any misrepresentation in the prospectus[325]. 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

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323 D.C. LANGEVOORT, *loc. cit.,* note 49, 773 and 774.
324 E.W. KITCH, *loc. cit.,* note 46.
325 O.S.A., *supra*, note 18, s. 130.

misrepresentation[326]. This defence, known as due diligence, creates an affirmative duty for the underwriter to verify the accuracy of disclosures relating to the securities offered[327].

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"[328]. In addition, the underwriter possesses the control of the distribution process to pressure the issuer to disclose adequate and truthful information[329]. If it does not agree with the information contained in the 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[330].

The Task Force on Small Business Financing recommends the elimination of the liability of underwriters for misrepresentations in an SME prospectus[331]. 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.

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326 *Id.*, s. 130 (4), (5). See: V.P. ALBOINI, *op. cit.,* note 265, § 23.1.4-23.1.12; M.R. GILLEN, *op. cit.,* note 20, p. 131-139; G.R.D. GOULET, *op. cit.,* note 18, p. 231-241.

327 D.C. LANGEVOORT, *loc. cit.,* note 49, 769; G.R.D. GOULET, *op. cit.*, note 18, p. 238; J.F. SEEGAL, "Due Diligence Procedures in Initial Public Offerings", 939 *PLI/Corp.* 335 (1996).

328 M.P. DOOLEY, "The Effects of Civil Liability on Investment Banking and the New Issues Market", 58 *Va. L. Rev.* 777, 786 (1972); see also: *A.E. Ames & Co. Limited*, [1972] O.S.C.B. 98, 112 and 113; *Escott* v. *BarChris Construction Corp.*, 283 F. Sup. 643, 696 (S.D.N.Y. 1968); D.M. GREEEN, "Due Diligence under Rule 415: Is the Insurance Worth the Premium?", 38 *Emory L.J.* 793, 804 and 805 (1989).

329 E. FOLK, "Civil Liabilities Under the Federal Securities Acts: The *BarChris* Case", 55 *Va. L. Rev.* 1, 54 (1969); D.M. GREEN, *loc. cit.*, note 328, 805; L. NICHOLAS, "The Integrated Disclosure System and Its Impact Upon Underwriters' Due Diligence: Will Investors Be Protected", 11 *Sec. Reg. L.J.* 3, 10 and 11 (1983).

330 L. NICHOLAS, *loc. cit.*, note 329, 15. On the capacity and function of the underwriter, see: M.P. DOOLEY, *loc. cit.,* note 328, 784-792; E.F. GREENE, "Determining the Responsibilities of Underwriters Distributing Securities Within an Integrated Disclosure System", 56 *Notre Dame Law.* 755, 761-764 (1981).

331 *Task Force Report*, *op. cit.,* note 221, p. 102.

i. The Importance of Underwriter Liability in Reputation Building

From the perspective of the accuracy enhancement disclosure paradigm, due diligence plays a central role in enhancing the allocational efficiency of the stock market[332]. Due diligence is important because it forces the disclosure of more truthful information that improves pricing accuracy[333]. The function of underwriters is thus to act as a gatekeeper of the integrity of the offering rather than as a risk-bearer[334].

Although reputational concerns are instrumental in shaping the gatekeeping efforts of underwriters, as mentioned previously, there is a need for liability because reputation is a noisy signal[335]. Investors can only observe indirectly the underwriters' efforts through the price performance of the issues brought to the market. 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.

For professor Reinier 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"[336]. 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[337].

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332 M.B. FOX, "Rethinking Disclosure Liability in a Modern Era", 75 *Wash. U.L.Q.* 903, 1018-1022 (1997); P.G. MAHONEY, "Mandatory Disclosure as a Solution to Agency Problems", 62 *U. Chi. L. Rev.* 1047, 1105-1111 (1995).

333 M.B. FOX, *loc. cit.*, note 332, 1010; see also: S.P. FERRIS, J.S. HILLER, G.A. WOLFE and E.S. COOPERMAN, *loc. cit.*, note 168, 585.

334 J.C. COFFEE, *loc. cit.*, note 208, 1168-1171; R.H. KRAAKMAN, "Corporate Liability Strategies and the Costs of Legal Control", 93 *Yale L.J.* 857, 890-891 (1984).

335 R.H. KRAAKMAN, "Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy", 2 *J. Law. Econ. & Org.* 53, 96 and 97 (1986).

336 *Id.*

337 J.N. GORDON and L.A. KORNHAUSER, *loc. cit.*, note 201, 814 and 815, n. 138.

An additional benefit of liability is that the actual standard 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"[338].

ii. Limiting the Costs of Underwriter Liability

The costs imposed on underwriters by the liability regime consist of two elements[339]. 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[340]. 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[341].

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[342]. According to the Task Force, the current liability regime fails to strike this balance by imposing costs on issuers that are not justified given the benefits yielded by underwriter gatekeeping.

Undoubtedly, underwriter compensation is a significant burden for small issuers going public. It represents the largest single direct

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338 R.H. KRAAKMAN, *loc. cit.,* note 335, 99.

339 M.P. DOOLEY, *loc. cit.,* note 328, 840; R.H. KRAAKMAN, *loc. cit.*, note 335, 75-78.

340 M.P. DOOLEY, *loc. cit.*, note 328, 841. The impact of the costs generated by liability on underwriter compensation is limited by the competition which exists between investment vehicles.

341 *Id.*; R.H. KRAAKMAN, *loc. cit.,* note 335, 77.

342 M.P. DOOLEY, *loc. cit.*, note 328, 798; see also: D.C. LANGEVOORT, *loc. cit.,* note 49, 770.

expense of any IPO and appears to have a substantial fixed-cost component[343]. While apposite, the Task Force's critique lacks a substantive analysis of the operation of the liability regime. Such an analysis is clearly warranted in order to determine whether the regime is flexible enough to enable the underwriting industry to evolve toward the provision of more limited, less costly services, that reflect the changes that the small business prospectus form would introduce.

Because of the complexity of the misconduct targeted, the current liability standard does not provide specific duties, but rather enacts a rather broad duty of investigation to define the scope of the underwriter's monitoring role[344]. The 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[345]. Specifically, 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"[346].

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[347]. Therefore, it is likely that the standard of reasonableness must be interpreted in relation to the professional standards of the service offered. 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 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[348].

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343 M. ANDREWS, *loc. cit.*, note 38, 11; *Financing Innovative Enterprise*, *op. cit.*, note 6, p. 50.

344 *Escott* v. *BarChris Construction Corp.*, *supra*, note 328, 697.

345 R.H. KRAAKMAN, *loc. cit.*, note 335, 79-83; L.D. SODERQUIST, *Understanding the Securities Laws*, p. 188 and 189 (1987).

346 O.S.A., *supra*, note 18, s. 132.

347 V.P. ALBOINI, *op. cit.*, note 265, § 23.3.1; A.M. LINDEN, *Canadian Tort Law*, Toronto, Butterworths, 1988, 133. Kraakman reads *Escott* v. *BarCrhis Construction Corp.* as enshrining illustrative monitoring procedures indirectly "by imposing liability for ignoring a range of previously informal monitoring practices": R.H. KRAAKMAN, *loc. cit.*, note 335, 80.

348 R.H. KRAAKMAN, *loc. cit.*, note 335, 80; M.B. FOX, *loc. cit.*, note 332, 1031. The absence of professional standards has not precluded the crafting of due diligence

The deference of courts to industry practices implies that the due diligence standard can evolve to reflect changes in the services provided to issuers. Thus, if underwriters were to adjust their due diligence procedure to the particularities of the SBPF, the liability regime would not constitute, *per se*, a barrier to the reduction of underwriter compensation. Still, it is doubtful that established underwriters would modify their verification procedure upon the adoption of the SBPF. Indeed, the industry standard of due diligence does not depend solely on liability risk but also on the necessity to protect reputation[349]. Accordingly, underwriters with reputational capital are likely to continue to wish to avoid failing firms and will therefore maintain thorough investigations[350].

This does not mean that regulators should repel underwriter liability as the Task Force proposes. For the reasons stated above, the elimination of underwriter liability would probably not have a significant impact on the compensation of reputable underwriters who can provide valuable certification to small issuers. Rather, as discussed elsewhere, regulators should seek to foster the emergence of new information intermediaries that could harness technology to offer alternative certification services for smaller issuers[351].

C. Removing Legal Obstacles to Greater Use of Future-Oriented Financial Information

For small growing firms making an initial public offering, it is critical to provide prospective investors with some form of future-oriented information[352]. Indeed, the utility of these firms' past

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into model verification procedures. See, for example: V.P. ALBOINI, "Due Diligence and the Role of the Securities Lawyer", (1981-82) 6 *Can. Bus. L.J.* 241, 263-267; S.M. BECK, "The Role and Responsibilities of the Lawyer in the Securities Law Context", in *Recent Securities and Corporate Law Developments, Advice to My Client*, Toronto, Public Seminar of the Canadian Bar Association, May 8, 1980, p. I-135; GOODMAN and GOODMAN, *op. cit.*, note 292; J.F. SEEGAL, *loc. cit.*, note 327.

349 *Contra*: M.B. FOX, *loc. cit.*, note 332, 1030-1032.

350 Letter from Aird and Berlis, *op. cit.*, note 254, p. 16 and 17; Letter from MM. Atlas, Baker and McKenzie, *op. cit.*, note 263, p. 14 and 15.

351 Stéphane ROUSSEAU, "Internet-Based Securities Offerings by Small and Medium-sized Enterprises: Attractions and Challenges", (2001) 34 *C.B.L.J.* (forthcoming).

352 On the importance of forward-oriented information, see: T.J. FIFLIS, *loc. cit.*, note 235, 99-104; Note, *loc. cit.*, note 236, 339-343; SECURITIES AND EXCHANGE COMMISSION, "Safe Harbor For Forward-Looking Statements",

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.

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*")[353]. 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[354]. In ordinary circumstances, FOFI must not extent beyond the end of the issuer's next financial year, that is 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[355]. 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

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Release Nos. 33-7101, 34-34831, 35-26141, 39-2324, IC-20613, File No. S7-29-94 (www.sec.gov) (hereinafter "*Safe Harbor For Forward-Looking Statements*").

353 "Policy No. 48 – Future-Oriented Financial Information", in *Canadian Securities Law Reporter*, *op. cit.,* note 288, par. 80-048 (hereinafter "*NP48*"). The requirements of *NP48* apply to prospectuses, preliminary prospectuses, and to offering memoranda used in connection with exempt offerings. For an overview, see: N. CAMPBELL, "Compulsory Disclosure of "Soft" Information", (1993) 22 *C.B.L.J.* 321, 350-352; J.C. SMART and P.L. OLASKER, *loc. cit.,* note 28, 228; F.G. WITHERS, "Future-Oriented Financial Information", in INSIGHT, *Complying with Public Disclosure Requirements*, Toronto, Insight Press, 1994, p. 131. Note that *NP48* will be replaced shortly by "National Instrument 52-101 – Future-Oriented Financial Information", (1997) 20 *O.S.C.B.* 3749 (hereinafter "*NI52-101*"), which does not modify it significantly.

354 *NP48*, *supra*, note 353, 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 hypothesis which must be plausible but need not represent most likely future outcomes. N. CAMPBELL, *loc. cit.*, note 353, 350.

355 *NP48*, *supra*, note 353, Part 9; CANADIAN INSTITUTE OF CHARTERED ACCOUNTANTS, *CICA Handbook*, Vol. I, Toronto, CICA, loose leafs, s. 4520 (hereinafter "*CICA Handbook*").

continuous disclosure rules and explain all significant differences between the FOFI and the results[356]. Finally, the issuer must disclose any change in events or assumptions which has a "material effect" on the FOFI[357].

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 infringe on the ability of SMEs to include FOFI in their offering documents.

1. The Need to Have Future-Oriented Financial Information 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[358]. 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.

Althoughthe Task Force refrainsfrom 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"[359]. This recommendationto eliminatethe requirement that FOFI be audited appears to be questionable[360]. In particular, the Task Force seems to overlook, on the one hand, the

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356 *NP48*, *supra*, note 353, Part 7.

357 Materiality is defined in accordance with the *CICAHandbook*, *op. cit.*, note 355, which uses a broader definition than the material change standards of securities regulation. *NP48*, *supra*, note 353, par. 3.3.

358 *Task Force Report*, *op. cit.*, note 221, p. 90.

359 *Id.*, p. 91; see also: *Financing Innovative Enterprise*, *op. cit.*, note 6, p. 127.

360 The recent reform of the regulation of FOFI has maintained the need for an audit. See: *NI52-101*, *supra*, note 353, Part. 7. Note that the Securities and Exchange Commission (SEC) does not require that prospective financial information be reviewed or reported on by an auditor. The SEC's policy statement on projections is set forth in Item 10(b) of Regulation S-K (Policy Statement). See: J.H. DOYLE, "Disclosure of Forecasts and Projections", (1992) 6:2 *Insights* 10, 12 and 13.

benefits that yield the 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[361]. 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 *ex ante* uncertainty and, thereby, lowers the degree of underpricing[362]. 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[363]. 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, the growing use of forward-oriented information by businesses has increased the involvement of auditors in the review of this type of information[364]. 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

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361 Firms with good news, such as information about earnings that is better than current market expectations, disclose the information when the benefits exceed 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, A. DONTOH, G. RICHARDSON and S.E. SEFCIK, *loc. cit.,* note 247, 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 and R. WATSON, *Small Firm Management – Ownership, Finance and Performance*, London, Blackwell Business, 1991, p. 181 (hereinafter "*Small Firm Management*").

362 P.M. CLARKSON, A. DONTOH, G. RICHARDSON and S.E. SEFCIK, *loc. cit.*, note 247, 616-623; P.M. CLARKSON and J. MERKLEY, *loc. cit.*, note 232, 62; see also: *Small Firm Management*, *op. cit.*, note 361, p. 181 and 182.

363 P.M. CLARKSON, A. DONTOH, G. RICHARDSON and S.E. SEFCIK, *loc. cit.*, note 247.

364 *Id.*, 633.

Institute of Chartered Accountants establishing the recommended procedures that auditors should follow when examining forecasts or projections disclosed in securities documents[365]. More specifically, the standards enact detailed guidelines for reviewing the forecasting process, assumptions and hypothesis, and the compilation of the forecast. In this context, there 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[366].

In addition, the independent review of FOFI 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.*[367]

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 element increases more slowly with the level of uncertainty than the

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365 *CICA Handbook*, *op. cit.*, note 355, s. 4250. See: N. CAMPBELL, *loc. cit.*, note 353, 328, 329, 351 and 352.

366 J.S. POOLE, "Improving the Reliability of Management Forecasts", 14 *J. Corp. L.* 547, 633 and 634 (1989).

367 *Id.*

benefit[368]. 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[369]. 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 *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"[370].

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 indicating the minimum and maximum outcomes expected for the projections or the forecasts can complement the certification of auditors by helping investors detect any unreasonable differences between projected and actual performance[371]. Ranges disclosure 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, the impact of the inclusion of ranges on the reliability of FOFI should not be overstated given the considerable latitude firms have to use ranges to promote over-optimistic forecasts[372]. For example, by using a simple range, they can set the forecast to be biased or misleading in a way such that the expected

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368 P.M. CLARKSON and D.A. SIMUNIC, *loc. cit.,* note 196.

369 CANADIAN INSTITUTE OF CHARTERED ACCOUNTANTS, "Report of the Special Committee to Examine the Role of the Auditor", *CA Magazine*, April 1978, 36, 40.

370 B.A. MANN, *loc. cit.,* note 233, 230; see also: N. CAMPBELL, *loc. cit.*, note 353, 355; A.R. RODIER, *loc. cit.,* note 80, 44.

371 Note, *loc. cit.,* note 236, 354.

372 For a sceptical view of ranges, see: Letter from Aird and Berlis, *op. cit.,* note 254, p. 13.

result is significantly more likely to be at one end of the range than the other[373].

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[374].

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 will ensure 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[375]. Removing the audit requirement will therefore increase the assessment and verification costs of investors attempting to compare audited financial statements with unaudited ones.

In the absence of hard numbers, there appears to be good a priori reasons to believe that the cost of having FOFI audited does not 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[376].

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373 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, *loc. cit.*, note 236, 354, note 89.

374 "FOFI in Prospectuses – An OSC Staff Survey", (1994) 17 *O.S.C.B.* 6; "Forecasts in Prospectuses – An OSC Staff Survey", (1990) 13 *O.S.C.B.* 707.

375 N. CAMPBELL, *loc. cit.*, note 353, 355; F.H. EASTERBROOK and D.R. FISCHEL, *loc. cit.*, note 42, 700 and 701.

376 Letter from D.J. Low, General Director of Professional Standards, Chartered Accountants of Ontario, dated September 15 1995, in response to request for comments (on file with the author), p. 2.

2. 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[377]. 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[378]. 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[379], judicial[380] and administrative[381] interventions providing "safe harbours" which insulate issuers from liability for inaccurate FOFI. More recently in Canada, the 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[382]. 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[383]. It is suggested here that the *Securities Act* should be

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377 E.W. KITCH, *loc. cit.*, note 46, 840 and 841.

378 V. BRUDNEY, "A Note on the Materiality and Soft Information Under the Federal Securities Laws", 75 *Va. L. Rev.* 723 (1989).

379 *Private Securities Litigation Reform Act of 1995*, Pub. L. No. 104-67 (1995) adding a new safe harbour provision for forward-looking statements as section 27A of the *Securities Act* of 1933. See: C.W. SCHNEIDER and J.A. DUBOW, "Forward-Looking Information – Navigating in the Safe Harbor", 51 *Bus. Law.* 1071 (1996).

380 For a review of the case law, see: J. CALDERON and R. KOWAL, "Safe Harbors: Historical and Current Approaches to Future Forecasting", 22 *J. Corp. L.* 661 (1997).

381 For example: *Rule 175*, 17 C.F.R. § 230.175 (1992); see also: *Safe Harbor For Forward-Looking Statements*, *op. cit.*, note 352.

382 COMMITTEE ON CORPORATE DISCLOSURE, *Responsible Corporate Disclosure*, Final Report, Toronto, Toronto Stock Exchange, 1997, p. 58 (hereinafter "*Allen Report*").

383 *Id.*, 67 and 68.

amended to enact such a safe harbour for forward-looking information disclosed either in the primary or in the secondary market[384]. 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 while shielding 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[385]. This 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.* [386]

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 information immaterial, or to make it unreasonable for investors to rely upon it[387]. 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[388].

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384 The legislation implementing the safe harbour advocated by the *Allen Report* (*op. cit.*, note 382) would not extend the safe harbour to forward-looking information disclosed in the prospectus.

385 The bespeaks caution doctrine originates in *Polin* v. *Conductron Corp.*, 552 F.2d 797 (8th Cir. 1977). For a good summary of the doctrine, see: R.A. ROSEN, "Liability for 'Soft Information': New Developments and Emerging Trends", 23 *Sec. Reg. L.J.* 3 (1995); M.I. STEINBERG, "Securities Litigation Developments: The 'Bespeaks Caution' Doctrine and Related Defenses", 23 *Sec. Reg. L.J.* 447 (1996).

386 *In re Donald Trump Casinos Sec. Litig.*, 7 F.3d 357, 371 (3d Cir. 1993), cert. denied, 114 S. Ct. 1219 (1994).

387 *Rubenstein* v. *Collins*, 20 F.3d 160, 167 (5th Cir. 1994); see also: R.A. ROSEN, *loc. cit.*, note 385, 37-39.

388 According to *NP48*, issuers providing projections must include a cautionary note stating that the projections are based on hypothesis and that there is a significant risk that actual results will vary, perhaps materially from the results projected. See: *NP48, supra,* note 353, s. 5.1.

Thus, in *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[389]. Likewise, the court in *In re Donald Trump Casinos Sec. Litig.* 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"[390].

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[391]. 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"[392]. 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[393].

Secondly, the bespeaks caution doctrine applies only to cases in which there was an affirmative disclosure of forward-looking information[394]. Thus, it does not extend to situations where there was a failure to disclose such information.

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389 *In re World of Wonders*, 35 F.3d 1407, 1413 and 1414 (9th Cir. 1994).

390 *In re Donald Trump Casinos Sec. Litig.*, *supra,* note 386, 371.

391 D.C. LANGEVOORT, "Disclosures that 'Bespeaks Caution'", 49 *Bus. Law.* 481 (1994).

392 *In re Integrated Resources Real Estate Ltd. Partnership Sec. Litig.*, 815 F. Supp. 620, 674 (S.D. N.Y. 1993); see also: *In re World of Wonders*, *supra,* note 389, 858.

393 R.A. ROSEN, *loc. cit.*, note 385, 34 and 35; M.I. STEINBERG, *loc. cit.*, note 385, 451.

394 *In re World of Wonders*, *supra,* note 389.

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[395]. This limitation purports to ensure that issuers are not afforded protection where they make statements designed to mislead investors[396]. 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[397].

What constitutes a reasonable basis is 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 good faith demonstrated by the issuers and their advisers in disclosing the information at issue[398]. 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[399].

In sum, the enactment of the proposed safe harbour would recognise that the very nature of forward-oriented information makes it possible 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

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395 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 317. For a review of earlier cases recognising such a safe harbour, see: T.J. FIFLIS, *loc. cit.*, note 235, 114-127.

396 J. CALDERON and R. KOWAL, *loc. cit.*, note 380, 675.

397 *Roots Partnership* v. *Land's End, Inc.*, 965 F.2d 1411, 1417 (7th Cir. 1992); J. CALDERON and R. KOWAL, *loc. cit.*, note 380, 675; R.A. ROSEN, *loc. cit.*, note 385, 36 and 37.

398 The good faith requirement exists under the American safe harbour. Although it is not stated explicitly in the safe harbour proposed by the *Allen Report*, the good faith requirement is arguably an implicit obligation that flows from the duty to provide full, true and plain disclosure.

399 *Eisenberg* v. *Gagnon*, 766 F.2d 770, 776.

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.

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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, the regulatory framework is not adequate for the purpose of ensuring the access of SMEs 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, this study discussed the reforms that should be undertaken in order to enhance the accessibility of public equity financing for SMEs. Emphasizing the importance of implementing a cost-effective regulatory regime, the 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. Admittedly, the proposals for reform considered 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.