2009RP-05

Proposal for a Single Securities Commission: Comments and Discussion

Cécile Carpentier, Jean-Marc Suret

Rapport de projet
Project report

Montréal
Septembre 2009

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ISSN 1499-8610 (Version imprimée) / ISSN 1499-8629 (Version en ligne)

Partenaire financier
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Québec

Proposal for a Single Securities Commission: Comments and Discussion

Cécile Carpentier[*], *Jean-Marc Suret*[†]

Executive Summary

This report analyzes and comments on the principal arguments put forward by the Crawford Panel to support the establishment of a single securities commission in Canada.

One argument advanced is that the current rules-based regulatory structure should be replaced with a principles-based approach similar to that of the United Kingdom's Alternative Investment Market (AIM). According to the Panel, this approach would allow for a relaxation of the conditions for corporate financing. We will point out the very distinctive characteristics of the Canadian market, which allows emerging companies—those without income and even without any revenue—to carry out initial and subsequent rounds of financing. Our estimates indicate that such financing is carried out at an advantageous cost, and the survival of new issuers seems more certain in Canada than in other countries where the rules for listing on a stock exchange are more restrictive. We believe it would be difficult to further relax the rules of a market in which 45% of issuers are able to list their securities on a stock exchange without reporting any revenue and in which 71% of new exchange registrants do not earn any income. This situation is unparalleled in the world. We will show that adopting a system similar to the AIM model would result in a significant percentage of existing issuers no longer being able to access the market. We therefore concur fully with the opinion expressed by one of the experts enlisted by the Panel, namely, that adopting a system similar to the AIM model in Canada is neither feasible nor desirable.

The Panel expressed concern about the conditions for the financing of junior issuers. We will show that, in general, the direct costs of such financings are lower in Canada than in the United States. We will see that, in fact, there is a very high number of small offerings and issues in Canada. The Canadian markets seem to have developed strategies that are well suited to the characteristics of an economy heavily dependent on small-cap companies and on the resource sector. An analysis of all financings, including traditional and non-traditional stock exchange listings as well as subsequent financings (a total of more than 10,000 transactions), clearly shows that financings are very small and are carried out locally and, in 77% of cases, by issuers from outside Ontario.

The Panel also expressed concern about the level of competitiveness of the Canadian market; this is a concern that we share. We will show that the principal challenge faced by the Canadian

[*] Professor, Laval University and CIRANO Fellow, Faculty of Administrative Science, School of Accountancy, Phone: 418-656 2131 #6385, email: Cecile.Carpentier@fsa.ulaval.ca.
[†] Professor, Laval University and CIRANO Fellow, Faculty of Administrative Science, School of Accountancy, Pavilion Palasis-Prince, 2325 de la Terrasse, Laval University, Québec (Québec) Canada, G1V 0A6, phone: 418 656 7134, fax: 418 656 7746, email: Jean-Marc.Suret@fsa.ulaval.ca.

market is the gradual shift of transactions involving cross-listed securities to the U.S. market. In contrast to the Panel, we do not believe that AIM listings constitute a major problem. When Canadian companies cross-list their securities, they opt for the U.S. market at a ratio of eight to one. The migration of companies and transactions towards the U.S. market has many causes, but it would be very difficult to argue that the regulatory structure is a key factor. The argument whereby the costs of capital are lower in the U.S. does not stand up to analysis. Several recent and thorough studies indicate that the difference in these costs between the two countries is minimal, leaning in favour of one country or the other depending on the study. Our own findings show that Canadian companies that cross-list their securities do not benefit from any lower costs. The decision to list securities on a foreign market is driven primarily by strategic business factors and by the search for large pools of investors. In that regard, Canada has no advantage, and it seems unlikely that regulatory changes will convert Canada into a significant source of financing for foreign companies. In our opinion, efforts should be focused, above all, on improving and sustaining the financing options available to Canadian issuers.

The Panel has argued that establishing a single commission is necessary for improving enforcement of securities laws in Canada. In this regard, Canada is often compared to the United States. An analysis of data on sanctions shows, firstly, that the SEC is far from being the source of the majority of sanctions imposed on financial market participants. It initiates less than 10% of proceedings involving financial matters and imposes less than one quarter of all monetary sanctions. Secondly, there has been an increase in sanctions imposed in Canada in this area. Thirdly, there are major differences between Canada and other countries. This explains the differences observed and perceived as regards enforcement. The experts enlisted by the Panel have, in fact, recommended a series of eight actions and have suggested, in the eighth item, pan-Canadian enforcement of the law. Consequently, these experts have not concluded that centralization of the securities commissions is an indispensable condition for enhancing the enforcement of securities laws.

The issue of costs arises very often in discussions regarding the Canadian regulatory system. Yet, there is little evidence showing that the current regulatory structure leads to significant costs for investors or issuers. The costs of the regulatory authorities represent a negligible percentage of the transaction costs borne by investors and of revenues from brokerage activities in Canada. The direct costs of regulatory authorities are lower than those incurred in other countries, when expressed on the basis of the number of reporting issuers. Finally, arguments to the effect that a single commission would generate substantial savings are less than convincing. Such savings would be possible only if the activities of securities commissions outside Ontario were virtually abolished.

Three elements appear from our analysis. First and foremost, the principal arguments put forward by the Panel to justify the urgency of centralizing securities commissions in Canada do not stand up to analysis and are, at times, contradicted by the research and the experts mandated by the Panel itself. Secondly, the major challenge faced by the Canadian market—the shift of enterprises and transactions to the U.S.—does not seem to have been perceived as such or even discussed. Finally, we believe it is essential to recognize and preserve the distinctive characteristics of the existing market. It is a market that welcomes growth companies and small-cap companies, is highly decentralized and is apparently very favourable to issuers.

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In its update report dated June 15, 2007, the Crawford Panel (Crawford Panel, 2007) refers to its proposal for modernizing the Canadian regulatory system that was the subject of its preceding report, issued in 2006. It notes that certain elements of the proposal have raised concerns, including the feasibility of adopting a principles-based regulatory system rather than a rules-based system, providing investors with better protection through national enforcement, the implications of a single regulator for small issuers and the competitiveness of the Canadian market. In its update, the Panel refers to the key elements of certain prior studies and states that its recommendations are such as to make Canada "the best place in the world in which to invest and raise capital for small and large businesses." The purpose of this document is to supplement and clarify several elements of the update report and discuss the arguments presented therein. To do so, we follow a three-step process. In the first part of our paper, we examine several characteristics of financings carried out in the Canadian market, based on recent empirical studies providing comprehensive and new data. These data are an indispensable foundation for discussing the Panel's proposals, which is the subject of the second part of our paper. In the third part, we discuss and analyze issues relating to the cost of regulation.

1 THE CANADIAN MARKET GLOBALLY

The Canadian securities market has very distinctive characteristics—as regards initial offerings and stock exchange listings, the rate of survival of initial offerings, subsequent financings, the costs of financing, and graduation and migration of issuers to other markets and exchanges—and it is important that these characteristics be properly described. The Canadian market is also characterized by a high degree of dispersion, given that a vast majority of financings take place outside Ontario. On the whole, the Canadian market is composed of enterprises with small and very small market capitalizations, as Nicholls indicates (2006). According to the various studies cited by the Panel, these are the transactions that require the most supervision from securities regulators and seem to be burdened most by regulatory requirements.

1.1 INITIAL OFFERINGS AND EXCHANGE LISTINGS

Canada offers growth companies three ways to access the securities market: traditional offerings (initial public offering or IPO), reverse takeovers (RTO) and the capital pool companies (CPC) mechanism. This tool is intended to facilitate market access by issuers that do

not satisfy the minimum listing requirements.[1] Through the CPC program, the TSX Venture Exchange offers "investors a venture investment market with comprehensive compliance standards."[2] The minimum listing standards are not at all restrictive. Table 1 sets out the characteristics of all initial offerings in Canada since 1986. The median offering size is quite small, namely, $1 million for the entire period. Thus, half of initial offerings in Canada during this period involved less than $1 million. The median size of issuers, prior to an offering, is very small: Half of issuers have pre-offering shareholders' equity of less than $310,000. Initial Canadian offerings are predominantly (71%) carried out by unprofitable companies, with 45.32% of issuers proceeding with an IPO without ever reporting any revenue. Some comparisons are useful for understanding the particular nature of the Canadian market as regards initial financings. In the United States, out of 4,538 IPOs carried out between 1990 and 2005, gross proceeds average US$96 million. (Ritter, 2006). The percentage of issuers reporting losses is 38.5%, namely, half of the Canadian figure, but NASDAQ recently reinstated a profitability requirement as part of the minimum listing standards. The rules of the new European markets (excluding AIM) required that initial offerings exceed 5 million euros. In Australia, the median size of offerings between 1995 and 2000 is approximately C$7.65 million.[3] On AIM, median gross proceeds are approximately C$6.84 million and the median post-offering capitalization is approximately C$30 million (Derrien and Kecskes, 2007). The percentage of issuers without revenue is generally not reported in other countries, because it is very low. The Canadian initial offerings market is also characterized by the large number of resource companies active in that market; they represent 44.33% of offerings between 1986 and 2003, compared with 9% on AIM. Companies without revenue are largely concentrated in the resource sector.

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[1] Exchange listings through the use of RTOs are infrequent in other jurisdictions and the SEC has revised and tightened the rules governing shell companies used in such transactions: SEC Votes To Adopt Securities Act Rule Reform and Shell Company Regulations. Blind pools, on which CPCs are based, are often likened to frauds. See the warning issued by the NASAA at: http://www.cyberdriveillinois.com/departments/securities/investor_education_services/investor_alert/nvstalt2.html.

[2] According to the brochure: Capital Pool Company Program, TSX Venture Exchange, http://www.tsx.com/en/pdf/CPCBrochure.pdf

[3] Australia amended the minimum listing requirements in 1999, introducing an A$10 million capitalization test as an alternative to the requirement that earnings exceed A$1 million and net tangible assets exceed A$2 million. The NSX was reactivated in 2000. It allows companies that do not satisfy the minimum listing requirements to be listed. In 2007 it listed 49 issuers.

Table 1 also sets out the principal characteristics of the 892 companies that listed their securities by way of an RTO between 1988 and 2006. These transactions involve median gross proceeds of approximately $1.5 million, with median pre-transaction shareholders' equity of $340,000, an amount similar to that for IPOs. The percentage of issuers without revenue and without profits is 40.59% and 75.25%, respectively.

We also identified 1,311 CPCs between 1991 and 2006, of which 992 completed a qualifying transaction before June 30, 2007. The median amount raised through these transactions is approximately $1 million. The average percentage of companies reporting losses is 68.98%, with 26.85% reporting no revenue at all. In all, 1,884 Canadian companies—predominantly very small companies—used a backdoor listing to access the securities market between 1993 and 2003. Companies in the United States also used RTOs to obtain exchange listings, but their numbers are low: There are 286 such transactions between 1990 and 2002 and they involve larger enterprises than in Canada. These enterprises have median assets of US$5.4 million (Adjei *et al.*, 2007). Moreover, the majority are profitable companies, with a return on assets of 10.5%.

Table 1 Listings and initial offerings on the Canadian public market, and principal characteristics of issuers. The number of observations is based on the number of transactions identified. The number in parentheses is equal to the number of observations for which operating data can be calculated. Median gross proceeds (GP) are expressed in millions of dollars. For CPCs, gross proceeds are equal to the amount of the qualifying transaction, expressed in millions of dollars. Operating data were compiled from the financial statements for the most recently completed financial year preceding the offering. The number of CPCs is equal to the number of capital pool companies; the number in parentheses is equal to the number of qualifying transactions carried out before December 31, 2002, for which operating data were available.

	Offering period	Number	Median GP	Median equity	% Nil sales	% Losses
Initial offerings	1986-2006	2616 (2028)	1.00	0.31	45.32	71.01
RTO listings	1988-2006	892 (202)	1.53	0.34	40.59	75.25
CPC listings	1991-2006	1311 (433)	1.00	0.31	26.85	68.98

Growth companies in Canada carry out numerous financing activities. We identified 4,500 exchange listing transactions in Canada between 1986 and 2006.[4] On average, each year, approximately 214 Canadian companies enter the securities market, representing almost 70% of the 313 U.S. initial offerings reported by Ritter (2004),[5] in a market 10 times smaller. Canada is often compared with Australia as regards the types of issuers. Between 1995 and 2000, 457 initial offerings were carried out in Australia. In Canada, during the same period, there were 1,295 listing transactions (IPOs, CPCs, RTOs). It is therefore difficult to argue that access to the public market presents a real challenge for emerging companies, given that in 60% of cases they are able to access that market without even reporting any income. Based on international standards, Canadian offerings are microcap offerings,[6] and the Canadian market allows growth companies—those without income and even without any revenue—to carry out initial offerings, a possibility not available in any other market. The vast majority of small offerings as well as

[4] We were unable to fully examine CPC transactions between 1986 and 1993, because no list exists. We therefore underestimated the total number of transactions.

[5] However, U.S. studies do not report offerings carried out at the state level; such offerings are not covered by the SEC.

[6] "The term 'microcap stock' applies to companies with low or 'micro' capitalizations, meaning the total value of the company's stock. Microcap companies typically have limited assets. For example, in cases where the SEC suspended trading in microcap stocks, the average company had only $6 million in net tangible assets — and nearly half had less than $1.25 million. Microcap stocks tend to be low priced and trade in low volumes." http://www.sec.gov/investor/pubs/microcapstock.htm

almost all CPC and RTO listings involve a single regulator, because they are carried out in only one province.

1.2 SURVIVAL

Despite the fact that listing requirements are minimal, initial issuers have a higher survival rate and longer life expectancy in Canada than in the United States. We measured the survival rate of IPO issuers after 5 and 10 years, identifying all cases in which issuers were delisted or suspended without any resumption of trading, or in which their securities were repurchased at very low prices (10 cents or below).[7] Table 2 sets out our estimates and the corresponding data in the U.S. After 5 and 10 years, the survival rate for Canadian issuers is greater than that reported in the U.S.[8] The survival rate at 5 years is 88.40%, comparing favourably with the rate measured by Demers and Joos (2006) for the same period. Only high-tech offerings have a greater probability of survival in the U.S., but they involve median amounts of US$121 million and, therefore, have nothing in common with offerings in Canada. The rates at 10 years are considerably higher than those observed by Fama and French (2004) for "small" businesses, namely, those with assets below the NASDAQ median. U.S. penny stock IPOs, which are the most comparable to Canadian offerings, were analyzed by Bradley *et al*. (2006). These offerings raise an average of US $5.7 million. After 3 years, the survival rate for these issuers is 68.5%. After 10 years, the survival rate for Canadian issuers is 71.71%. The very high survival rate of small Canadian offerings is attributable, in part, to the fact that listed emerging companies are in a position to carry out subsequent financings before turning a profit.

[7] So that our estimates can be compared with U.S. studies, we applied a delisting rule based on U.S. standards for maintaining a listing (the penny stock rules). A stock that trades for seven months at a price that never exceeds 10 cents is considered to be a failure.
[8] See Carpentier and Suret (2007) for a detailed analysis of the survival rate.

Table 2 Comparison of survival rates at 5 and 10 years for issuers having carried out an initial public offering in Canada and in the U.S.; acquired or merged enterprises are classified as surviving, except when acquired at a price of less than 10 cents per security.

	Offering period	Number of observations	Duration	Survival rate
Canada				
Carpentier and Suret (2007)				
	1986-2002	1974	5	88.40%
	1986-1997	1605	10	71.71%
United States				
Fama and French (2004)				
Small businesses	1980-1991	1416*	10	59.50%
Large businesses	1980-1991	1416*	10	87.80%
Demers-Joos (2006)		3973		
Non HT	1985-2000	16.7	5	83.30%
HT + Internet	1985-2000	23.1	5	76.90%
High Tech	1985-2000	9.2	5	90.80%
Bradley *et al*. (2006)				
Penny stocks	1990-1998	251	3	68.50%
Non-penny stocks	1990-1998	2707	3	93.60%

* Estimated based on Table 7 of Fama and French (2004).

1.3 SUBSEQUENT FINANCINGS

Canadian reporting issuers often use private placements to raise funds. Table 3 sets out the principal characteristics of these types of financing transactions, based on almost all of the 4,592 placements identified between 1993 and 2003. One out of two private placements involve amounts below $3 million. The majority of private placement issuers are small, with median shareholders' equity of $5.52 million. Of these issuers, 74.15% report losses and 41.94% report no revenue. Two thirds of private placement issuers operate in the natural resource sector.

Although subsequent public offerings are larger than private placements ($8.87 million), 59.88% of them are carried out by issuers without income, with 25.16% of total issuers having no revenue at all. This situation is in stark contrast to the U.S. situation, where subsequent offerings are carried out by highly profitable companies and for significant amounts (US$30 million to US$160 million, according to the studies). It does not appear that unprofitable

companies participate to any significant extent in subsequent offerings in the U.S. As with initial offerings, the Canadian market for subsequent offerings clearly differs from those in other countries, particularly the U.S., in that it allows emerging companies to obtain subsequent financing.

Table 3 Profile of subsequent financings by Canadian companies between 1993 and 2003. No. refers to the number of offerings. GP refers to gross proceeds, expressed in millions of dollars. Operating data (equity, sales, net income) were compiled for the most recently completed financial year preceding the offering. Shareholders' equity is expressed in millions of dollars. % NR (natural resources) refers to the number of offerings by mining companies. % OG refers to the number of offerings by firms in the oil and gas sector.

	No.	Median GP	Median equity	% Nil sales	% Losses	% NR	% OG
Private placements	4592	3	5.52	41.94	74.15	41.36	26.71
Public offerings	2862	8.87	19.82	25.16	59.88	28.86	24.15

1.4 Financing Costs

The cost of financing consists of two principal components. The first is associated with direct and indirect costs incurred to raise the funds (costs of offerings) and the second is the rate investors expect to earn to make the funds available to businesses.

1.4.1 Costs of Offerings

Kooli and Suret (2003) studied the costs of offerings in Canada and the U.S. The following cost factors were measured: (1) brokerage fees; (2) other costs appearing in the prospectus, which are related to legal costs, fees and preparation of the prospectus; and (3) the initial undervaluation, which reflects the cost to companies whose securities are disposed of at a lower price than what the market will establish.

Direct costs are significantly higher for small issues than for large issues. Costs can therefore only be compared for offerings of similar size. Table 4 shows that the average total direct cost of a Canadian junior issue (US$1 million to US$10 million) is less (15.98%) than that of a U.S. issue (17.99%). However, the direct cost for large-cap issues (more than US$100 million) is similar in both countries.

In the two countries, brokerage commissions constitute the largest part of total direct costs. They are 8.12% for issues from US$1 million to US$10 million and 5.53% for issues greater than US$100 million. In the United States, the average commission is 9.29% for issues from US$1 million to US$10 million and 6.09% for issues over US$100 million. The initial undervaluation is more significant in Canada than in the U.S., but this cannot be tied to regulatory matters. This analysis, which confirms a number of previous studies, indicates that junior issuers are not penalized in Canada as a result of the regulatory framework with respect to direct costs of offerings. However, the analysis highlights the importance of the initial undervaluation of the price of the securities issued, which is the principal component of the costs of offerings. A 30% undervaluation indicates that the securities were sold at a price that represents 70% of the future value on the secondary market. This major component of the costs of offerings seems to be linked to brokerage operations and the conduct of parties at the time of the offerings.

Table 4 IPO costs according to size of issue, excluding capital pool issues, for the period 1997-1999, according to Kooli and Suret (2003). The average percentages are all statistically different from zero to the 1% level.

Size of issue (US$ million)	Number of IPOs	Brokerage fees (%)	Other expenses (%)	Total direct costs (%)	Undervaluation (%)
Canada					
1.0 – 9.9	53	8.12%	7.86%	15.98%	30.61%
10.0 – 49.9	49	6.14%	3.31%	9.45%	11.30%
50.0 – 99.9	10	6%	2%	8%	10.76%
100 and over	16	5.53%	1.75%	7.28%	8.88%
Average		6.88%	4.9%	11.78%	18.95%
Weighted average (by size)		5.35%	1.84%	7.19%	5.11%
United States					
1.0 – 9.9	119	9.29%	8.7%	17.99%	9.05%
10.0 – 49.9	532	6.93%	3.70%	10.63%	26.15%
50.0 – 99.9	300	6.88%	2.12%	9%	55.57%
100 and over	237	6.09%	1.2%	7.29%	67.19%
Average		7%	3.3%	10.30%	37.5%
Weighted average (by size)		5.79%	1.43%	7.22%	38.38%

1.4.2 Cost of Capital

Overall, based on a measurement of data for large-cap businesses, the cost of capital in Canada seems to be identical to the cost of capital in the United States. On the whole, Hail and Leuz (2006) attribute a slight advantage to the U.S. (10.2% compared with 10.5%), while Claus and Thomas (2001) attribute a 20 basis point advantage, but in favour of Canada. Comparisons between the two countries, however, are difficult due to differences in their industrial structures. He and Kryzanowski (2007) therefore analyze the differences in each sector and show that there are no significant differences in any of these sectors. Indeed, Canada has a net advantage of some 100 basis points in the finance and resource sectors. Very recently, Witmer and Zorn (2007) re-examined these differences,[9] using various methodologies and taking enterprise characteristics into account. On average, they analyzed 180 Canadian businesses per year, of which one third were cross-listed. The financial sector was excluded. The authors estimate that the cost of equity is 30 to 50 basis points higher in Canada, but this difference has

[9] Figure 1 in the Witmer and Zorn study illustrates the diversity of findings in previous studies on this matter.

decreased since 1997, a decrease the authors attribute to changes in the relationship between interest rates in the two countries. Given the diversity of results, the small sample sizes studied and the findings of the various studies, it appears difficult to state that there are major differences between the cost of capital for Canadian companies and U.S. companies in recent years. The differences reported are, in fact, minor, while measuring the cost of capital always involves significant estimation errors, regardless of the method used. Moreover, it is very difficult to make a link between differences in the cost of capital and regulatory differences. Table 5 sets out Hail and Leuz's (2006) estimates of the cost of equity. The Table indicates that the cost of equity in Canada is one of the lowest in the world, a figure consistent with estimates of the quality of regulation and disclosure. In particular, Canada is in a better position than either of the countries often used as a reference point by reason of their centralized regulation, namely, Australia and the United Kingdom.

Table 5 Analysis of the relationship between the cost of capital and the quality of regulation in various countries. The reported cost of equity is the average of four estimates using different models, applied between 1992 and 2001.

	Cost of equity	Quality of disclosure indicator	Quality of securities regulation indicator	Quality of the legal system indicator
United States	10.24%	1	0.97	1
France	10.37%	0.75	0.58	0.9
Canada	10.53%	0.92	0.91	1
Italy	10.61%	0.67	0.46	0.83
United Kingdom	10.64%	0.83	0.73	0.86
Australia	10.72%	0.75	0.77	1
Belgium	11.00%	0.42	0.34	1
New Zealand	11.14%	0.67	0.48	1
Austria	11.21%	0.25	0.18	1
Israel	11.41%	0.67	0.65	0.48
Netherlands	12.75%	0.5	0.62	1
Finland	13.40%	0.5	0.49	1
India	14.39%	0.92	0.75	0.42
Hong Kong	14.58%	0.92	0.81	0.82
Mexico	15.59%	0.58	0.35	0.54
Brazil	20.85%	0.25	0.39	0.63
Egypt	25.27%	0.5	0.34	0.42
Total (average)	12.97%	0.65	0.56	0.74

Source: Hail and Leuz (2006)

We are particularly interested in the cost of capital for junior issuers. The rate at which businesses are financed is on average equal to the rate of return that investors expect to earn. It can be estimated, on average, using the rate of return that investors actually earn.[10] It is generally recognized that the lack of transparency in financial statements and risk are two factors that have a positive impact on the cost of capital. In the case of Canadian issuers, which often report no income, it could therefore be expected to be particularly high. We have estimated the rates realized in the three years following an offering in the case of private placements, initial public offerings (IPOs), follow-on offerings, capital pool companies (CPCs) and reverse takeovers. Table 6 summarizes the results of these estimates, which appear as annual spreads compared with returns earned by similar businesses.[11] All categories of offerings are followed by abnormally negative returns. Based on these estimates, which cover 8,575 financing operations over 20 years, it can be said that the cost of capital for Canadian issuers tends to be lower than that required for the market as a whole. The spread is not always statistically significant, but it is economically material. At a minimum, we estimate it to be 300 basis points per year for CPCs and 348 basis points for IPOs. Such a spread can give these issuers a competitive advantage. The observation that returns following an offering are abnormally low is not limited to Canada. An explanation of this development and its impact on investors will not be discussed here.[12] Our task was to demonstrate that general financial conditions available to growth companies through the stock market are highly favourable in Canada, whether in respect of direct or indirect financing costs.

[10] Bhattacharya (2006) sets out the various approaches used for measuring the cost of capital and provides an overview of the links between regulation and the cost of capital. Measuring the cost of capital based on the return earned is not the best method, but it is the only possible method for small issuers, for which no data forecasts are available.

[11] The issuers are usually smaller than the market overall and also have different growth profiles. Estimated return spreads are therefore calculated based on size, market and growth, using the multifactor Fama-French model. CPCs are those whose qualifying transaction took place before January 1, 2004. These estimates are complex and, as regards IPOs, CPCs and RTOs, should be considered as an order of magnitude and not as definitive estimates. Details of estimates for subsequent financings are set out in the study by Carpentier *et al.* (2007).

[12] A low cost of capital obviously provides a significant advantage to issuers, because it gives them a comparative advantage. However, such returns indicate that investors earn very poor returns on average when financing these issuers. Ultimately, this situation presents the risk that investors will turn away from financing growth companies. However, we have observed that the lowest returns are those of companies that carry out offerings or issues without showing revenue. It will likely be necessary to inform investors about the risks and probabilities of realizing returns with such issuers.

Table 6 Estimated cost of capital for Canadian issuers, based on return spreads when compared with similar companies.

		Return spread 36 months		
	No. obs.	Monthly	Annual	Significant
Initial offerings (1986-2003)	1809	-0.29%	-3.48%	no
Reverse takeovers (1986-2003)	682	-1.20%	-14.37%	yes
Capital pool companies (1995-1999)	714	-0.25%	-3.00%	no
Private placements (1993-2003)	3291	-0.75%	-9.00%	yes
Subsequent offerings (1993-2003)	2079	-0.67%	-8.04%	yes

1.5 Graduations and Migrations

Both Canadian markets are places of transition. The TSX Venture Exchange views itself as an incubator and considers the graduation of its issuers to the senior marketplace to be a sign of success. In total, since 1989, 827 companies have moved from a Canadian venture exchange to the TSX, representing approximately 45 companies per year (Table 7). Thus, despite lenient listing requirements, junior exchanges provide the opportunity for a relatively large number of new entrants to grow so as to satisfy the requirements of the senior exchange. Since 1986, 511 Canadian companies have obtained listings on one of the U.S. exchanges. More than 330 of them listed their securities on a U.S. over-the-counter (OTC) system, according to Doidge *et al.* (2007), and some chose to list themselves on London's Alternative Investment Market (AIM). In all, 555 issuers joined the 95 issuers that were already listed on a U.S. exchange at the beginning of 1986. Canadian companies list their securities on a U.S. exchange so as to improve their visibility and access new pools of investors in a more liquid and deeper market. They also do so for strategic business reasons when the market for their products or services is growing in the United States. A number of authors also suggest that the presence of a strong regulatory system in the United States draws foreign companies that are seeking a certification effect. Conversely, the number of foreign companies listed in Canada is low and the percentage of transactions carried out by them in Canada is marginal.[13]

[13] As at the end of June 2007, 17 foreign issuers, primarily US firms, were cross-listed on the TSX and carried out 5.6% of their total transactions in that market (source: TSX Review, June 2007).

Table 7 Annual distribution of company moves (graduations) from junior exchanges (TSX Venture and predecessor exchanges) to senior exchanges (TSE and TSX) as well as to U.S. exchanges. Annual distribution of Canadian issuers cross-listing in the U.S. and on AIM. The year 2007 includes the months of January to June.

Year	TSXV issuers migrating to the TSX or a U.S. exchange	Canadian issuers cross-listing on a U.S. exchange	Canadian issuers cross-listing on AIM
1986	N/A	14	-
1987	N/A	27	-
1988	N/A	27	-
1989	33	16	-
1990	24	12	-
1991	13	8	-
1992	28	16	-
1993	40	23	-
1994	57	32	-
1995	47	30	-
1996	56	36	-
1997	56	28	-
1998	47	36	1
1999	33	29	-
2000	44	49	-
2001	27	24	-
2002	29	12	3
2003	60	17	3
2004	75	20	11
2005	61	28	8
2006	72	22	12
2007	25	5	6
Total 95-07	632	336	44
Total 86-07	827	511	44

Sources: Graduations: TSX Venture and TSX Review; Cross-listing in the United States and on AIM: compilation by authors based on TSX Review and AIM website. An analysis of cross-listings is available in Carpentier *et al.* (2007c).

1.6 DISPERSION OF TRANSACTIONS

The various documents prepared for the Panel highlight the duality of the Canadian securities market, which is composed of a limited number of large-cap securities and a rather significant number of small-cap securities. Nicholls (2006, p. 152) reports that the very large enterprises are usually incorporated under the federal system. He illustrates that there is a larger number of reporting issuers in British Colombia or Alberta than in Ontario (Figure 2). An analysis of head office locations indicates that over 63% of head offices are not located in Toronto. Moreover, if the average number of employees is used as an indicator of the size of a company, Montréal, Toronto and Calgary are on an equal footing (Table 8).

Table 8 Distribution of head offices in Canada and average staff, by province, in 2005, according to Statistics Canada.

	Number	Percentage	Average staff per head office
Montréal	536	21.51%	69
Ottawa—Gatineau	101	4.05%	46
Toronto	918	36.84%	64
Winnipeg	129	5.18%	53
Calgary	316	12.68%	61
Edmonton	157	6.30%	22
Vancouver	335	13.44%	36
Total	2492		

Sources: D. Beckstead and W. M. Brown (2006). Head Office Employment in Canada, 1999 to 2005. Analytical paper No 11-624-MIE, Micro-economic Analysis Division, Statistics Canada

A significant portion of the responsibilities and tasks of securities commissions is related to financing activities, which are very numerous in Canada. We established the location of the issuers involved in each of the following transactions between January 1993 and December 2003: initial public offerings (IPOs), the establishment of capital pool companies (CPCs), exchange listings through reverse takeovers (RTOs), private placements carried out by public companies (PPPCs) and subsequent public offerings (SPOs). The province of origin of an issuer incorporated federally was considered to be the province where its head office is located. In all, we identified and analyzed over 10,000 financing transactions. Table 9 shows the distribution

of these transactions in the provinces in which they occur most frequently. We subdivided the 11 years into two subperiods, to better highlight changes.[14]

Issuers in Alberta and British Colombia account for 58.63% of all financing activities, regardless of type, in Canada. This percentage is stable over the two subperiods. Ontario accounts for 22.85% of transactions. Here, too, there is little variation over time. Québec issuers account for 6.68% of transactions between 1993 and 1998. This percentage rises to 10.16% between 1999 and 2003. The increase is seen across all categories of financing. The percentage of transactions carried out in the other provinces as well as by non-Canadian issuers declines.[15] An analysis of each type of transaction indicates that Ontario companies are proportionally more active in subsequent issues, which is consistent with the presence of larger and more mature companies in that province.

It is therefore clear that the majority of financing transactions occur elsewhere than in the province of Ontario. These financing activities usually involve small amounts, but they represent the amounts required to satisfy the funding needs of small- and medium-sized public companies. These companies constitute more than 80% of reporting issuers in Canada. Financing activities in Canada—like the breakdown of head offices and reporting issuers—reflect the wide dispersion of activities governed by securities commissions in Canada. Non-traditional exchange listing transactions (CPCs and RTOs) continue to be largely concentrated in the western provinces.

[14] We did not break down the amounts, because such figures would have little meaning, given the existence of a few transactions involving several billions of dollars, while the amounts raised in Canada are generally in the vicinity of a few million dollars.

[15] The decline in transactions categorized as "other" is due, on the one hand, to the decreased activities of non-Canadian issuers and, on the other hand, to a decrease in issues by companies located in the Yukon.

Table 9 Distribution of financing activities in Canada between January 1993 and December 2003, based on the issuer's head office location. Initial public offerings (IPOs), the establishment of capital pool companies (CPCs), exchange listings through reverse takeovers (RTOs), private placements carried out by public companies (PPPCs) and subsequent public offerings (SPOs) were identified using the Financial Post database, stock exchange reviews and various other databases, and the numbers reported represent the population of identifiable transactions. The category "Other" represents issuers from the other provinces and foreign issuers.

	Alberta		British Columbia		Ontario		Québec		Other		Total
	#	%	#	%	#	%	#	%	#	%	#
Period 1: 1993-1998											
IPOs	226	28.83	168	21.43	232	29.59	82	10.46	76	9.69	784
CPCs	527	85.28	24	3.88	36	5.83	20	3.24	11	1.78	618
RTOs	30	10.07	97	32.55	113	37.92	9	3.02	49	16.44	298
PPPCs	907	28.04	997	30.82	696	21.51	157	4.85	478	14.78	3235
SPOs	428	30.53	320	22.82	376	26.82	155	11.06	123	8.77	1402
Total	2118	33.42	1606	25.34	1453	22.93	423	6.68	737	11.63	6337
Period 2: 1999-2003											
IPOs	53	20.87	69	27.17	73	28.74	36	14.17	23	9.06	254
CPCs	201	49.63	117	28.89	23	5.68	27	6.67	37	9.14	405
RTOs	73	31.33	74	31.76	57	24.46	13	5.58	16	6.87	233
PPPCs	503	37.07	373	27.49	238	17.54	110	8.11	133	9.80	1357
SPOs	427	29.25	276	18.90	452	30.96	191	13.08	114	7.81	1460
Total	1257	33.89	909	24.51	843	22.73	377	10.16	323	8.71	3709
All observations combined, 1993-2003											
IPOs	279	26.88	237	22.83	305	29.38	118	11.37	99	9.54	1038
CPCs	728	71.16	141	13.78	59	5.77	47	4.59	48	4.69	1023
RTOs	103	19.40	171	32.20	170	32.02	22	4.14	65	12.24	531
PPPCs	1410	30.71	1370	29.83	934	20.34	267	5.81	611	13.31	4592
SPOs	855	29.87	596	20.82	828	28.93	346	12.09	237	8.28	2862
Total	3375	33.60	2515	25.03	2296	22.85	800	7.96	1060	10.55	10046

1.7 CONCLUSION

A number of documents prepared in connection with the discussion of Canada's securities regulatory system describe a market heavily penalized by an inadequate, inefficient and costly regulatory structure. The elements we have highlighted, based on a review of all company financings, disappearances and migrations in Canada over a period of 20 years, provide a more positive picture. The Canadian markets seem to have developed strategies that are well suited to the characteristics of an economy heavily dependent on small-cap companies and on the resource sector. Issuers are able to obtain financing and refinancing on favourable conditions at an early stage in their development. Their survival rate is higher than in the other markets, and

migrations to senior markets are numerous. The direct costs of financing are low and the rates demanded by investors, estimated on the basis of the rates earned, are also very favourable to issuers. The pace of financing transactions is very brisk. The majority of transactions involve amounts that do not exceed one or two million dollars, and these transactions are most often carried out locally. A great majority of financing transactions, regardless of type, takes place outside Ontario, and the Canadian market seems considerably dispersed.

It is certainly possible to improve the functioning of the Canadian system, particularly in order to retain issuers that migrate to foreign markets and in order to attract issuers from other countries. However, we believe it is essential to maintain and eventually improve the financing conditions for local businesses. Our analysis of the Panel's proposals and arguments will therefore be conducted with the foregoing in mind.

2 THE PANEL'S PROPOSALS

2.1 REGULATION BASED ON PRINCIPLES AND THE AIM EXAMPLE

The Panel suggests that principles-based regulation would be more efficient and attractive, improve Canada's competitiveness and thereby allow Canada to compete with the United States. Moreover, this type of regulation should be applied uniformly and therefore requires a single securities regulator. In this regard, the Panel states that it has relied on academic studies carried out under the auspices of the Task Force to Modernize Securities Legislation (p. 12). Below, we will address the following questions:

(1) How is a principles-based system different from a rules-based system?

(2) Does a principles-based system provide securities exchanges with a decisive advantage?

(3) Can such a system be applied in Canada and what would its potential impact be?

2.1.1 Principles-Based Regulation

Principles-based regulation promises to replace detailed sets of rules that prohibit, restrict or authorize conduct with one or more general principles. The United Kingdom's Financial Services Authority uses such a regulatory approach. It also applies a vast set of rules, as pointed

out by its president.[16] The Alternative Investment Market (AIM) represents the most spectacular application of this approach, having replaced minimum listing standards with the principle that the admission of a new issuer should not be detrimental to the reputation of the exchange. A business seeking to be admitted on AIM must find a Nominated Advisor (Nomad) who certifies that the issuer has the required qualities to be listed on the exchange.[17]

2.1.2 Does a Principles-Based System Provide Securities Exchanges with a Decisive Advantage?

AIM is considered to be a success: It was created in 1995 and, based on the information on its website, it has attracted 2,700 companies. These include a large number of foreign companies that have cross-listed on AIM or carried out their initial offering on AIM. However, the increase in the number of foreign companies cross-listed on AIM is recent: There were 55 of them in 2002 and 242 in 2006. As Rousseau points out (p. 88), this increase is largely based on economic conditions, and owes much to European interest in the natural resource sector, which has grown very rapidly since 2001.

The growth of this market has attracted the attention of various countries, including the United States. The decrease in the relative share of initial offerings resulting from a shift to AIM, as well as to the Asian markets, has raised serious concerns, as clearly illustrated in the report commissioned by the mayor of New York and Senator Schumer (McKinsey & Company, 2006). The report notes a decline of 4% to 7% in New York's relative share of financings and the loss of a significant number of jobs in the financial sector, and attributes this situation to regulatory causes, among others. This report, as well as the study carried out by Goldman Sachs (2007) and the work of Doidge *et al*. (2007), shows that a number of factors, other than the regulatory system, explain the success of the London marketplace. The growth of the European and Asian markets is the first factor. In many countries, market capitalization represented a much lower portion of the gross national product than in North America. This gap is being closed and financing activities are refocusing on Europe and Asia. London has a significant time zone advantage, providing an overlap of trading hours both with Asia and with

[16] See: Callum McCarthy, *Financial Regulation: Myth and Reality*, British American Business London Insight Series and Financial Services Forum (Feb. 13, 2007), available at: http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2007/0213_cm.shtml

[17] Rousseau analyzed the functioning of this exchange and the appropriateness of this type of regulation in the Canadian context (2006); therefore, we will not replicate this discussion here.

the Americas, whereas the markets open on the U.S. East Coast only after the close of all other markets. London is integrated in the European Union, even though it has not adopted its currency. Finally, the growth of hedge funds, mutual funds and pension plans is, and will continue to be, more rapid outside than inside North America. The same is true of economic growth, particularly in India, China and Russia. According to McKinsey & Company, the availability of human resources is also a key component of financial market competitiveness. Finally, Doidge *et al*. show that changes in listing choices are largely reflective of changes in the nature of issuers. Companies that obtained listings on AIM would generally not have been able to list themselves on the large U.S. exchanges. The foregoing explain the following finding by Goldman Sachs (p. 2): "Legal and regulatory factors probably do matter, and policy reform might strengthen New York's competitiveness. Nonetheless, we do not see them as the critical drivers behind the shift in financial market intermediation, even in the aggregate. Quite simply, economic and geographic factors matter more."

These arguments do not mean that regulatory factors have no impact. Indeed, the interviews conducted by McKinsey & Company indicate that the existence of an integrated regulator, like the Financial Services Authority, is an important element for financial sector participants. However, the significance of factors other than regulatory indicates that it is probably illusory to think of competing with AIM by merely adopting a principles-based system. That this is particularly true is shown by the studies carried out for the purpose of explaining the growth of AIM; by analyzing cross-listing premiums, these studies highlight that a strict regulatory and governance structure can provide certain advantages.

Companies that cross-list in the United States benefit from a cross-listing premium (CLP): Their value is higher than the value of similar companies that are not cross-listed. This premium exists for companies from all countries, and is not specific to Canada. Indeed, in Canada, the premium seems to disappear after a few years (King and Segal, 2005). It is therefore exaggerated to view the CLP as a consequence of Canadian regulatory deficiencies, as suggested by Coffee (2007).[18] On average, the CLP is estimated at between 17% and 22% (according to estimation methods) for a listing on a U.S. exchange (Doidge *et al*., p. 31). It results from the fact that a company that is listed in the United States subjects itself to a more

[18] See "*Canada's position in a Globalizing World of Securities Markets: an Outsider's perspective,"* presentation by J.C. Coffee, Meech Lake, June 19, 2007.

stringent regulatory environment as well as to greater scrutiny by the authorities, analysts and institutional investors (Doidge *et al*., 2007, p. 3). This environment improves the governance system. The premium can also be linked to better possibilities for financing growth. Doidge *et al*. show that the premium has persisted for U.S. listings, even after the adoption of the Sarbanes-Oxley Act (SOX). However, they observe a discount, rather than a premium, when foreign companies cross-list on an exchange in the United Kingdom. In practical terms, a foreign company that cross-lists in the United States sees an increase of 17% to 22% in value, while a company that opts to cross-list on AIM sees its value diminish by 5%. The authors conclude that due to the regulatory system in place, a listing on a U.S. exchange provides specific advantages that the London markets cannot offer.

Therefore, the implementation of a principles-based system has the advantage of allowing a greater number of companies to list themselves, but may also have negative consequences.[19] Indeed, the level of AIM requirements has raised concerns, and requirements relating to certain offerings have been re-examined.[20] The past experience of European venture exchanges during periods of economic reversal urges caution. The lack of very significant advantages of an AIM listing probably explains why there are still only a limited number of Canadian companies listed on AIM.

2.1.3 AIM and Canada

As Table 10 shows, although 44 Canadian companies have listed on AIM since 1995,[21] 336 of them listed in the United States during the same period. The attraction for AIM is therefore relative, and Canadian companies opt on a ratio of eight to one for a traditionally regulated market. The limited number of Canadian issuers listed on AIM is even more curious, given the existence of an accelerated listing process for firms already listed on the TSX. This situation does not indicate a strong preference for a principles-based system, contrary to the Panel's assertion.

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[19] For a discussion of the advantages and problems of the two regulatory approaches, see "*SEC Regulation Outside the United States,"* Commissioner R. C. Campos, U.S. Securities and Exchange Commission, London, March 8, 2007, http://www.sec.gov/news/speech/2007/spch030807rcc.htm

[20] Jeremy Warner, "OUTLOOK: Taking AIM." The Independent, London (April 9, 2005); James Mackintosh "FSA to act on foreign IPO concerns," Financial Times and FT.com (April 5, 2007).

[21] Among them, 4 were already listed on a US exchange.

An analysis of the attributes of issues that have taken place on AIM provides an indication of the implicit standards resulting from the application of the principles by Nomads. Derrien and Kecskes (2007) report figures, summarized in Table 10, for 786 IPOs completed on AIM between 1995 and 2004. We have estimated corresponding values for Canadian IPOs for the same period.[22] We base our comparisons on medians and on the first quartile (25% of issuers have a value below the value reported), given that averages have little meaning in such a context. The median post-issue capitalization is $31.66 million on AIM and $12.64 million on all Canadian exchanges. While 75% of issuers on AIM have a market value that exceeds $14.22 million, 50% of Canadian issuers have a market capitalization of less than $12.64 million. A comparison of revenues also highlights significant differences: Half of Canadian issuers have revenues of less than $286,000, while 75% of issuers on AIM have revenues above $325,000.

The vast majority of Canadian issuers **would likely not have been able to list on a securities exchange if a system similar to AIM had existed.** Canadian financing requirements for growth companies therefore appear much more flexible than the principles-based system on which AIM relies, in particular because of the parallel CPC and RTO mechanisms, as Rousseau notes (2006, p. 102). Although certain AIM issuers report losses, the majority of them earn revenue, and their market capitalization is significant by comparison with that of Canadian issuers. Transplanting the system to Canada would result in a significant tightening of exchange listing requirements. It might also increase the costs to access the market, given that direct costs on AIM are estimated at between 10.5% and 12% for an issue of $20 million, compared with 9.45% in Canada (Table 4). Moreover, Rousseau expresses much doubt on the possibility of implementing the Nomad system in Canada—an integral part of the principles-based system of AIM—and indicates that such a system could result in raising the already high concentration that exists in the Canadian brokerage industry.

[22] The authors report their figures in pounds. We used an exchange rate of 2.286 Canadian dollars per pound, namely, the average rate that prevailed during the period in question.

Table 10 Comparison of attributes of IPOs followed by listings on AIM and on Canadian stock exchanges, in millions of Canadian dollars

	AIM, 786 IPOs between June 1995 and July 2004	Canada (TSX and TSXV), 678 IPOs between January 1995 and December 2003
Capitalization		
Average	61.70	114.49
Median	31.66	12.64
1st quartile	14.22	3.68
Sales		
Average	15.9	65.20
Median	3.34	0.286
1st quartile	0.325	0.00
Net income		
Average	-1.49	1.285
Median	-0.297	-0.062
1st quartile	-2.30	-0.452

Source AIM: Derrien and Kecskes (2007)

Transplanting the AIM system to Canada would therefore prevent a significant portion of Canadian issuers from accessing the market. We must therefore agree with Rousseau's first proposal, which reads as follows (p. 84): "Canadian stock exchanges and regulators should abstain from transplanting the Nomad system, and related features, of the AIM model in Canada."

2.2 The Canadian Market and Junior Issuers

2.2.1 Current Situation

In part 1 of this paper, we showed quite clearly that Canadian issuers benefit from favourable financing conditions, whether financing opportunities or terms, as regards direct and indirect costs. In particular, financings which, in other countries, would involve venture capital firms providing financing at rates in excess of 25%, are carried out in Canada at a rate apparently lower than the rate generally sought in the securities market. The Panel states that moving to a single regulator system would clearly reduce the costs of capital for small and medium-sized enterprises (SMEs), reduce the costs related to offerings and provide greater access to Canadian

investors. The Panel relies heavily on a study carried out by the Canadian Bankers Association (the "CBA Study"), which indicates that additional costs must be borne when issuers seek to raise capital through IPOs in several provinces. The CBA Study states that (1) the majority of IPOs are carried out in several provinces and (2) offerings in several provinces give rise to significant additional costs. We will address each of the three benefits which, according to the Panel, would result from the implementation of a single regulator.

2.2.2 Reduced Cost of Capital

We have shown that the cost of capital for Canadian issuers, predominantly SMEs, is abnormally low. It would therefore seem difficult to reduce it even more. Moreover, reducing this cost would further lower the rate of return earned by Canadian investors, likely causing them to stop participating in the offerings market. Rather than focusing on further reducing the financing costs borne by issuers, committees and organizations studying the matter should focus more on the reasons behind the situation and on the means for providing investors with sufficient information and training so that, on average, they can earn returns consistent with the degree of risk they have assumed. This is an essential condition for ensuring that issuers continue to have access to favourable financing terms. Over the long term, a financial market will grow only if issuers provide investors with returns consistent with the level of risk they have assumed. We do not believe that reducing the cost of capital for SMEs in Canada is an absolute priority, because there is no indication that it is abnormally high. Indeed, the prevailing situation seems to be one that favours issuers to the detriment of investors.

Moreover, the conditions for reducing the cost of capital are relatively well-known. The first condition, an all-encompassing one, relates to the quality of the regulatory and disclosure system. We have shown (Table 5) that the level of quality in Canada is deemed equivalent to that in the United States and better than that in the United Kingdom and Australia. Beyond domestic factors, the cost of equity is company-dependent and varies based on the degree of risk and uncertainty involved. Uncertainty results from lack of information transparency and the difficulty in evaluating certain classes of issuers.[23] An initial means of reducing the cost of capital for SMEs would therefore be to limit exchange listings by companies that carry the

[23] The cost of equity is related (inversely) to the level of disclosure (Botosan, 1997) and is also affected by the liquidity of securities (Amihud and Mendelson, 2000).

highest degree of risk and are the most difficult to assess accurately, namely, issuers without revenue, which comprise 45% of IPO issuers, and those that obtain an exchange listing through an RTO or CPC. Theory and empirical studies suggest quite strongly that the cost of capital varies inversely with regulatory stringency. It is therefore paradoxical to state that relaxing the regulatory system, or implementing differentiated requirements, would reduce the cost of capital. The likely impact would be the opposite of what is intended.

2.2.3 Access to Canadian Investors

According to the CBA Study, IPO issuers often approach investors in several provinces. A total of 299 offerings were analyzed.[24] The study ignores the 290 CPCs that were created during the same period and were limited to a single province. Based on this sampling, the CBA argues that issuers raise capital in several provinces and, as a result, incur additional costs. No information is provided on the percentage or characteristics of multijurisdictional issuers. It is therefore impossible to measure the extent of any potential problem.

We estimate that the majority of offerings and exchange listings in Canada are local transactions that involve only one securities commission. This is the case for the vast majority of RTOs, CPCs and offerings involving gross proceeds of less than $2 million. These transactions represent approximately 3,900 of the 4,900 offerings we identified, namely, about 80% of offerings. Larger offerings frequently take place simultaneously in several provinces. Therefore, the additional costs attributable to simultaneous offerings in several jurisdictions are economically negligible.

2.2.4 Direct Costs

If we compare offerings of the same size, the direct costs of issue in Canada are lower than those in the United States as well as those on AIM in the United Kingdom. It is therefore difficult to argue that creating a single regulator such as in these two countries, or implementing a principles-based regulatory system such as the one in the United Kingdom, would generate a significant reduction in costs. Moreover, we only measured IPO costs. In principle, the costs of an exchange listing by way of RTO or CPC should be even lower. We also measured the direct and indirect costs of private placements and subsequent offerings (Carpentier *et al.*, 2005). We

[24] It is difficult to determine if the study is limited to initial offerings or if it covers subsequent offerings.

found that the total cost for private placements stood at 13.30%, including the discount. This total value is considerably less than the discount measured in the United States, which alone amounts to 20%. We found the total cost for subsequent offerings to be 7.55%, an amount that is also lower than amounts identified in U.S. studies. For example, Lee *et al*. (1996) report direct costs of 13.28% for subsequent offerings of less than US$10 million. Regardless of the type offering, the direct costs are lower than in the United States. It is obviously desirable to reduce them further.

Using an example that examines 7 offerings, the CBA's analysis indicates additional costs of $30,000 for offerings of $6 million, when the offering takes place in several provinces. This merits a number of comments. Firstly, the spread represents 0.5% of the gross proceeds of the offering. Secondly, in order for the spread to be significant, it should be estimated over a very large sample and take into account the other factors that affect the costs of issue: first and foremost the size of the offering. Finally, the principal cost borne by IPO issuers is the initial undervaluation, which deprives small issuers (less than $10 million) of approximately 30% of the proceeds of their offering. Any serious effort to reduce the costs of issue should focus more on reducing this major component, which is linked to brokerage operations.

The situation is different for offerings of $10 million and more, which seem to constitute the bulk of the CBA Study's sample. However, for these offerings, the cost spread has little economic significance and its analysis requires that the effects of offering size be considered separately from the effects attributed to multiple jurisdictions.

2.2.5 Conclusion

The Panel proposes to reduce the cost of capital for Canadian SMEs. This cost is already very low, and it would be possible to reduce it only by limiting access by the highest risk issuers or by increasing the level of disclosure. The Panel then argues that the existence of multiple jurisdictions results in additional direct costs of offerings. However, the evidence relating to these costs is quite sparse, and our estimates indicate that the vast majority of financing transactions are carried out locally. In fact, they involve amounts below $2 million. Therefore, there does not seem to be a major problem as regards the cost of financing of growth companies through the securities market. It is equally difficult to see how the creation of a single regulator and the implementation of a principles-based regulatory system would improve the situation.

Moreover, in a market in which 45% of issuers list their securities on an exchange before reporting any revenue, providing greater financing flexibility for such companies does not appear to be an essential need.

2.3 The Competitiveness of the Canadian Market

Competition between markets has increased significantly in recent years, reflecting the significant concentration of exchanges. According to Coffee (2002), the number of exchanges throughout the world should continue to decrease considerably, due to globalization as well as technological advances. DiNoia (2001) even foresees consolidation toward a single market, except where working arrangements allow for the creation of cooperative networks. The key component of competition between markets is the ability to attract foreign issuers, generally by way of cross-listings. In this regard, the U.S. and U.K. markets, each of which have different regulatory approaches, are the indisputable winners. The Panel suggests that only the creation of a single regulatory body would allow Canada to become a world-class financial centre able to compete with the United States and the United Kingdom. The report, as well as Coffee's statements in 2007, specifically mention the higher cost of capital that exists in Canada. Below, we will address the following questions.

(1) What is Canada's competitive position?
(2) What are the key elements of competition between markets?
(3) Are Canadian companies driven to list on other markets as a result of regulatory issues?
(4) What regulation and strategies are offered in Canada?

2.3.1 Canada's Competitive Position

The position of securities markets has declined significantly, beginning in the early 1990s. Canada's global ranking fell from sixth to ninth in 2004 as regards the volume of trades. Net growth in trading volume (excluding the effect of variation in the index) was 8.84%. This is the lowest rate of growth observed in the developed countries, excluding Japan. The primary cause of the decrease in the relative importance of trading volume in Canada is the transfer, to the United States, of a significant volume of trades in securities of Canadian companies. In 2006, this volume reached $816 billion, representing 94% of the trading volume in Canada of cross-

listed securities.[25] The percentage of trades of cross-listed Canadian securities that account for more than 50% of trades in the United States rose from 28% in 1990 to 55% in 2006. The many studies examining competition between exchanges have highlighted the major role of certain elements, which we discuss in the following part.

2.3.2 What Are the Key Elements of Competition Between Markets?

Karolyi (2006) discusses the principal elements that explain a company's decision to list its securities on a foreign exchange. These elements are: bonding (becoming subject to more stringent regulatory requirements), gaining access to a larger pool of investors and reducing the cost of capital (market segmentation argument), reducing transaction costs and increasing liquidity and, finally, drawing markets closer to products and services. Overall, the "gravity" model is the model that best explains the cross-border movement of capital.

The segmentation argument: Segmentation exists when two markets are not fully integrated, namely, when there are barriers to capital flows between the two countries. In such a case, by listing on a foreign exchange, a company reduces its risk through diversification that cannot otherwise be achieved due to the market barriers. Moreover, by listing on this market, the company gains access to a pool of new investors. It should be able to finance its growth more easily and see a stronger demand for its shares. Despite significant integration between the Canadian and U.S. markets, the opinion that there is a major reduction in cost of capital for Canadian issuers listed in the United States has largely prevailed. We therefore re-examined these assertions. Nevertheless, it is undeniable that the pool of private and institutional investors in the United States and in the United Kingdom is considerably larger than in Canada, such that Canada is at a considerable disadvantage in that respect.

Liquidity and trading costs: According to Domowitz *et al.* (2001), in general, execution costs are lower and liquidity is higher in the United States than in other countries. They show (Table 1) that total one-way trading costs are 52.4 basis points in Canada compared with 38.1 in the United States. Based on these estimates, a portfolio with a quarterly turnover incurs additional annual trading costs of 85.8 basis points if the trades are carried out in Canada rather than in the United States. The Canadian disadvantage is therefore significant.

[25] A detailed analysis of changes in trading of Canadian shares traded in the United States is available in Carpentier *et al*. (2007b).

Bonding hypothesis: Businesses from countries with weak minority shareholder protection, in particular, can indicate their willingness to better protect those rights by listing on markets where the protection is stronger. According to Coffee, (2002, p. 11) "cross-listing may also be a bonding mechanism by which firms incorporated in a jurisdiction with weak protection of minority rights or poor enforcement mechanisms can voluntarily subject themselves to higher disclosure standards and stricter enforcement in order to attract investors who would otherwise be reluctant to invest (or who would discount such stocks to reflect the risk of minority expropriation)." Furthermore, listing in the United States increases monitoring by analysts and institutional investors. In this regard, Canada is not at a major disadvantage, given the similarity in the securities regulatory systems.

Strategic component: Companies list on markets where they develop their business activities so as to create strategic advantages and facilitate mergers and acquisitions. Bancel and Mittoo (2001) state that business considerations have become the principal factor driving Canadian companies to list in the United States. In this regard, too, the Canadian disadvantage is incontestable. The relative size of the two economies will generally require a Canadian company to develop in the United States in order to achieve global recognition; the converse is not true.

These various elements probably explain why the gravity model is the model that best explains the international flow of capital (Portes and Rey, 2005). The movement of capital is essentially driven by the various components for measuring the relative size of economies (GNP, market capitalization and wealth) and is limited by certain frictions, primarily those resulting from the distance between countries. These variables explain 83% of the differences observed between international capital flows. Within the scope of this model, the Canada-United States relationship is characterized by maximum size differences and minimal distances. Canada's relative loss of importance therefore seems inevitable.

It is therefore inaccurate to suggest that the regulatory structure is a key component of the market's loss of competitiveness. This loss of competitiveness manifests itself, first and foremost, by the migration of businesses and transactions toward the United States, a phenomenon explained primarily by strategic and transaction cost considerations. In the

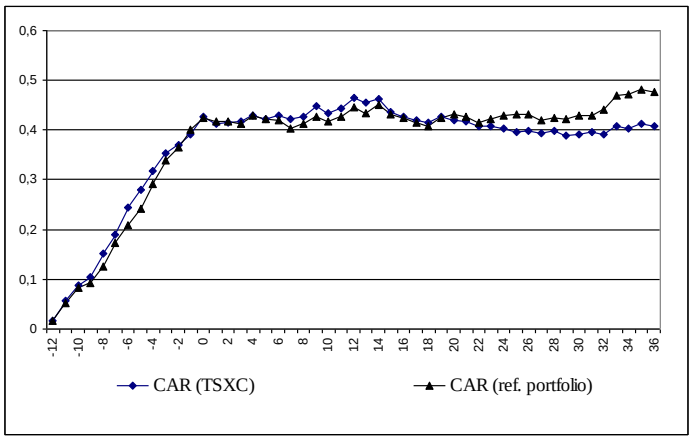
following section, we analyze the argument whereby this migration is caused by an advantage resulting from the regulatory system.

2.3.3 Listing in the United States and Its Effects

Certain studies show that the performance of Canadian companies listing in the United States is abnormally low following such listing. For example, Mittoo (2003) estimates such underperformance to be 13% during the post-1990 period. By equating these realized rates of return with rates expected by investors, several authors associate this effect with a reduction in the cost of capital (Errunza and Miller, 2000). Thus, issuers benefit from listing in the United States, given that their financing costs diminish following a cross-listing. This argument is similar to the premium argument,[26] mentioned by Coffee (2007), who sees three possible origins: "weak enforcement, suboptimal corporate governance and costly and inflexible regulation." In summary, the weak performance of Canadian companies following a U.S. listing is evidence of deficiencies in the Canadian regulatory system. These findings and statements required further examination. We analyzed all Canadian companies that listed their securities on a U.S. exchange since 1990, using various methods for estimating abnormal performance (Carpentier *et al.*, 2007c). The principal finding is illustrated in Figure 1: Performance following a U.S. listing is perfectly normal. Pre-listing performance is very high, evidencing two elements: Companies that cross-list their securities are generally good performers, and their shareholders see a number of advantages in the decision to cross-list. However, our findings contradict the argument whereby a U.S. listing reduces the cost of capital.

[26] The value of a share is equal to the present value of future cash flows. If the discount rate (the cost of capital) decreases, the value increases and a premium appears.

Figure 1 Cumulative abnormal returns by Canadian companies cross-listing their securities in the United States. We estimate abnormal returns for the year preceding the cross-listing (month 0) and the three years following the cross-listing. The complete sample includes 336 cross-listings that took place between January 1990 and December 2005. Abnormal returns are estimated using 2 comparison indices: the S&P/TSX Capped Index (TSXC) and reference portfolios with a similar size and ratio of shareholders' equity to market capitalization (ref. portfolio).



2.3.4 The Role of Regulation and Possible Strategies

The position of the Canadian securities market is deteriorating as a result of the shift of transactions to U.S. exchanges. Canada attracts few foreign companies, and the percentage of transactions carried out in Canada is low (approximately 5%). Can regulatory changes alter this situation?

Regulatory and tax factors very likely play a part in limiting foreign investment activities in Canada. According to the Conference Board (2007), there is limited foreign investment in Canada because "Canada's effective tax rate on capital is the highest in the developed world; we are also the most restrictive among the G7 countries in terms of barriers to foreign ownership." These factors are not related to securities, but their effect can be significant. Securities regulation also plays a role, but it would probably be excessive to attribute to the securities regulatory system primary responsibility for the situation. Similarly, the creation of a single regulator would likely have a marginal effect on the Canadian market's ability to hold on to local transactions or attract foreign issuers. Indeed, competition between securities exchanges is essentially played out at the cross-listing level. Cross-listing primarily involves large companies, which are generally the best performers and the most focused on growth. The principal factors driving them to cross-list are strategic ones, and they also seek to access larger

pools of investors where transaction costs are low and liquidity is high. Moreover, companies that cross-list their securities do so first and foremost in markets that have geographic, economic, industrial and cultural proximity (Sarkissian and Schill, 2004). Therefore, it is not clear how changing the regulatory structure would influence the decisions made by these issuers. Their local obligations primarily pertain to securities exchanges, and a single regulator would therefore have a limited effect on the costs and constraints imposed upon such issuers. In recent years, competition between securities exchanges seems to have focused on new listings. The market for foreign IPO issuers, however, is limited, and its recent growth is likely attributable to the desire for certain small U.S. companies to avoid the application of SOX as of 2007. Two options are therefore suggested in Canada. The first consists in developing regulatory requirements that are more stringent than those in the United States and would attract issuers seeking to cross-list their securities in order to achieve a bonding effect. In light of the nature of Canadian issuers, this seems unrealistic. The second option, favoured by the Panel, consists of adopting a strategy that imitates AIM. In the preceding section, we showed that transplanting the AIM model to Canada would be difficult and would probably prevent a significant portion of Canadian issuers from accessing the market.

While we do not deny that there is room for improvement in the Canadian securities regulatory system, we refute the idea that the system is the principal obstacle to the development of Canadian exchanges. Moreover, given the unavoidable existence of economic and geographic factors that influence competition between markets, as well as the uniqueness of the Canadian market, we believe efforts should be focused, above all, on improving and sustaining the financing options available to Canadian issuers.

2.4 ENFORCEMENT

The Crawford Report emphasizes the need to improve enforcement, so as to reduce the cost of capital for Canadian companies. ”There is little doubt in our minds that ensuring the credibility of securities regulation in Canada through vigorous enforcement will reduce this premium, attract risk averse investors to our markets, and thereby increase liquidity and correspondingly reduce the cost of capital to Canadian issuers” (The Task Force to Modernize Securities Legislation in Canada, 2006, p. 107). We have shown, through our own studies and by referring to studies carried out by other researchers, that there is no significant difference between the

cost of equity in the United States and in Canada. **Enforcement problems are not such that they influence the cost of corporate financing.**

However, there is a strong feeling that economic crime, in the broadest sense, is not being sufficiently deterred in Canada. According to the Panel, this impression is largely attributable to the visibility of U.S. enforcement measures: "Securities law enforcement in the United States has been highly visible on both sides of the border due to press coverage, due to the size and impact of the market abuses in question, and due perhaps to the search for profile by some involved. (...) The high visibility of securities law enforcement action in the United States has led many Canadian investors (justifiably or not) to conclude that Canadian regulators are failing in this area. There has been great concern expressed in the Canadian press with respect to what is perceived as the tepid reaction of Canadian securities regulators to the vigorous American reaction in cases of alleged securities law violations involving cross-border listed Canadian companies" (Report of the Task Force, p. 112).

According to the Panel, a single regulator would allow for effective and fair enforcement across the country. The Panel also points to dissatisfaction with the current system. More specifically, one of the studies commissioned by the Panel points to the following elements as evidence of Canada's failure with respect to enforcement: the lack of legal proceedings and convictions in too many high profile cases,[27] the failure to prosecute insider trading, excessively long delays and inadequate penalties (de C. Cory and Pilkington, 2006). Comparisons with the United States are frequent, particularly as regards proceedings instituted following the financial scandals that occurred in the late 1990s.

2.4.1 Different Strategies

The strategy adopted by the SEC is characterized as revolutionary (Ford, 2005). According to this author, the strategy is based on levying huge penalties against companies and other regulated entities. The SEC has also implemented mechanisms (The Framework for

[27] The National Pensioners and Senior Citizens Federation particularly deplores the fact that in the cases involving Nortel Networks Corp., Royal Group Technologies Ltd., Portus Alternative Asset Management Inc., Norbourg Asset Management Inc. and Norshield Asset Management Ltd., the RCMP (via the IMETs) did not lay any charges. See "*Canadian seniors group calls for enforcement reform*," D. Clarke, Investment News, March 12, 2007 http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20070312/FREE/70308027/-1/INIssueAlert04&ht=

Cooperation) that allow companies to reduce the penalties levied against them in exchange for their cooperation or remedial measures. Penalties are widely reported and, according to Ford, these various actions create a culture of compliance. Finally, the U.S. system relies quite heavily on private lawsuits, including in matters of insider trading. When enforcement of securities laws depends on regulators, it is said to be public. When laws and regulations relating to disclosure facilitate legal proceedings by individuals, enforcement is said to be private. La Porta *et al.* (2006) studied the relationship between the growth of the markets and the public and private dimensions of enforcement, and conclude as follows: "We examine the effect of securities laws on stock market development in 49 countries. We find little evidence that public enforcement benefits stock markets, but strong evidence that laws mandating disclosure and facilitating private enforcement through liability rules benefit stock markets."

In Table 11, borrowed from Jackson (2006), we illustrate legal proceedings and penalties imposed in the United States, on an average annual basis, between 2002 and 2004. The Table illustrates the relatively marginal role played by the SEC with respect to legal proceedings: It initiates 9.7% of proceedings and its actions give rise to 24% of the total penalties imposed. The Table also illustrates the very important role of private lawsuits, which represent 44.6% of the cases and nearly 40% of the amounts imposed on the entities sued. In the United States, class actions account for 38% of the penalties imposed for financial misconduct.

For a variety of reasons, the experts consulted, as well as those who sat on the various committees that studied enforcement, do not recommend that the U.S. example be followed, particularly as regards the publicity surrounding major penalties and as regards private lawsuits which, in Canada, are more limited and difficult than in the United States.[28] Thus, comparisons between Canada and the United States are still difficult, as Jackson points out (2006).

However, Table 11 shows that securities commissions are not the primary enforcers of legislation. It therefore seems unlikely that a significant change in enforcement in Canada can be effected by modifying the structure of these commissions. This is particularly true given that certain measures to fight economic crime were introduced rather belatedly in Canada and still do not seem to be functioning properly.

[28] For an analysis of the differences between US and Canadian class actions involving securities, see Ward Branch, of Branch MacMaster: Securities Class Actions in Canada: Haven or Hinterland http://www.branmac.com/go/download/securities.pdf.

Table 11 Summary of enforcement of securities laws in the United States, for the years 2002-2005, expressed as an annual average.

Section A: Number of proceedings

	Number of proceedings	Percentage of total	Percentage of "public" proceedings
Public proceedings			
SEC	639	9.70%	17.60%
Department of Justice (DOJ)	112	1.70%	3.10%
State agencies (estimate)	1,482	22.60%	40.80%
Subtotal	2,233	34.10%	61.50%
NASD	1,170	17.90%	32.20%
NYSE	227	3.50%	6.30%
Subtotal	1,397	21.30%	38.50%
Total	3,630	55.40%	100.00%
Private proceedings			
Class actions	210	3.20%	n.a.
NASD arbitrations	1,720	26.20%	n.a.
NYSE arbitrations	994	15.20%	n.a.
Total	2,924	44.60%	n.a.
Grand total: private and public	6,554	100.00%	n.a.

Section B: monetary sanctions (millions of US$)

	Amounts	Percentage of total	Percentage of "public" proceedings
Public proceedings			
SEC	2,164.7	24.60%	40.90%
DOJ	766.5	8.70%	14.50%
State agencies (estimated)	1,114.9	12.70%	21.10%
Subtotal	4,046.1	46.10%	76.50%
NASD	1,078.3	12.30%	20.40%
NYSE	163.1	1.90%	3.10%
Subtotal	1,241.3	14.10%	23.50%
Total	5,287.5	60.20%	100.00%
Private proceedings			
Class actions	3,336.3	38.00%	n.a.
NASD arbitrations	162.3	1.80%	n.a.
NYSE arbitrations			n.a.
Total	3,498.7	39.80%	n.a.
Grand total: private and public	8,786.2	100.00%	n.a.
Grand total adjusted for double counting	8,176.7	93.10%	n.a.

Source: Jackson (2006, Table 14, p. 113)

2.4.2 Major Fraud and Inter-Agency Mechanisms

The lengthy delays and the failure to obtain any convictions in connection with the Bre-X scandal recently highlighted the difficulties faced by Canadian regulators in securing convictions in major fraud cases. This state of affairs seems to be in stark contrast with the situation that followed, in the United States, after the Enron and WorldCom scandals, among others. The Canadian situation in this regard differs considerably from that in several countries where the fight against major fraud and against economic crimes, in general, takes place through the creation of specialized national entities that bring together parties from the various agencies and departments involved.

In the United Kingdom, the Serious Fraud Office (SFO)[29] was created in 1987 to address public dissatisfaction with the lack of detection and prosecution of major fraud cases. The main recommendation of the Roskill Report[30] commissioned in order to guide the government in this matter was: "the setting up of a new unified organisation responsible for the detection, investigation and prosecution of serious fraud cases." The SFO reports to the justice department and is responsible for investigating and prosecuting cases of fraud that involve amounts in excess of £1 million (C$2 million). Moreover, the London police has a renowned fraud squad that cooperates with the SFO.

In the United States, the Fraud Section of the Department of Justice is responsible for complex prosecutions involving securities as well as economic crimes and Internet fraud.[31] The Corporate Fraud Task Force (the "Task Force"),[32] established by the President of the United States following the financial scandals, boasts a total of 1,236 convictions in major fraud cases. The Task Force is also responsible for having paid out to victims of fraud more than one billion dollars confiscated from the perpetrators of those frauds. In Enron alone, charges were laid against 36 persons, including former CEO Kenneth Lay. The Task Force brings together officials from the Department of Justice, seven U.S. attorneys, and the persons in charge of the following entities: the Departments of Treasury and Labor, the Securities and Exchange Commission, the Commodity Futures Trading Commission, the Federal Energy Regulatory

[29] http://www.sfo.gov.uk/about/creation.asp
[30] An analysis of this important report was conducted by Levi (1986)
[31] The description and the activity reports of the Fraud Section are available at http://www.usdoj.gov/criminal/fraud/
[32] http://www.usdoj.gov/dag/cftf/

Commission, the Federal Communications Commission, the U.S. Postal Inspection Service, and the Department of Housing and Urban Development's Office of Federal Housing Enterprise Oversight. The proceedings initiated during the five years of existence of the Task Force have covered fraud involving securities, insider trading, market manipulation, backdating of options, money laundering and Internet fraud. The Task Force emphasizes the importance of cooperation among participants: "Over the past five years, the task force has increased cooperation among federal agencies and leveraged the resources of the federal government to combat corporate fraud." The sharing of information with prosecutors and other stakeholders is cited as a major advance.[33] In New Zealand, a similar department was created in 1990: "The Serious Fraud Office (SFO) is a Government Department that detects, investigates and prosecutes cases of serious and complex fraud. The SFO Act 1990 gives the SFO powers to obtain evidence during the course of its investigations."[34]

Canada adopted, belatedly and cautiously, this method for fighting major fraud and economic crime. Those in charge acknowledge that "law enforcement activity is only one component required to effectively protect the capital markets. To be truly effective, a strong integration is essential between law enforcement, securities commissions, Investment Dealers Associations of Canada, Market Regulation Services, Mutual Fund Dealers Association of Canada, Canada Revenue Agency and the Public Prosecution Service of Canada."[35] The Integrated Market Enforcement Teams (IMETs) were established at the end of 2003 in Toronto and Vancouver. According to the Royal Canadian Mounted Police (RCMP),[36] their goal is to "detect, charge and prosecute those using capital markets to harm the economic interests of Canadians. The RCMP manages the IMET program and works in partnership with the Department of Justice Canada and Public Safety and Emergency Preparedness Canada. The IMET program also enjoys support from the Department of Finance Canada. The investigative teams work closely with securities regulators, representatives of other federal enforcement agencies, law enforcement agencies of local jurisdiction and forensic accountants." The IMETs appear to still

[33] See the press release at http://www.usdoj.gov/opa/pr/2007/July/07_odag_507.html
[34] http://www.sfo.govt.nz/
[35] Deposition of Pierre-Yves Bourduas, Deputy Commissioner, Federal Services and Central Region, Royal Canadian Mounted Police, before the Standing Senate Committee on Banking, Trade and Commerce, June 3, 2007 (p. 25-7) at http://www.parl.gc.ca/39/1/parlbus/commbus/senate/Com-e/bank-e/pdf/25issue.pdf
[36] http://www.rcmp-grc.gc.ca/fio/imets_brochure_e.pdf

be at the development and implementation stage. In May 2007, Mr. Nick Le Pan, the former federal Superintendent of Financial Institutions, was appointed senior expert advisor to the RCMP on IMETs. He is to make recommendations (in October 2007) to improve the functioning of this group. The companion document to Budget 2007 (Creating a Canadian Advantage in Global Capital Markets) indicates that a plan will be implemented "to improve the effectiveness of the IMETs (...) [in order to]: attract and retain the best-qualified police and other expert resources to conduct and support investigations into criminal capital market offences; strengthen the central coordination of the IMETs (…); improve coordination between the IMETs, securities regulators and provincial Crown prosecutors (…)."

The hearings held by the Standing Senate Committee on Banking, Trade and Commerce (June 13, 2007)[37] provide a good illustration of the limited resources available for this initiative, and, in particular, the serious problem faced by the IMETs in recruiting and retaining staff. The senators point out that the budget for the Manhattan district attorney's office alone, to fight white-collar crime, is four times the budget allocated to the IMETs for all of Canada. Moreover, officials emphasize that it is difficult to compare the Canadian and U.S. situations as regards the fight against economic crime, because of major difference in the legislative framework: According to Mr. Constant (pp. 25-19) "Their legislative framework is quite different from ours. If we want to hold that comparison, it is important to ensure we bring the legislative framework that supports that kind of enforcement. We do not have the grand jury style here in Canada. We do not have the partial immunity for suspects. We do not have the compelling evidence from witnesses."

Securing convictions in cases of major fraud therefore seems to require the establishment of specialized and highly integrated groups, of which the securities commissions are but one component. By contrast with the United States and the United Kingdom, the creation of such an entity came late in Canada, the entity seems to have limited resources and its functioning is still in the early stages.

[37] http://www.parl.gc.ca/39/1/parlbus/commbus/senate/Com-e/bank-e/pdf/25issue.pdf

2.4.3 How Is the Canadian Situation Different?

The foregoing may explain, in part, the existence of a critical situation as described by the Panel. However, a careful reading of the research commissioned by the Panel itself shows that its statements, as regards both findings and resources, can be qualified.

The Findings

In Table 12, we have supplemented the data regarding enforcement, initially compiled by Jackson (2006). The Table illustrates changes in the number of legal proceedings initiated and the number of penalties imposed. Jackson writes (p. 112): "I do think that there is strong evidence that the overall level of enforcement intensity has risen in Canada over the past few years."

As of the second half of 2005, we incorporate into Table 10 data relating to actions initiated by the IDA (Investment Dealers Association), RS (Market Regulation Services) and the MFDA (Mutual Fund Dealers Association). These entities intervene relatively infrequently, compared with the situation observed in the United States (Table 9). Provincial regulators are responsible for 59% of legal proceedings and 89.1% of penalties imposed in connection with public enforcement of securities laws. The author concludes that, based on the proceedings instituted, and regardless of the adjustment factor applied in order to compare the two markets, the likelihood of securities enforcement proceedings remains noticeably higher in the United States than in Canada. He highlights the much smaller role played by SROs in Canada, for which he establishes an "enforcement ratio" of 17.2 to 1 (IDA) and 12.6 to 1 (RS). The corresponding ratio is 5.2 to 1 for the securities commissions. In addition, private legal proceedings are noticeably less significant in Canada than in the United States.

Table 12 Changes in principal data on enforcement of securities laws in Canada, per six-month period, April 2004 to April 2007. Amounts are expressed in thousands of Canadian dollars.

	04-2004 09-2004	10-2004 03-2005	04-2005 09-2005	10-2005 03-2006	04-2006 09-2006	10-2006 03-2007	Annual average
Number of disciplinary actions resolved	56	68	61	91	77	85	146
Amount of penalties imposed	2,400	367,947	3,648	6,893	12,232	6,342	133,154
Disgorgement	360	19,200	1,475	0	992	53	7,360
Reimbursement of costs	634	293	392	944	638	882	1,261
Total penalties, in ($000s)	3,394	387,440	5,514	7,837	13,862	7,277	141,775

Source: Jackson (2006, Table 7, p.101) from April 2004 to September 2005 and annual reports of the CSA between October 2005 and March 2007

Resources

Comparing the costs and resources allocated to securities regulators is a delicate task when the size of the markets differs as much as do the Canadian and U.S. markets. The various comparisons carried out by Jackson (2006) indicate that the resources allocated to the regulatory system seem proportionally greater in Canada, but he concludes that there is no significant difference in budgets or staffing levels. After adjusting for economies of scale, the level of resources is not abnormally different from the resources available in the United States. The main difference between the two countries lies in the budgets allocated per employee of the Canadian entities. These are lower than comparable numbers in the United States.

The Canadian enforcement environment is improving, but still falls short of expectations and enforcement actions elsewhere. We have shown that the causes of this situation are varied. They cannot be attributed entirely to the provincial commission structure, and it also seems illusory to think that a single regulator could remedy the situation quickly. Indeed, the experts consulted by the Panel mention centralization as one of the factors, from among many others, that might improve enforcement.

2.4.4 Is a Single Regulator the Solution and Would It Result in an Improvement?

The majority of studies on this subject mention the centralization of securities regulation as one of the factors that might improve Canada's performance in matters of enforcement, but this is

neither the only nor the main component. The study carried out by de C. Cory and Pilkington (2006) and commissioned by the Panel, makes the following recommendations to strengthen the investigation, prosecution and adjudication of securities offences:

(1) Regulators and agencies should establish enforcement as a priority.

(2) The mandate of IMETs with respect to investigations should be expanded, provincial interests should be taken into account, the recruitment and retention of staff should be improved and a senior independent review officer in charge of strategies should be appointed for each IMET location.

(3) Prosecutions should be coordinated nationally.

(4) Adjudicative functions should be transferred to an independent specialized tribunal and judges should be better prepared to manage cases involving the financial markets.

(5) Penalties: Discrepancies between the sanctions applied in the provinces seem to be a major issue for the Panel. However, this situation exists in the United States, even within the framework of uniform regulation. Weiss (2001) and Loomis (2000) write that different courts in the United States have expressed completely different opinions on matters such as insider trading.[38] The report recommends that penalties be harmonized across the country, that guidelines be established for provincial offences and that the costs of prosecutions be recoverable.

(6) Redress for harm to investors: The regulatory system should be structured so as to allow for disgorgement or compensation to victims of financial crime and so as to provide investors with the possibility of instituting proceedings based on a court or tribunal finding of misconduct.

(7) Self-regulatory organizations (SROs): The roles, jurisdiction and powers of SROs should be reviewed.

(8) National management of enforcement: Allow for a better use of resources and a better development of skills. The authors see numerous limits in the current structure of the IMETs, which further complicate matters as regards the acquisition of skills. They consider IMETs to be a largely inadequate response to the enforcement challenge.

38 Loomis (2000) illustrates these discrepancies as follows: "The 9th Circuit has articulated the most defence-friendly standard. Its 1999 decision in re Silicon Graphics Inc Securities Litigation, 183 F3d 970, affirming a 1997 decision from the Northern District of California, requires pleadings to provide 'in great detail, facts that constitute circumstantial evidence of deliberately reckless or conscious misconduct.' Stock sales before a steep drop in stock market value alone do not satisfy the standard. The winds blow in a different direction on the East Coast. In 1998, the Southern District of New York ruled that a plaintiff claiming fraud need plead only that the defendant had 'motive and opportunity,' a standard that can be met, for example, by alleging stock sales by corporate executives before a surprise announcement that causes stock prices to drop. This year, the 2nd Circuit affirmed the ruling in Novak v. Kasaks, 216 F3d 300, although the parties disagree as to the grounds of the statement."

Centralized enforcement is but one of eight sets of measures proposed by these experts who were enlisted by the Panel. In fact, it is possible to provide for national enforcement by way of cooperation. The authors conclude: "Whatever the results may be of the negotiations to establish a unified or harmonized approach to securities regulation, it remains fundamentally important that the approach to enforcement be managed on a national basis. A centralized approach would facilitate the efficient use of resources in the development and deployment of the special knowledge and skills that are required for the effective investigation, prosecution and adjudication of complex securities matters." Thus, the study does not conclude that centralized regulation is an essential condition for strict enforcement of the law.

3 THE ISSUE OF COSTS

3.1 THE COST ARGUMENT

The argument regarding the excessive cost of Canadian securities regulation is put forward, on a recurrent basis, to justify the centralization of the Canadian regulatory system. Regulation results in compliance costs as well as direct costs. We discussed the issue of compliance costs for new issuers in section 2.2. Here, we address two other aspects that we believe are important, namely, the costs to investors and direct costs. Investors bear costs when buying and selling securities on the secondary market. Direct costs are those related to the securities commissions. They are generally labelled as excessive, and certain reports argue that is it possible to reduce them significantly (Wise Persons' Committee, 2003 p. 34). Below, we answer the following questions:

> (1) Can it be said that the costs borne by investors in Canada are higher due to the regulatory system?
>
> (2) Are direct costs of regulation excessive in Canada, compared with direct costs in other countries?
>
> (3) Are indirect costs a major problem?
>
> (4) Would it be possible to reduce the costs significantly by creating a single securities regulator?

3.2 INVESTOR COSTS

The regulatory costs borne by investors should be a major consideration. Previously, we mentioned the significant shift of trades in Canadian securities cross-listed in the United States; these securities are now traded to the same extent in both countries. This shift constitutes a considerable challenge for the Canadian market, and the possibility of trading at a lower cost is one of the factors that explains the shift in trading activity. Investors are subject to a variety of costs—regulation is but a relatively minor component. It is possible to argue that the costs resulting from regulatory mechanisms are, ultimately, borne by both groups of users, namely, issuers and investors. It therefore seems appropriate to consider these direct regulatory costs in relation to the total costs supported by both these groups.

In Canada, according to the TSX Review, trading volume on the TSX reached $1,075 billion in 2005. If trading costs are similar to those in the United States, investors, as a whole, paid 1,075 x 0.0075 = $8.063 billion. Jackson (2006) assesses the total cost of securities commissions in Canada at $143.3 million (Table 1, p. 90), which represents 1.77% of trading costs. In Canada, a reduction in trading costs from 0.75% to 0.737% would have as much effect on the total costs directly incurred by the markets as would abolishing all securities commissions. The trading costs in Canada for medium and small-cap securities are very high. For example, Cleary *et al.* (2002) set these costs at 1.3% for securities trading at between $15 and $20, when a discount broker is used. They amount to 3% if a full-service broker is used. The 0.75% estimate used here applies to trades carried out over the Internet and to liquid securities trading at high prices, as well as to institutional investors. We have therefore underestimated the total cost borne by investors. It is also possible to consider regulatory costs in relation to revenues in the Canadian securities industry. In 2003, revenues were $10.6 billion and commission costs were approximately $110 million. The relationship between the two amounts is also in the order of 1.03%. Reducing the regulatory burden is a commendable objective. However, it is clear that regulation is only responsible for a very negligible fraction of the costs borne by issuers and investors in Canada. Attributing the relative inefficiency of the Canadian markets solely to the costs of regulation ignores the fact that the bulk of trading costs is linked to the functioning of the markets and to brokerage commissions, which are primarily under the control of the brokerage industry itself. It is obviously possible to argue that the costs

are essentially indirect. Beyond the facts presented above, we also refer to the study commissioned on this subject by the Wise Persons' Committee (Anand and Klein, 2003).

3.3 Are Indirect Costs a Major Problem?

Indirect costs are examined in the study by Anand and Klein on four levels: registrants, IPOs, exempt market transactions and acquisition transactions.

As regards registrants, the authors write: "While material incremental compliance costs were not the norm for our case study participants, smaller firms are less able to bear these costs and consequently are more likely to find them to be material. Thus, the existence of multiple securities regulators in Canada may impose a competitive disadvantage on smaller firms."

With respect to IPOs, the authors state the following: "Because we have not found material incremental costs with respect to the IPOs that we examined, we have no basis on which to conclude that one model is preferred to any other or even that any of the alternative models is preferred to the current system."

As regards exempt market transactions, they state the following: "Material incremental compliance costs were not the norm for our case study participants. However, smaller issuers are less able to bear these costs and consequently are more likely to find them to be material. Thus, the existence of multiple securities regulators in Canada may impose a competitive disadvantage on smaller issuers."

Finally, as regards acquisition transactions, the authors write: "In acquisition transactions where regulatory hearings were held, case study participants reported opportunity cost risk which related to the delays that may arise if multiple regulators are involved in the hearings."

In none of the cases did the researchers show "material" costs[39] that could constitute the norm. Additional costs related to multiple regulation are therefore, most often, negligible. Apparently, there are a few cases where issuers or smaller registrants may have to bear costs that may penalize them more heavily than larger institutions, as is the case with any regulation. On the basis of evidence shown in support of the Wise Persons' Committee report, it is difficult to argue that the present structure imposes a significant additional cost on Canadian participants.

[39] The concept of materiality is commonly used in accounting to distinguish between what must be reported and what need not be reported.

3.4 Are Securities Regulatory Costs Disproportionate in Canada?

It is routine to state that Canadian regulatory costs are abnormally high in relation to the capitalization of the Canadian market or in relation to the gross national product. The source for data relating to costs is generally the Financial Services Authority, which, since 2003, has kept track of four components of securities regulatory costs.[40] In 2003, the direct costs related to these components were £73.8 million in Australia, £56.8 in Canada, £37 in the United Kingdom and £977.3 in the United States. As a percentage of total capitalization, the amounts were 0.029%, 0.015%, 0.004% and 0.014% respectively. However, the responsibilities of regulators are more a function of the number of listed issuers than they are a function of capitalization. It is possible to calculate a cost per listed issuer. It is $123,000 in Australia, $33,600 in Canada, $37,300 in the United Kingdom, and $324,700 in the United States. It therefore seems difficult to claim, on this basis, that the direct costs of regulation are higher in Canada than in other countries in which market practices are rather similar.

3.5 Would a Single Regulator Reduce Costs?

The argument regarding the reduction of costs originates essentially from the Charles Rivers Associates analysis (2003), which has several important limitations:

- It analyzes, together, very different structures with varying responsibilities (provinces, states, countries).
- Securities activity is measured on the basis of the GNP. This is particularly inaccurate in the United States, where the GNP at the state level is included in the country-wide GNP. It is well-known that the GNP is not proportional to securities activity or to capitalization.
- A single measurement of the cost differences for each factors is taken into account, namely, the cost of living.
- The relationship between securities activity and the direct cost of regulation is considered to be linear, which is certainly not the case.

However, the main issue is the following. The savings referred to in the report of the Wise Persons' Committee, namely $46.6 million per year, are associated with a model whose securities regulatory and oversight activity is practically nonexistent in all provinces, except

[40] These components are: (1) Securities firms and fund management firms - prudential supervision, (2) Supervision of and standards for exchanges / clearing and settlement systems / market service providers (3) Supervision of, and standards for conduct on, capital markets (including transaction reporting but excluding exchange's own rules) and (4) Standards for / approval of listing of securities.

Ontario. Table 13, which summarizes the information provided in Tables 19 and 20 of the Charles Rivers Associates study, illustrates this clearly:

Table 13 Cost of securities regulation in Canada, based on the Charles Rivers Associates model (Tables 19 and 20).

	Actual	**New regime**	**Savings**
All of Canada	127.8		46.6
Ontario Head Office		70.2	
Alberta Branch		2	
British Columbia Branch		2.8	
Manitoba Branch		1.4	
Nova Scotia Branch		1.2	
Québec Branch		3.6	

Thus, Québec would only be left with $3.6 million to assume its remaining responsibilities with respect to securities. This amount only allows for minimal activity. Approximately 90% of its current activities would be eliminated.

The configuration that would give rise to the savings referred to in the report of the Wise Persons' Committee **consists in abolishing virtually all securities commissions other than the Ontario Securities Commission.** This model is inconsistent with the proposal in the report, which suggests maintaining a significant local presence and the use of provincial expertise. According to the Charles Rivers Associates study, Ontario would be responsible for substantially all securities regulation in Canada through a $14 million increase in operating expenditures for the Ontario Securities Commission, compared with the existing budget. This seems rather unrealistic.

3.6 CONCLUSION

An analysis of regulatory costs indicates that there is little evidence showing that the current regulatory structure leads to significant costs for investors or issuers. The direct costs of regulatory authorities are lower than those incurred in other countries, when expressed on the basis of the number of reporting issuers. Finally, arguments to the effect that a single commission would generate substantial savings are less than convincing.

4 CONCLUSION

In the first part of this paper, we documented the fact that Canada is, by far, the country that offers growth companies the best possibilities for initial financings, exchange listings and subsequent financings. The direct costs of offerings are lower than those in the United States for offerings of the same size, time frames are shorter than those in the United States and, in particular, the cost of financing for small issuers, measured by the returns earned by investors, is favourable to issuers. These market characteristics provide issuers with a considerably higher life expectancy at the time of an offering than that observed for offerings by more mature companies in other countries, including the United States. Improvements are certainly possible, but it is difficult to argue that the existing regulatory structure has been an obstacle to the development of solutions tailored to the financing of growth companies. The experts mandated by the Panel emphasized the importance of taking steps to reduce the cost of corporate financing. We have shown that, in general, this cost is identical to that in the United States. For issuers, it seems abnormally favourable, especially in the case of growth companies.

We analyzed Canada's competitive position. First, it must be recognized that the Canadian market is not a large-cap market. At the end of 2006, 73% of the 60 Canadian securities with the highest capitalization were also listed in the United States, and the percentage of trades carried out in that country is increasing on a regular basis. The Canadian market is therefore essentially reserved for medium and small-cap securities. The Panel's suggestion to implement a principles-based regulatory system, in imitation of AIM, so as to attract foreign issuers merited analysis. However, there is a significant risk that it will exclude a large number of Canadian issuers from the market. Moreover, the economic and geographical conditions governing competition between markets do not seem favourable in Canada. The experts mandated by the Panel advise against the implementation in Canada of a system based on AIM for the listing of new issuers.

With respect to enforcement, numerous factors other than the securities regulatory structure can explain the fact that Canada has performed below expectations. The experts consulted by the Panel produced reports suggesting multiple avenues for solutions. Centralizing the securities commissions is certainly one of those avenues, but it is not the only one and, indeed, does not even seem to be the main avenue suggested.

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