Proportionate Securities Regulation: The Potential for Scaled Treatment of Junior Issuers

A Research Study Prepared for the
Expert Panel on Securities Regulation

Janis Sarra

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The Potential for Scaled Treatment of Junior Issuers

Biography

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She was a commercial and labour arbitrator prior to joining the Faculty of Law in 2000, and is a member of the Bar in Ontario. Dr. Sarra previously taught advanced corporate law at the Faculty of Law University of Toronto and taught at the Faculty of Business Ryerson University. Recent publications include *Business Organizations: Principles, Policy and Practice* (Emond Publications, 2008), with R. Yalden, M. Condon, M. Gillen, R. Davis; *Securities Law in Canada, Cases and Commentary*, co-authored with Mary Condon and Anita Anand (Toronto: Emond Montgomery Publications, 2005); *Rescue! The Companies' Creditors Arrangement Act* (Toronto, Carswell, 2007); *The 2009 Annotated Bankruptcy and Insolvency Act* (Toronto, Carswell, 2008); *Modernizing Disclosure in Canadian Securities Law: An Assessment of Recent Developments in Canada and Selected Jurisdictions,* Report to the National Task Force on the Modernization of Securities Law, March 31, 2006; *Review of the Derivative Action Provisions of the Canada Business Corporations Act*, *Policy Implications and Options,* Report to Corporations Canada, 2005; and "The Current Global Financial Crisis and Implications for China's Emerging Economy" (forthcoming, 2008).

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1. Executive Summary

Particular features of Canada's capital market inform our consideration of moving towards a more proportionate regulatory system, specifically, Canada has a large number of small public companies; its market cap is concentrated largely in four provinces; it has a particular focus on mining, resources and technology; and a significant number of issuers are cross-listed on US exchanges. Canadian securities regulators have already recognized some measure of proportionate regulation in their national instruments, based on the type of listing.

The paper suggests that a number of overriding principles or considerations should be taken into account in respect of a further move towards proportionate regulation. They include:

- Proportionate regulation must balance access to capital and the long term sustainability of the market; a key objective is maintaining the integrity of Canadian capital markets.

- The benchmark of the regulatory system continues to be materiality, in that while periodic disclosure or other compliance requirements may be proportionate, all issuers must continue to ensure that material change is disclosed to the market in a timely, accurate and comprehensible manner, a requirement that should not be scaled.

- Decision making in respect of adopting further proportionate regulation should be timely, transparent and relevant for market participants and should be implemented only after broad consultation. A possible methodology is to identify a problem or difficulty that may justify a proportionate response and then work with market participants to scale the requirement appropriately, using one or more of the tools cited above or other problem solving strategies.

- There is a need for transparency and bright line delineation in respect of which issuers fall in which category of proportionate regulatory requirements.

- Investors must have a clear understanding of the risk associated with issuers that comply with modified disclosure and governance requirements, including explanatory notes on periodic reporting documents and prospectuses, public education and plain language disclosure.

- If the delineation is venture/non-venture, smaller issuers on the TSX and comparable exchanges must be given guidance regarding compliance with the more extensive requirements.

- If the delineation is market capitalization, at either end of the market size, there is a need for well-founded and transparent criteria on which to make a determination of which category issuers are located.

- Disclosed risk factors should be focused for all issuers, not overly generalized.

- Any proportionate regulation must be accompanied by consistent and rigorous compliance and enforcement, to ensure integrity of the market.

- Proportionate regulation can be used to reduce disproportionate compliance costs by eliminating regulatory compliance requirements where they do not add value to the integrity of the market.

- Any proportionate regulation should recognize the extensive oversight of junior issuers by the TSXV.

- Any proportionate regulation must ensure that the costs of compliance associated with any new requirements do not outweigh the benefits to market participants.

- Under a shift to a principles/standards/outcomes-based system, all market participants must have a shared understanding of regulatory expectations, specifically, what broad high level principles mean in practice.

    - Develop high level principles that are universal and allow junior issuers to develop best practices sensitive to their structure and needs.
    - The flexibility of principles/standards/outcomes regulation should be used to focus requirements on junior issuers, rather than create opaque expectations.
    - There should be recognition that there is a continuum of principles/standards and outcomes-based regulation, and that any further shifts should occur after measured consideration of benefits to the market, involving broad based and meaningful consultation.
    - Any evolution from existing standards should be measured, in terms of assessing what outcomes a shift from current rules to principles or outcomes is aimed at achieving and measuring the effectiveness of any shifts.
    - Regulators assessing good governance practice should share that experience with other market participants, increasing the overall knowledge base of good practice.
    - Resources need to be directed towards junior issuers in terms of supporting any shift to principles/standards/outcomes-based regulation and transparent and accessible guidance on best practice, so that junior issuers can develop the capacity to meet practice compliance under any adopted principles.
    - Resources are needed to allow junior issuers to participate in a meaningful way with regulators in developing future policy or practice.
    - Set appropriate strategic milestones for junior or small issuers.

- Consultation regarding any shift to proportionate regulation and principles/standards/outcomes-based regulation should be broad, including all market participants, advocacy organizations and exchanges.

- Any further move towards proportionate regulation should engage market participants in consideration of regulatory standards and how they differentially impact market participants.

- There should be wide-spread public education regarding the different risks associated with issuers that are proportionately regulated.

- Evaluation of proportionate regulation, under whatever type of system is adopted, should measure outcomes against clearly articulated goals, including assessing clear milestones, measure the culture of compliance, cost effectiveness, ease of implementation, reduction of investor and market risk, and benefits to market participants.

    - Regulators need to develop tools for assessing compliance if a principles/standards and outcomes based approach is adopted.

2. Introduction

The Expert Panel on Securities Regulation in Canada is to examine the best way to improve securities regulation in Canada.[1] Part of that mandate is to consider adoption of a proportionate regulation regime. This paper explores the potential for proportionate regulation of reporting issuers, including defining options for what such a system may entail, and the underlying policy rationale.[2] While previous studies have made reference to the need to consider proportionate regulation, the contours and limits of adoption of such a strategy have not been articulated in the public policy debate.

There are two basic questions to such an inquiry. First, what objectives of Canadian securities law would proportionate regulation meet, both in terms of the substantive law and the regulatory framework? Second, how can one delineate issuers by size or type, in terms of the criteria to be applied? This paper commences with a discussion of the context for the proportionate regulation debate; then considers these two questions, including a discussion of how proportionate regulation has already been adopted, to a limited extent, in Canada. It considers principles that might be applied in considering future proportionate regulation.

Part 3 examines the context for the paper. Part 4 examines the objectives of Canadian securities law that proportionate regulation may be responsive to, including efficient capital markets and investor protection. It examines the challenges for introducing proportionate regulation under various regulatory models, including the passport and common securities regulator models, principles or outcomes based regulation, and cross-border harmonization considerations. Part 5 explores how one can delineate issuers for regulatory purposes, including type of listing, market capitalization and revenue based approaches, using examples in Canada, the UK and the US. While the focus of the paper is on small or junior issuers, Part 6 briefly discusses implications of a proportionate regulation system for seasoned or larger issuers. Part 7 sets out broad principles and basic tools to move towards proportionate regulation. Part 8 concludes.

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[1] The Expert Panel on Securities Regulation in Canada is to provide advice and recommendations to the Minister of Finance and the provincial and territorial ministers responsible for securities regulation. Information in this paper is current to July 31, 2008. The author deeply appreciates the cooperation of regulators from across Canada, and, in particular, appreciates the assistance of Douglas Hyndman and Sandy Jakab of the British Columbia Securities Commission, William Rice of the Alberta Securities Commission, and Kevan Cowan and John McCoach of TMX Group. Thanks also to Bernard Lau, UBC Law II for research assistance.

[2] The mandate of this paper was confined to reporting issuers only, and there are different considerations for small registrants and other market participants.

3. The Context

The issue of proportionate regulation arises because of the unique structure of the Canadian capital market, which is primarily national, with distinct regional features. Canadian based issuers represent approximately 96 per cent of the companies listed on the Toronto Stock Exchange (TSX) and TSX Venture Exchange (TSXV) and 92 per cent of the aggregate market capital of public companies, while foreign issuers represent a relatively small, but increasing, number of total TSX and TSXV listings.[3] There are over 4,000 issuers on the TSX and TSXV, with an average size of $1.3 billion on the senior market and $22.6 million on the junior market.[4] The TSX is the largest small-to-medium enterprise (SME) exchange in North America, and second in the world based on the number of issuers listed.[5] Canada's public equities market is a tiered market with 59 per cent of companies listed on the TSXV.[6] More than a third of TSX listed issuers, 1,373, are mining companies.[7] Based on aggregate market capital, the oil & gas industry is the most significant industry in Canada, at 25 per cent, followed by financial services at 24.8 per cent and mining at 17 per cent.[8] Many issuers on the TSXV are at the development or exploration stage.

Based on aggregate market capital of companies with head offices in the respective provinces, the largest provincial markets are Ontario at 40 per cent, Alberta at 26 per cent, Québec at 11 per cent, and British Columbia at 8 per cent.[9] These provinces represent 92 per cent of all public companies listed on the TSX and TSXV.[10] In terms of average market capital, Alberta is highest at $785 million; Ontario is at $700 million, Québec at $653 million and British Columbia at $133 million.[11] Much of the Canadian capital market is made up of SME issuers in the public equities market.[12]

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[3] Rik Parkhill, Interim Co-CEO, TSX Group Inc., Speech to 8th Annual Metals and Mining Conference of The New York Society of Security Analysts, June 4, 2008, http://www.tsx.com/en/news_events/speeches/#Jun04-08, at 4. He observed that the TSX added 49 new international listings in 2007. There are 30 Australian mining companies and 12 South African mining companies on the TSX or TSXV, at 6. In 2007 alone, 219 new resource companies listed on TSX Group exchanges, including 13 from the U.S., 9 from Australia, 2 from each of South America, China and the U.K. At the end of last year, TSX had 58 Chinese and Chinese related companies, and to June 2008, three Chinese issuers have joined the TSX, to total 60 Chinese issuers, making the TSX one of the top three exchanges for the number of Chinese listings. The aggregate market capital of companies listed on the TSX and TSXV is $2.15 trillion, up from $1.17 trillion five years.

[4] *Ibid.*

[5] *Ibid.* at 6. TSX Group is second in the world based on the number of issuers listed on our exchanges. The exchange with the largest number of issuers is the Bombay Stock Exchange, the small company exchange in Mumbai, India.

[6] *Ibid.*

[7] *Ibid.* at 7.

[8] Based on TSX and TSXV data as at December 31, 2007; Alberta Securities Commission (ASC). The Alberta Capital Market: A Comparative Overview, 2008, Report, May, 2008: http://www.albertasecurities.com/news/ASC%20Publications/6116/The%20Alberta%20Capital%20Market.pdf, last accessed August 3, 2008 at 4.

[9] *Ibid.* at 3.

[10] *Ibid.*

[11] *Ibid.* at 5.

[12] Income trusts represent almost 9 per cent of the aggregate market capital in Canada and 6 per cent of the listings on the TSX and TSXV. The aggregate market capital associated with income trusts has decreased

Each regional market has some unique characteristics. Ontario has the greatest number listed on the TSX, followed by Alberta, and both have more issuers with over $1 billion in market capital than other jurisdictions. British Columbia has the largest number listed on the TSXV, followed by Ontario and then Alberta.[13] 628 of British Columbia's TSXV listed issuers have market capital of less than $10 million, whereas the province has fewer companies than Alberta or Ontario listed on the TSX with market capital of over $250 million.[14] Ontario, Alberta and British Columbia all have strong junior markets, although the concentration differs, with mining significant in British Columbia, oil & gas in Alberta and technology and mining in Ontario.[15] 84 per cent of British Columbia based companies have a market capital of under $100 million, whereas this figure is 69 per cent for Alberta. Alberta's public equities market is a tiered market with a relatively even distribution of small, medium and large companies.[16] Companies with market capital of less than $25 million represent 49 per cent of Alberta's capital market, 40 per cent of Ontario's capital market, 56 per cent of Québec's capital market and 67 per cent of British Columbia's capital market.

Canada has the largest number of mining companies listed on its stock exchanges in the world. More than one third of TSX listed issuers, 1,373, are mining companies, twice as many as the next strongest mining exchange, which is Australia's ASX, and six times as many as the London Stock Exchange and AIM.[17] Hence, Canada has a large number of small public companies; its market cap is concentrated largely in four provinces; it has a particular focus on mining, resources and technology; and a significant number of issuers are cross-listed on US exchanges. These particular features drive any consideration of moving towards a more proportionate regulatory system.

The structure of the Canadian capital market suggests that there may be different capacities to engage in regulatory compliance with respect to the proliferation of regulatory change implemented or being considered in the post-Enron and *Sarbanes-Oxley Act* era. A principal mechanism by which regulators exercise oversight is through disclosure requirements for entry and participation in the market, from the offering stage through to the periodic disclosure of financial statements and the timely and accurate disclosure of material changes. More recently, there have been requirements to disclose corporate governance practice and internal financial controls, measuring such practices against suggested norms, creating another set of compliance requirements. These requirements are part of participation in modern capital markets, whether an issuer is listed only in Canada or seeks capital in the US and other markets. Issuers necessarily consider the administrative and resource costs of disclosure compliance in their choice of market. Yet the question is whether existing or proposed regulatory requirements ought to be applied in

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almost 4 per cent and the number of income trusts has decreased by almost 16 per cent in the past year, largely due to changes in federal tax law, *ibid.* at 6.

[13] *Ibid.*

[14] *Ibid.* at 11.

[15] *Ibid.* at 5.

[16] *Ibid.* at 4.

[17] Parkhill, *supra,* note 3 at 7.

the same manner or to the same extent for all issuers, given the different structure of the Canadian market and the large number of small and junior issuers.

A number of studies have observed that securities regulation can be an obstacle to small business finance and continued participation in the market.[18] Due to fixed compliance costs, small firms are disproportionately affected because larger public issuers have more resources at their disposal than junior issuers, and the costs of compliance per dollar of revenue generated may be lower than for junior issuers. Larger issuers can often rely on their own personnel to comply with securities regulations rather than having to outsource internal auditing, legal work, and compliance. Junior issuers frequently incur the costs of such external assistance.

Often the internal expertise of a junior issuer includes geologists, engineers and other professionals in the sector that the junior issuer is engaged in research and development or exploration, and they have not yet hired much financial expertise, relying on underwriters, auditors and legal advisors for that assistance. They often have relatively fewer managerial resources; and the time required to qualify securities under a prospectus is frequently longer. Managers of junior issuers are usually aware of regulatory requirements, but often daunted by the complexity of disclosure and other rules.

The cost of compliance with new internal control requirements can frequently be disproportionate to the need for such controls given the size of the issuer; and such costs may outweigh any benefit of protection for investors. Junior issuers may have limited access to audit assistance from big accounting firms that direct their energy first towards their larger clients, creating issues in respect of compliance deadlines. Corporate governance and accountability structures designed for large and complex organizations are frequently too onerous for junior issuers, who may have only limited personnel and a governance structure that is essentially just direct accountability to senior officers.

Junior issuers may have difficulty meeting independent director best practice requirements, given increased compensation and insurance costs for such directors.[19] Given that junior issuers are frequently not yet generating revenue, they have not invested in governance structures and controls, and such controls may be unhelpful given their stage of development and may direct valuable resources away from developing the business. In turn, excessive or inappropriately directed regulation may create a serious market disadvantage for junior issuers.

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[18] H. Y. Chiu, "Can UK Small Businesses Obtain Growth Capital in Public Equity Markets? An Overview of Shortcomings in UK and European Securities Regulation" (2003) 3 Delaware Journal of Corporate Law 933-977; Ontario Securities Commission, Task Force on Small Business Financing, Final report (1996), http://www.osc.gov.on.ca/About/Publications/op_small_business.pdf ; J.L. Huffman, "The Impact of Regulation on Small and Emerging Business" (2000) 4 Journal of Small and Emerging Business Law 307-317; Ginger Carroll, "Thinking Small: Adjusting Regulatory Burdens Incurred by Small Public Companies Seeking to Comply with the Sarbanes-Oxley Act", (2006) 58 Ala. L. Rev. 443; Interim Report of the Committee on Capital Markets Regulation, 30 November, 2006, online: http://www.capmktsreg.org.

[19] Roberta Romano, "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance", (2005) 114 YALE L.J. 1521, 1588.

(a) Lack of Empirical Data

The precise scope of barriers that small or junior issuers face in Canada has not, however, been well documented empirically, in terms of study on the true impact of proportionate regulation or its absence. One recent empirical study on the effects of the 2001 changes to Canadian private placement regulations to facilitate access to equity financing by SMEs observed a statistically significant effect only on the number of issues by closed corporations; and the authors concluded that the study results did not confirm the policy argument that securities regulation was a major constraint to small business capital raising, although they acknowledged that the results did not rule out that the reforms eased some financing.[20] US scholars examining a number of empirical studies relating to *Sarbanes-Oxley Act (S-Ox)* regulatory requirements concluded that there was evidence that *S-Ox* had a disproportionately negative impact on smaller firms, at least at its initial implementation, but the evidence was not conclusive in respect of long-term effects.[21] Hence, while uniform regulation is likely in some instances to be onerous to smaller issuers, there needs to be further empirical study of precisely the extent to which the problem exists, how it affects capital raising processes, and how any changes could respond to such problems.

Similarly, there is little empirical data on the extent to which junior or smaller issuers do or do not pose higher risks to the marketplace from governance, financial or regulatory compliance deficiencies. Where such issuers are seeking capital, there is a considerable amount of information in the market because of the need for the issuer to attract underwriter support and meet prospectus and other regulatory requirements. However, in the periods between offerings, there may be less market and regulatory scrutiny, posing some risk to secondary market investors. While the quantum of potential harm to investors could be lower than from larger issuers, given the size of market capitalization, the risk of non-compliant behaviour could be higher for some firms that lack the resources, skill or information to ensure best practices and regulatory compliance. Junior issuers are often relationship based, and the degree of best practices may depend largely on the senior officers and the culture of compliance and best practice encouraged. There appears to be little data to support or negate the extent of risks unique to junior issuers. Regulatory compliance and governance risks need to be distinguished from the higher risks associated with the inherent nature of a junior issuer in its exploratory or research and development stage.

With that important caveat about the availability of Canadian data, this paper considers proportionate regulation as a policy choice. The degree of regulation on the activities of market participants must be proportionate to the regulatory objectives.

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[20] Cecile Carpentier, Jean-Francois L'Her and Jean-Marc Suret, "Does Securities Regulation Constrain Small Business Finance? An Empirical Analysis", forthcoming in (2008) *Small Business Economics*, http://ssrn.com/abstract=1131792, last accessed July 25, 2008. The changes came about as a result of an OSC Task Force, which found that in respect of public financings, the costs of preparing and filing a prospectus and related costs are borne disproportionately by SMEs because the direct costs are relatively higher for smaller offerings, at 7.

[21] Kamar, Pinar Karaca-Mandic, and Eric Talley, "Sarbanes-Oxley's Effects on Small Firms: What is the Evidence?" (June 2007), USC CLEO Research Paper No. C07-9, http://ssrn.com/abstract=993198; but see the study by Wu *et al,* discussed below under the Part on public float.

The financing needs of junior issuers vary significantly depending on the type of business and stage of development, as financing is usually a multi-stage process. There is no common standard for defining small issuers or junior issuers. They are variously defined by reference to their market capitalization, type of listing, revenues, assets, debt facilities, length of operating history and ownership structure.

4. What Objectives of Canadian Securities Law Would Proportionate Regulation Meet?

"Proportionate", "scaled" or "measured" regulation is the notion that securities regulation should recognize the different risks and benefits of issuers by their size, experience in the market, resources or capacity to act. Its underlying premise is that junior issuers often do not have the resources or personnel to comply with the full range of disclosure and other regulatory requirements. Given the size and nature of their capital needs, regulators in some jurisdictions have concluded that small or junior issuers pose lower risk to the market, and should be subject to different or less onerous requirements.[22] Other regulators, such as in the US, have concluded that larger seasoned issuers should also receive scaled treatment because of their record in the market and the availability of more information over a sustained period.[23]

Proportionate regulation can mean a range of options, from exemption from particular regulatory compliance to a range of measured or scaled adjustment of specific requirements for particular size or type of issuer.

(a) Efficient Capital Markets and Investor Protection

In Canada, securities laws articulate two concurrent goals: to foster fair and efficient capital markets; and to provide protection to investors from unfair, improper or fraudulent practices. British Columbia describes these goals as fostering a securities market that is fair and warrants public confidence, with a dynamic and competitive securities industry that provides investment opportunities and access to capital.[24] While sometimes juxtaposed as competing objectives, these concurrent goals are really aspects of the same challenge, as investor protection is a necessary element of fostering confidence in the market such that capital can be raised in a timely and efficient manner. Proportionate regulation can advance these concurrent goals.

Regulatory requirements should advance the public's understanding of the risks inherent in the issuer's activities. Where disclosure and other regulatory requirements do not advance public policy goals, they should not be required. Scaled requirements that allow the market access to the information required to make effective investment choices can assist with

[22] See the discussion below in respect of the FSA in the UK and the SEC in the US. Some may contest that they impose lower risk to the market.
[23] See the discussion in Part 5 below.
[24] British Columbia Securities Commission Service Plan 2008-2011, http://www.bcsc.bc.ca/uploadedFiles/ServicePlan_2008-2011.pdf. See also British Columbia Securities Commission (BCSC), submission to Expert Panel on Securities Regulation, June, 2008, www.bcsc.ca.

raising capital on a less costly basis. Investors are protected through continued, but more focused requirements, but they must be able to fully appreciate any demarcation in terms of different standards being applied. A critical aspect of any proportionate regulation is to ensure that the integrity of regulatory requirements and the rigour of enforcement are maintained.

The objectives of securities regulation and the principles of transparency, fairness and certainty underlay any policy choices. The categorization of issuers that will have different regulatory requirements must be transparent for capital market participants. Transparency for issuers is necessary in terms of understanding qualifying criteria and regulatory obligations; for understanding when they would transition from one set of regulatory requirements to another, either upward or downward, based on issuer definitions. Transparency is also essential for investors, their advisors, and other consumers of securities in terms of their understanding the different reporting and oversight protections, so that they can make appropriate assessments of risk and return. Regulators must also have clear expectations of issuers in continuing disclosure and other aspects of securities law, in order to appropriately assess compliance; facilitate options for joint problem solving; allow for effective risk-based enforcement; and in order to understand the legal standard of proof to be met in any enforcement activities.

The objective of protection of investors from particular kinds of market conduct also engages notions of fairness in considering proportionate regulation. For issuers, this concern is fairness in terms of what side of a demarcation line the issuer falls on and the consequent regulatory requirements. If the measure for the smaller issuer is market capitalization, for example, the issue is what are the appropriate cutoff points distinguishing the size of issuer. With respect to investors and other consumers, fairness is engaged in terms of their reasonable expectations of the role of regulators in their oversight of market participants. The delineation of what companies may be subject to different time requirements or differently focused disclosure requirements may not create unfairness if there is transparent notice to consumers that different standards apply and clear policy reasons for different standards. Examples are the oil & gas and mining sectors, where there are specialized requirements for disclosure, aimed at allowing potential investors and others to have particular technical data in order to make informed choices regarding potential risk and return in their capital investment.[25]

Another consideration for investor protection is the role of market participants other than regulators, as sources of information in the market about both junior and senior issuers. Analyst following and underwriter involvement provide external information to the market; and one issue is the extent to which this scrutiny or analysis serves an investor protection function. For example, in a study of 100 Canadian issuers with 10 firms in each of ten market ranges of capitalization, Pritchard and Choi found that analyst coverage increases with issuer size, although they also found that small issuers making an offering were also

[25] See for example, NI 51-101 *Standards of Disclosure for Oil and Gas Activities*, 2002, as amended effective December 28, 2007 and NI 43-101 *Standards of Disclosure for Mineral Projects,* 2001, as amended effective December 30, 2005.

likely to have analyst coverage.[26] Out of the firms making offerings in their study, only two issuers under a market cap of $345 million had no analyst coverage. Based on that analysis, Pritchard subsequently suggested that issuers with a market cap of greater than $345 million had better analyst coverage such that they should qualify for well-known seasoned issuer (WKSI) type treatment in Canada.[27] In developing the category of issuers for WKSI treatment in the US, the SEC relied on analyst coverage as one of the factors.[28] Thus, proportionate regulation may have to take account of the fact that there is lower analyst coverage for junior or small issuers. Analyst coverage of junior issuers is likely to be less, although where they are seeking capital through an offering, the amount of coverage increases.[29]

This lower coverage may be offset in part by information to the market from underwriting offerings. Junior issuers seek underwriting as a means to attract market confidence in their offering. Underwriters provide considerable information to the market about the issuer for both reputational and regulatory certification reasons, whether under "best efforts" or "firm commitment" underwriting arrangements.[30] The role of external market information must be assessed in conjunction with regulatory oversight in considering investor protection in any proportionate system.

Proportionate disclosure should be based on what is relevant to investors. For example, investors in start up and junior companies may attach considerable importance to the record of management, the track record of finding the resource or mineral sought, in building equity, in securing mineral rights or licences, probable reserves, or intellectual property rights in the case of some sectors such as biotechnology. These indicia of potential return may be more important to investors than extensive disclosures on governance controls. While financial statements are critically important aspects of continuous disclosure, they could be more targeted for junior issuers, in terms of what needs to be assessed by market participants, fostering greater confidence in the market.

The issue of proportionate regulation also engages the question of market competitiveness. As the discussion of the Alternative Investment Market (AIM) in the United Kingdom (UK) below indicates, issuers will be drawn to regulatory systems that are more responsive to their needs and which do not impose regulatory requirements that do not advance goals of investor protection or efficient markets. There is a balance that needs to be achieved between the cost of regulation and its benefits to all market participants.

[26] Study cited in Adam Pritchard, "Well-Know Seasoned Issuers in Canada", Research Study for the Task Force to Modernize Securities Legislation, May, 2006 at 17.
[27] Firms with $345 to $800 million market cap had an average of 3.5 analysts per issuer. Adam Pritchard, "Well-Know Seasoned Issuers in Canada", *ibid.* at 7.
[28] Along with two other factors, trading volume and institutional ownership, Securities Offering Reform, Securities Act Release No. 33-8591, July 19, 2005, at 35.
[29] Pritchard observes that the higher level of analyst coverage for firms making offerings should be interpreted with caution as firms may provide such coverage in an effort to attract underwriting business, *supra*, note 26 at 19.
[30] M. Condon, A. Anand and J. Sarra, *Securities Regulation in Canada*, (Toronto: Emond Montgomery, 2005).

(b) Regulatory Oversight and Proportionate Regulation

The options for the oversight of a proportionate regulation system offer different advantages and disadvantages, although design and implementation of proportionate regulation is equally feasible for a passport securities regime, a passport system with a common adjudicative scheme, or a common securities regulator. Proportionate regulation requires national cooperation if it is to be uniformly applied. Otherwise standards would be too fragmented and create prohibitive cost barriers to raising capital in more than one jurisdiction. It would also lack the requisite transparency and certainty for investors and other market participants, in that different regional standards would mask the contours of risk and protection to investors.

Without analyzing the merits of any of the regulatory oversight options, as that complex and important issue is well beyond the scope of this paper, there are some considerations that can briefly be set out in terms of thinking about issues that may arise with the different proposed models.

Passport System

Under the passport system, all Canadian regulators, except Ontario, have agreed that one securities regulatory authority acts as the principal regulator for all materials relating to a filer.[31] All jurisdictions have agreed to cooperate under National Policy 11-202, *Process for Prospectus Reviews in Multiple Jurisdictions,* effective March 2008, which sets out the means by which an issuer can enjoy the benefits of co-ordinated review by the principal regulator and Ontario regulator in filing and receipting of prospectuses.[32] The system marks a new level of coordination among securities regulators and offers the potential for further negotiation of national instruments and policies that would consider proportionate regulation.[33] The advantage of the passport system for proportionate regulation is that any further recognition of scaled requirements through this system would be highly sensitive to differences in regional capital markets. The process of negotiation among different regulators has to date allowed for considerable public policy debate on the impact of proposed standards on particular types of issuers, investors and the market more generally. Any further development towards proportionate regulation would benefit from this broad based consultative input.

The disadvantage of the passport system in terms of moving toward greater proportionate regulation is the time and cost of building consensus on regulatory changes that may be required. The question is whether that time and cost is merited because the outcome in respect of how proportionate regulation is implemented is more sensitive to regional market differences. There is also the challenge of different regulators interpreting and

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[31] NI 41-101 expressly recognizes the passport system, creating a "passport prospectus" and a "dual prospectus", where issuers are seeking to distribute in more than one Canadian jurisdiction. National Policy 11-202 *Process for Prospectus Reviews in Multiple Jurisdictions,* effective March 17, 2008, describes the process for filing and review of prospectuses, including investment fund and shelf prospectuses, amendments to prospectuses and related materials in multiple jurisdictions.
[32] NI 11-202 *Process for Prospectus Reviews in Multiple Jurisdictions.*
[33] Some examples of proportionate regulation in Canada are discussed in the next part of this paper.

enforcing nationally negotiated proportionate standards differently, although regulators in recent years have cooperated to a greater degree in their compliance and enforcement initiatives.

Passport System with National Adjudication Structure

A passport system with a national adjudication structure poses some of the same benefits and challenges in terms of negotiating principles or standards for proportionate regulation, although once a principle or standard is established and affirmed by a national adjudicative tribunal, it would be uniformly applied by the regulators across Canada. The principal advantage is in having the benefit of carefully negotiated regulation, as discussed for the passport system, and then having one interpretation of national instruments, legislation and other rules that create special requirements for junior issuers. Such an option could increase fairness and lower transaction costs for small or junior issuers because there would likely be clear and consistent adjudicative guidance on what standards mean in practice, which does not necessarily occur under the passport system.

The negative feature of proportionate regulation under this second model may be the adjustment costs as regulators amend or shift their local policy and compliance structures and norms to meet with any national adjudicative body's substantive ruling in respect of a small or junior issuer requirement, a challenge not only confined to the issue of proportionate regulation.

Common Securities Regulator

A common securities regulator would possibly allow for greater ease of policy change, allowing for more timely decision making in respect of regulatory change more generally and proportionate regulation more specifically, a significant advantage, assuming that there are processes in place for meaningful participation based on region and type of market participant. Smaller issuers and other market participants could potentially have more timely and cost effective interactions with regulators, as they would deal with only one jurisdiction and pay one set of regulatory fees, although considerably more resources would be needed to effectively serve smaller market participants on a national basis.[34] As with the common adjudicative option, the interpretation of proportionate regulation could be more consistent and fair across the country, advancing the goals of investor protection and market efficiency.

However, a common securities regulatory system may be less sensitive to regional difference, and in particular, the regulatory compliance needs of junior issuers that are not located in Ontario, where many national regulatory bodies tend to be located. Under such a system, regional enforcement centres would not necessarily be the solution if there was not meaningful regional input by the public and regulatory authorities into policy choices regarding compliance.

[34] The issue of the amount of fees that would be required to sustain a national system sensitive to regional needs is beyond the scope of this paper, but is an important question.

Key considerations for proportionate regulation in a common regulator system would be that there is a decision making mechanism that assesses the need for, and possible options for, modified regulation that is sensitive to differences in regional markets by size and sector; that the system create the resources and structure to allow small or junior issuers to be involved in a meaningful way in such policy and regulatory development; that the common adjudicative function be designed to ensure sensitivity to type and sector of junior and small issuers; and that any new proportionate regulation be monitored for its effectiveness or outcomes as measured against the rationale for the differentiated standard.

Market Competition/Hybrid Model

A hybrid of a passport system and common securities regulator is another possibility, similar to corporate law, where companies have the option of incorporating under the Canada *Business Corporations Act (CBCA)* or any provincial or territorial corporate law. Provinces design their corporate law to attract companies, such as unlimited liability companies in Nova Scotia or companies with par value shares in British Columbia. While provincial corporate law has extraterritorial provisions to facilitate companies moving or undertaking arrangements or other capital structure changes that engage more than one province or territory, companies can opt to register under the *CBCA* for federal coverage and one set of rules, wherever they operate. This dual structure has arguably created a market for incorporation in Canada.

Considering only the issue of proportionate regulation under a dual securities law structure, a common regulator could continue to develop proportionate regulation on a national basis, in a timely fashion, having regard for regional needs and input as discussed above.[35] While national buy-in of all jurisdictions would be the goal of any new regulatory principles or standards for junior issuers, all issuers would have the potential to immediately opt into a proportionate regulation system by registering with the common regulator. In essence, there would be a market for registration, as issuers could list with the common regulator or with a passport provincial jurisdiction.

While the contours of such a hybrid approach are beyond the scope of this discussion, the common regulator with a clearly proportionate regulatory regime could provide a market alternative for issuers and their advisors. The issuer would not face fragmentation in requirements; and there would be a high degree of transparency in a single set of scaled requirements. The same considerations in respect of access to regulatory decision making, sensitivity to regional diversity, and monitoring for effectiveness would apply to this approach, as noted above.[36]

[35] Under such a system, provincial or territorial regulators could opt to authorize the common regulator to undertake all regulation and oversight in their jurisdiction, thus becoming part of a national regulatory system, or could opt to carry on as a regulator under the passport system.
[36] If the common regulator were to adopt a principles or outcomes based approach, there would be a further aspect of a market for securities regulation created and different considerations would apply, as discussed below.

National Enforcement Approach

A fourth option being considered is a national enforcement agency. This option is harder to speculate on with respect to considerations for proportionate regulation as the idea appears to separate the policy and oversight function of securities regulators from the enforcement and adjudicative function, which seems counter intuitive from both a need to ensure that the range of regulatory tools – communication of principles and policies, setting of standards, guidance, problem solving, and compliance warnings - are compatible with enforcement, the latter of which really only becomes important when earlier parts of the system do not work. In terms of junior issuers, who may be more in need of those earlier tools, any disconnect between regulatory oversight and enforcement could be extremely costly and, in some cases, could affect the financial viability of the junior issuer. Regulators in Canada currently tend to focus on different aspects of regulatory requirements in their enforcement activities,[37] and it is not clear as to whether these regional differences are a function of particular regional conduct or enforcement preferences of particular regulators. Absent a clearer understanding of these dynamics and the pattern along the continuum of information, guidance, compliance and enforcement, it is difficult to assess the potential issues associated with proportionate regulation and this model.

In summary, the passport system, the national adjudicative model, the common regulator model and the hybrid approach all offer some positive potential for proportionate regulation, but each also pose challenges in considering how policy choices would be made and implemented. If layered with principles-based regulation, the challenges could be more complex if practice develops regionally in terms of meeting broad principles and standards and is adjudicated nationally.

(c) Principles/Standards/Outcomes Based Approaches and Proportionate Regulation

Proportionate regulation as a policy option requires consideration of the interplay between a rules-based and a principles-based regulatory regime. In reality, Canada, as many jurisdictions, is moving to an amalgam of these concepts, redefining rules as "standards" or "outcomes-based regulation" and informing them through articulated principles.[38] This debate is the subject of another paper for the Expert Panel, and beyond the scope of this paper.

However, it merits note that if Canada is to shift further towards a principles/ standards/outcomes-based system, then it is necessary to examine the implications for

[37] Mary Condon, *The Use of Public Interest Enforcement Orders by Securities Regulators in Canada,* research paper for the Wise Persons Committee, 2003.

[38] See for example, Ontario Securities Commission, Annual Report 2007, http://www.osc.gov.on.ca/About/AnnualRpt/2008/goal1.html; CSA, Principles and Practices for the Sale of Products and Services in the Financial Sector; http://search.osc.gov.on.ca/en/query.html?col=osc&qt=+principles&charset=iso-8859-1&ql=&rf=1&Search.x=5&Search.y=3; IDA, *Establishment and Amendment of IDA Rules to Implement the Core Principles of the Client Relationship Model,* http://www.osc.gov.on.ca/MarketRegulation/SRO/ida/rr/srr-ida_20080229_amd-client-relation.pdf . See also, as an example, the discussion of proposed NI 31-103, below in this part.

proportionate regulation. The premise of such a system is that regulators should intervene in the market only where necessary and only to the extent to remedy a market problem in a fair and cost efficient way that reduces risk to the integrity of the market.[39] Such a system could recognize the barriers faced by junior issuers and the need to appropriately scale compliance requirements to reflect both their resources and the assurances sought by their investors.

The UK sets broad principles with guidance on compliance and standards where necessary, measuring the value of regulatory intervention by assessing outcomes and milestones, the cost effectiveness of regulation, and the effectiveness of enforcement.[40] The FSA's high level principles of business conduct focus on skill, care, diligence, risk management, financial resources, fair treatment of investors and market conduct.[41] The FSA's approach is that a regulator should only intervene in markets where the market is failing to deliver acceptable outcomes, and where the costs of intervention are justified by the benefits to be delivered by regulation.

Endorsing a similar approach, the British Columbia Securities Commission (BCSC) has used the term "outcomes-based regulation", which uses both principles-based and prescriptive rules in conjunction with other regulatory tools such as compliance monitoring, guidance, education and enforcement, with the goal of eventually reducing the emphasis on prescriptive rules.[42] It believes that risk-based regulation is a critical component of outcomes-based regulation, not a separate regulatory goal and that regulators should only intervene where the sole means to address a problem is regulation to effectively remedy the problem.[43]

British Columbia's 2004 proposed legislation is the best example of its outcomes-based approach, expressly enshrining its principles and outcomes based approach in the statute.[44]

[39] BCSC, *supra*, note 24 at 2.

[40] The FSA mandate under the UK *Financial Services and Markets Act 2000* is to promote efficient, orderly and fair markets; help retail consumers achieve a fair deal; and improve business capability and effectiveness. FSA Handbook, http://fsahandbook.info/FSA/html/handbook/Glossary/S, last accessed July 20, 2008.

[41] The FSA has set 11 high level principles, in place since 2001: 1. A firm must conduct its business with integrity. 2. A firm must conduct its business with due skill, care and diligence. 3. A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems. 4. A firm must maintain adequate financial resources. 5. A firm must observe proper standards of market conduct. 6. A firm must pay due regard to the interests of its customers and treat them fairly. 7. A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading. 8. A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client. 9. A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgement. 10. A firm must arrange adequate protection for clients' assets when it is responsible for them. 11. A firm must deal with its regulators in an open co-operative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice; FSA, "Principles-based regulation – Focusing on the Outcomes that Matter," FSA Paper, April 2007, online: http://www.fsa.gov.uk/pages/Doing/small_firms/general/pbr/index.shtml, last accessed July 28, 2008.

[42] BCSC, *supra*, note 24 at 2, 6.

[43] *Ibid.* at 5.

[44] British Columbia Bill 38, *2004 Securities Act*, not in force, http://www.leg.bc.ca/37th5th/3rd_read/gov38-3.htm.

While it placed its proposed legislation on hold in the interests of trying to make the passport system work, the BCSC carries out its oversight, enforcement and policy activities based on an outcomes-based approach. For example, the BCSC's *Service Plan 2008-2011* sets out broad principles and goals, such as promoting a culture of compliance and cost-effective regulation, and then measures each of its initiatives against those goals.[45] Regulatory intervention is viewed as needed only occasionally to correct non-compliance, and the Commission's administrative activities are directed towards supporting issuers in their efforts to put in place effective controls and systems.[46] The BCSC considers the impact of administrative initiatives on issuers of different sizes. While its enforcement strategy is to be rigorous, in administering the statute, the BCSC takes account of what issuers are trying to accomplish, assessing whether an issuer is achieving the underlying objectives of particular requirements.[47] If issuers are being duly diligent in their efforts to meet regulatory requirements, the BCSC`s compliance examination team will be flexible in how it works with them to improve an aspect of their conduct. The BCSC applies a scorecard to each regulatory decision; and it tracks outcomes in response to market problems, giving credit for outcomes-focused results.[48] In the BCSC's reporting of activities, it sets out its goals and performance measurements by specific objectives and the annual targets for each year.[49]

In terms of BCSC's approach to policy development through its work with the CSA, its express goal is to advance cost-effective regulation, emphasizing practical solutions in terms of a range of regulatory responses, not simply further codification.[50] An example is proposed National Instrument 31-103, *Registration Requirements*, which is, in part, principles and outcomes based.[51] The proposed business conduct rules set out what issuers must achieve, setting a broad requirement to provide a relationship disclosure document to clients, with a principles-based provision requiring registrants to provide information that a reasonable client would consider important.[52] Compliance examiners will have to assess outcomes as opposed to measuring issuers against a prescribed list.[53] Other parts of the proposed instrument, such as compliance system requirements and complaints provisions establish broad principles and standards, and will be measured based on the system established and its outcomes.[54]

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[45] BCSC *Service Plan 2008-2011, supra*, note 24 at 7-8.
[46] *Ibid.* at 9.
[47] *Ibid.*
[48] *Ibid.* at 20.
[49] *Ibid.* at 17-20.
[50] *Ibid.* at 14.
[51] CSA, Proposed National Instrument 31-103, *Registration Requirements*, February 29, 2008.
[52] *Ibid.,* part 5, Conduct Rules, and NI 31-103 Notice and Request for Comments, February 29, 2008 at 11.
[53] CSA, Proposed National Instrument 31-103, *Registration Requirements, supra,* note 51, section 5.15.
[54] *Ibid.,* sections 5.23 and 5.28. Section 5.23 specifies "(1) A registered firm must establish, maintain and apply a system of controls and supervision sufficient to (a) provide reasonable assurance that the firm and each individual acting on its behalf complies with securities legislation, and (b) manage the risks associated with its business in conformity with prudent business practices. (2) The system of controls referred to in subsection (1) must be documented in the form of written policies and procedures. Section 5.28 specifies "5.28 A registered firm must document, and effectively and fairly respond to, each complaint made to the registered firm about any product or service offered by the firm or a representative of the firm".

Under a principles/standards/outcomes-based system, tools for compliance are tailored to specific outcomes; so, arguably, there is no need for bright line, size-based regulation. Under this model, regulators work with market participants to identify broad principles and then the content of those principles is developed through implementation and practice. Principles would appear to be important to set universally, regardless of size or type of issuer. Ideally, then, the design of regulatory standards or the development of issuer practice to meet those principles could be scalable, thus working effectively for all sizes and/or types of issuers. To the extent that junior issuers cannot fit within one universal standard and proportionate requirements are implemented, they would need to fit the criteria of transparency, certainty and scalability discussed above. In this sense, regulation could be tailored to junior issuers in particular sectors or markets and could avoid the bright-line delineation problems discussed below.

Proportionate regulation under such a regulatory model raises the issue of whether junior issuers have the appropriate resources or capacity to develop appropriate regulatory practices, in the absence of tools or guidance from regulators. On the one hand, the governance and compliance resources of junior issuers may be directed more effectively; on the other hand, junior issuers may not have the internal expertise or the financial resources to hire the expertise to design governance and control practices that achieve the express regulatory principles and are responsive to the market in which they participate. Broad practice norms evolving from principles applied on the ground need to be sensitive to these limitations faced by junior issuers. Given that senior issuers have greater internal expertise and resources, their practice in a particular governance or control area could become the accepted compliance norm or threshold, creating further barriers to junior issuer compliance.

An important consideration for principles/standards/outcomes-based regulation is that, while junior issuers may want less regulation, they also frequently want transparency and clarity in standards or guidance, so that they can meet the requirements in a cost effective manner.[55] There may be unnecessary costs incurred where requirements are not clear, as junior issuers may incur the costs of additional professional opinions where they are uncertain. This issue is particular worth considering with the introduction of secondary market civil liability in a number of jurisdictions, in terms of officers' fear of not "getting it right", notwithstanding their best intentions.

Thus, consideration of principles/standards/outcomes-based regulation on a proportionate basis must engage those that are affected, creating opportunities for their participation in policy discussion, guidance and tools for practice. Expectations must be clear, accessible and relevant, based on the outcomes sought that have been articulated as public policy goals. There must be meaningful participation by junior issuers and market participants to improve the quality of decision making that is aimed at scaling regulation.[56]

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[55] The CSA promulgated forms under national instruments are a good example of regulators being clear on what their expectation is for filing or disclosure.

[56] Julia Black, "Involving Consumers in Securities Regulation", in *Canada Steps Up,* Final Report of the IDA Task Force to Modernize Securities Legislation in Canada (2006), Volume 6 at 543, http://www.tfmsl.ca/docs/V6(9)%20Black.pdf, last accessed June 21, 2008, citing education, information, consultation and participation as the four main components of investor participation in the regulatory process.

An example of mixed proportionate and principles based regulation is the AIM in the UK.[57] As an exchange-regulated market, AIM is only indirectly supervised by the UK financial sector regulator, the Financial Services Authority (FSA), with regulatory oversight by the London Stock Exchange (LSE).[58] A junior market, AIM has a regulatory system that is specifically tailored to the needs of small, growing companies, providing a set of less prescriptive rules. Its hallmark of differentiated regulation by type of listing are the Nominated Advisers (Nomads), which are investment bankers, brokers or accounting firms that are responsible to both the companies they are advising and to the LSE for ensuring the integrity of the market.[59] Their oversight, for both entry and meeting ongoing compliance, serves a functional alternative to prescriptive rules, but means that there is a fair degree of oversight of junior issuer activity.

In practice, proportionate regulation on AIM has meant that, in some cases, there is no scaled regulation and in others there is. The criteria for being admitted to AIM are less restrictive.[60] The regulation of corporate governance is less prescriptive than for companies listed on the Main Market. Companies on the Main Market are under a "comply or explain" obligation with respect to the Combined Code on Corporate Governance; AIM companies simply have to have appropriate corporate governance structures. However, Nomads are required to work with directors to ensure adoption of appropriate corporate governance measures that accord with the principles of existing codes.[61] AIM's rationale for proportionate requirements is that young, growth companies should not be impeded by unnecessarily rigid or inappropriate restrictions on their internal operations; rather, investor protection is met by Nomads ensuring that the company acts appropriately, coupled with enhanced disclosure to investors through new AIM Rules for Companies, effective February 2007.[62] Companies admitted to AIM are subject to the same ongoing obligations for disclosure and transaction reporting that apply to the Main Market, though there are some differences. Investors are warned in disclosures that due to its less prescriptive

[57] Companies admitted to trading on AIM are UK companies, foreign companies, UK registered holding companies, particularly in the oil, gas and mining sectors, and closed-end property and investment funds.
[58] Sridhar Arcot, Julia Black and Geoffrey Owen, *From Local to Global, The Rise of AIM as a Stock Market for Growing Companies,* September 2007, www.londonstockexchange.com/aim. Under provisions of EU law implemented November 2007, AIM's regulatory status changed to being a multi-lateral trading facility operated by the Exchange, *ibid.* at 9.
[59] *Ibid.* at 12. There are currently 76 registered Nomads, although 30 Nomads are appointed to around 80 per cent of AIM companies. In 2006, AIM introduced new Rules for Nomads in order to emphasize and clarify their obligations; AIM Rules for Nominated Advisors (RN). To become a Nomad, both firms and individuals within the firm must meet specific requirements as to experience and qualifications, and must be independent from the issuer. Independence is defined in RN r.21 and Schedule 1. The overriding principle is whether the firm or its qualified executives 'might endanger the reputation and integrity of AIM'.
[60] For example, there are no minimum capital requirements and no requirement for the company to have been trading for three years prior to admission, although the requirement for three years' of audited accounts for companies that have been trading is the same as for the Main Market; AIM Notice 24 (October 2006) and introduced in Notice 27 (February 2007) available at www.londonstockexchange.com/en-gb/products/companyservices/ourmarkets/aim_new/For+AIM+Advisers/aimnotices.htm.
[61] *Ibid.* AIM RN r.18, Sched 3 AR2.
[62] *Ibid.* at 22. The regulation over the LSE, and thus AIM, changed significantly in 2006 and 2007, partly to meet changes in EU law, notably the *Market in Financial Instruments Directive* (MiFID).

regulation, investing in AIM companies is more risky than investing in equities listed on the Main Market.[63]

With respect to the FSA's direct regulatory oversight (primarily investment firms), it uses a risk-based approach. The system is evolving, in that rules continue to exist as the FSA moves to a more principles-based approach to regulation, but as firms interpret principles, they can be exempt from compliance with the rules if they can demonstrate that their practice is achieving the public policy principle. The FSA uses different methodology for assessing small firm outcomes.[64] While its model is not directly applicable to Canada in that the 18,000 small firms that the FSA oversees are largely investment firms with considerably more market expertise than Canadian junior issuers, it nevertheless illustrates some broad policy choices.[65] The FSA approach is that regulation should be proportionate, risk-based, evidence-based, and properly designed so that they achieve specified outcomes.[66] On this basis, the FSA directs less regulatory energy or resources to small firms because they are of comparatively lower risk to investors and the market. The FSA articulates principles, such as duty of care towards customers, and then uses a number of tools to identify firms most at risk of non-compliance and to minimize incentives small firms may have to be non-complaint, with a mix of communication, education, supervision and enforcement, setting key milestones for small retail firms.[67] Its aim is a "rigorous regulatory environment for UK financial services, but with more effective regulation and "outcome focused rules".[68] Its focus is on "sign posts" or guidance on controls. For

[63] *Ibid.* at 24. In 2007, the FSA has also acquired new powers to review rules of the LSE, to ensure that the rules preserve the UK's proportionate and risk-based approach to financial services regulation. The rules relating to trading venues have been altered by the introduction of the MiFID, to facilitate the establishment of trading platforms by removing the ability of member states to require trading to be concentrated on a single market. MiFID introduces broad requirements on exchanges operating MTFs to establish transparent and nondiscretionary rules and procedures for fair and orderly trading and to establish objective criteria for the efficient execution of orders, *ibid (why "ibid").*

[64] FSA Handbook, http://fsahandbook.info/FSA/html/handbook/Glossary/S, last accessed July 27, 2008. Financial Services Authority (FSA). FSA Regulation and Hedge Funds: An Effective and Proportionate Approach for a Dynamic, International Marketplace, Speech by Dan Waters, Director, Asset Management Sector Leader and Director of Retail Policy, FSA Asia Hedge Conference, Hong Kong, 19 October 2006, http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/1019_dw.shtml.

[65] The FSA's focus on market integrity seeks to deter abuse through pro-active surveillance of likely 'hot spots,' disclosure, and an effective enforcement program against market abuse. See for example, Hedge funds: A Discussion of Risk and Regulatory Engagement, FSA? 06/2, February 2006, http://www.fsa.gov.uk/pages/library/policy/dp/2006/fs06_02.shtml.

[66] *Ibid.* FSA Handbook, SYSC 3.1.1R. See also SYSC 3.2.11G which states that "A firm's arrangements should be such as to furnish its governing body with the information it needs to play its part in identifying, measuring, managing and controlling risks of regulatory concern. Three factors will be the relevance, reliability and timeliness of that information." Speech by the Economic Secretary to the Treasury, Ed Balls MP at the FSA Principles-based Regulation Conference, 23 April 2007, http://www.hm-treasury.gov.uk/newsroom_and_speeches/press/2007/press_48_07.cfm.

[67] FSA, "Principles-based regulation – Focusing on the Outcomes that Matter," FSA Paper, April 2007, online: http://www.fsa.gov.uk/pages/Doing/small_firms/general/pbr/index.shtml, last accessed July 28, 2008. It is currently conducting research on which characteristics identify small firms that are most at risk of being non-compliant. FSA, Regulating Small Firms, http://www.fsa.gov.uk/pages/Library/research/economic/interest/regulating.shtml, last accessed July 22, 2008.

[68] *Ibid.*

example, it currently has embarked on a three-year enhanced strategy aimed at helping small firms achieve its policy goal of "Treating Customers Fairly". By December 2008, firms must: demonstrate that senior management have instilled a culture within the firm regarding fair treatment of customers, and how errors are promptly found and remedied. They must demonstrate that they have implemented appropriate and accurate measuring of performance against customer fairness issues materially relevant to their business.[69] The FSA reports that it takes tough enforcement action by focusing on and dealing more visibly with a targeted group of firms that are failing to deliver fair treatment of customers.[70] Education is an important part of the FSA's small firm strategy, with interactive roadshows linked to its regional assessment program and case studies as models of good practice.[71]

The FSA's approach to proportionate regulation has several hallmarks. Its approach is to set broad principles that it wants to achieve, and then impose standards or milestones. It dedicates fewer regulatory resources to small firms based on risk assessment. It exempts firms from regulatory compliance based on their practice, rather than blanket exemptions based on size of issuer. In the Canadian context, such an approach may mean assessing each new policy instrument to assess what the policy objective is and whether a proposed standard for junior issuers does anything to advance that objective, based on risks to investors and risk to market competitiveness. Given the number of junior issuers in the Canadian market, allocation of education, compliance and enforcement resources would have to recognize the size and materiality of the junior market and recognize that such issuers may pose a lower risk to regulatory misconduct. Moreover, the expertise of the investment firms to which the FSA's approach applies may be more sophisticated in terms of its ability to set milestones, and the experience, while informative, may not be directly responsive to challenges faced by junior issuers in public equity markets.

A principles/standards/outcomes based regulatory approach should be accompanied by rigorous enforcement of securities law and regulation. Fewer and less prescriptive rules should not mean less rigorous enforcement. Canadian securities regulators already engage in risk-based assessment and enforcement; specifically, they adopt differing levels of scrutiny based on risk, materiality and proportionality. However, principles/standards/ outcomes based regulatory approach might mean that regulators use a range of tools, as the FSA has, in finding solutions to an identified market problem or stated goal, including guidance, education, public participation in setting expectations, monitoring and enforcement. Such an approach may treat junior issuers differently, depending on the issue, but the driver of policy choice is what is most effective and cost efficient as opposed to regulation by type of issuer.

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[69] FSA, "Treating customers fairly – culture", July 2007, where the FSA published a "Management behaviour framework" for small firms, Appendix 1. Financial Services Authority "Treating Customers Fairly: Progress Update", at 16, June 2008, http://www.fsa.gov.uk/pubs/other/tcf_progress.pdf, last accessed July 20, 2008. The FSA uses a different methodology to assess smaller firms and relationship-managed firms, set out in its Appendix 1, including assessing whether measures capture outcomes; the integrity and accuracy of measures; the operational use of the material; assessing whether the firm had robust measures against all the TCF outcomes appropriate for that firm.

[70] ARROW assessments, *ibid.*

[71] *Ibid.*

The BCSC has previously suggested that a properly designed outcomes-based regime will provide sensible outcomes for all market participants without having to devise separate regimes.[72] It observed that disadvantages include the difficulty in getting the correct thresholds between classes of issuers and that "even if it works most of the time, the regime spins off a welter of exemption applications as issuers who should be in one category find themselves in a different one." It was also concerned that there is a risk that issuers regulated in the less rigorous categories would be seen as less desirable investments. Its view is that less regulation, if replaced by outcomes-based requirements, properly implemented and supervised by the regulator, actually increases investor protection.[73]

Risk-based enforcement systems are essentially the end-part of a proportionate regulation system, in that choices are made in respect of the highest priorities for monitoring and enforcement. How these choices interact with front-end regulatory and disclosure requirements has an impact on the overall efficacy and fairness of the regulatory regime. If standards or expectations are not clear, principles-based systems can offer challenges for junior issuers, who want clarity in what is expected of them.

(d) Cross-Border Harmonization

Another consideration for proportionate regulation is continued access to US and other international markets. Since 1990, the SEC and Canada's securities regulators have participated in the Multi-Jurisdictional Disclosure System that permits issuers in the US and Canada to more easily access each other's markets. Currently, the SEC and Canadian securities regulators are in discussions for a potential US-Canada mutual recognition arrangement.[74] Harmonization with the US is unlikely given the different structure of the respective capital markets and different normative views of the extent of rules needed. Mutual recognition is more feasible, whereby regulators rely on their counterparts in other countries where two systems have comparable goals. Under mutual recognition, US exchanges would be able to operate in Canada under US rules and regulations, and Canadian exchanges would be able to operate in the US under Canadian rules, regulation and oversight.[75]

The purpose of "free trade" in securities is to lower costs through the efficiencies that are realized in the reduction of dual regulation and regulatory overlap, resulting in increased liquidity, better valuations and more dynamic markets.[76] Another aspect of mutual recognition is the move by Canada to International Financial Reporting Standards (IFRS);

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[72] *Another Way Forward for Securities Reform,* Presentation to The Task Force to Modernize Securities Legislation in Canada, British Columbia Securities Commission, Brent W. Aitken, Vice Chair, October 14, 2005, http://www.tfmsl.ca/Documents/BCSC.pdf (last accessed July 20, 2008).
[73] *Ibid.*
[74] May 29, 2008 joint press release, CSA and SEC. In March 2008, the SEC had announced that it would explore the possibility of a limited mutual recognition arrangement with one or more foreign regulatory counterparts, and that those arrangements could provide the basis for the development of a more general approach to mutual recognition through rulemaking. The SEC is engaged in discussions concerning a possible mutual recognition arrangement with Australia, and is pursuing a process agreement with the European Commission and the Committee of European Securities Regulators.
[75] *Ibid.* at 12.
[76] Rik Parkhill, *supra*, note 3 at 12.

the US proposes to allow foreign companies in the US to use IFRS without requiring reconciliation with US GAAP.[77] The pursuit of mutual recognition is unlikely to be harmed by the continued introduction of proportionate regulation as many Canadian issuers are within the US definition of small cap.

5. Delineating Issuers for Regulatory Purposes

The second policy question is whether size, type of exchange listing, or some other criterion should be the determinant of how proportionate regulation is structured. A critically important policy question is how to delineate which issuers fall within a category of issuers that are entitled to different regulatory treatment.[78] The distinctions may involve different standards of disclosure or other compliance, or outright exemption from some regulatory requirements for particular specified issuers. Here again, principles of transparency, fairness and certainty underlay any policy choices.

The delineation could be by market type of exchange on which issuers are listed; by capitalization; by revenue; or some combination.

(a) Type of Listing Approach

One option is to scale regulatory requirements based on the type of exchange that the issuer is listed on. In Canada, that distinction has been made based on listing with the Toronto Stock Exchange (TSX) or comparable exchange, such as the NYSE, versus listing on the TSX Venture Exchange (TSXV) or similar exchange, such as the AIM. Under several national instruments, venture issuer is defined as: "a reporting issuer that, as at the applicable time, did not have any of its securities listed or quoted on any of the Toronto Stock Exchange, a U.S. marketplace, or a marketplace outside of Canada and the United States of America other than the Alternative Investment Market of the London Stock Exchange or the PLUS markets operated by PLUS Markets Group plc".[79] Thus, the distinction for purposes of proportionate regulation is venture issuer in the junior market versus non-venture issuer in the senior market, rather than distinguishing based on size.

The TMX Group has characterized the distinct nature of the TSXV in the following way:

> The TSX Venture market is unique in its own right. It has had a long history of small issuers successfully raising small amounts of public capital at an earlier stage than senior market issuers. These are higher risk enterprises, both in terms of business risk but also in terms of the absence of classical internal controls,

[77] *Ibid.* at 13.

[78] Part of that inquiry is whether there should be different kinds of considerations in respect of listing vehicles such as capital pool companies or income trusts.

[79] Where the "applicable time" in respect of (a) Parts 4 and 5 of this Instrument and Form 51-102F1, is the end of the applicable financial period; which can be the end of the most recently completed financial year, the date of acquisition, or the date of the meeting of the securityholders; NI 51-102 *Continuous Disclosure Obligations,* http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule_20080704_51-102_unofficial-cons-ni.pdf, last accessed July 23, 2008.

> such as segregation of duties. While there are compensating controls such as management supervisory controls, shareholders know and accept that those controls are thoroughly dependent on trust in officer and director integrity and tone at the top. This market has its own listing, corporate governance and other requirements that are tailored to emerging companies. This market is branded separately from the senior market, which among other things, provides a bright-line notice to investors of the distinct and higher risk profile of this market. … The corporate governance and financial reporting securities law requirements that apply to TSX Venture listed issuers are more robust than similar requirements that apply to issuers on AIM or ASX. Generally, TSX Venture issuers must comply with more stringent requirements covering, among other things, audit committee composition, including independence and financial literacy requirements and quarterly financial reporting requirements.[80]

The TSXV monitors listed issuers on an ongoing basis, and if they fall below its ongoing listing standards, the issuers are moved to a separate trading board of the TSXV, the NEX.[81] Industry participants are thus alerted to the higher risk profile of the issuer, pending efforts by the issuer to refinance, restructure, reactivate, engage in a reverse takeover, or other measures to eventually graduate to TSXV. NEX issuers must re-apply to TSXV and provide evidence of their compliance with TSXV listing requirements.[82]

Venture issuers are also monitored for compliance by the Investment Industry Regulatory Organization of Canada (IIROC). IIROC monitors trading activity on the TSXV and other marketplaces in Canada and enforces non-compliance with universal market integrity rules, including imposing trading halts, administering and monitoring compliance with TSXV policies on timely disclosure requirements, unacceptable trading practices, suspected breaches of TSXV trading activity, take-over, substantial issuer and normal course issuer bids, and other requirements.[83] The objective is independent, timely and effective enforcement to advance investor protection and market integrity.

Thus, junior issuers on the TSXV pose higher risk, but not from the lack of regulatory scrutiny; rather, because of the inherently developmental nature of many of the activities of these issuers.

The advantage of a listing approach to distinguishing issuers for purposes of proportionate regulation is its transparency for investors and ease of monitoring. For example, there are different kinds of compliance requirements depending on whether the issuer is listed on the TSX or the TSXV, and depending on the type of issuer, such as capital pool companies or venture issuers. Such a bifurcation recognizes the stage of development of the firm and the

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[80] TMX Group, June 28, 2007, submission on Request for Comments - Proposed Repeal and Replacement of MI 52-109, *Certification of Disclosure in Issuers' Annual and Interim Filings*, at 5.
[81] http://www.tsx.com/en/nex/index.html, last accessed July 30, 2008.
[82] Prior to NEX being created, companies that fell below TSX Venture's ongoing listing standards were designated "inactive" and given 18 months to meet the standards or be delisted, *ibid.*
[83] http://www.iiroc.ca/English/About/OurRole/Pages/MarketplaceWeRegulate.aspx, last accessed July 30, 2008.

challenges for junior companies.[84] Differences in regulation are independent of the issuer's size or market capitalization, but rather, dependent on the location of its listing. A principal reason that the TSX and regulators have distinguished requirements is their recognition that junior issuers often lack the resources or in-house expertise to which larger corporations have access.

Canadian securities regulators have already recognized some measure of proportionate regulation in their national instruments based on the type of listing. Three examples are illustrative: corporate governance disclosure; continuous disclosure requirements; and the proposed new officer certification national instrument.

(i) Corporate Governance Disclosure

Pursuant to NI 58-101 *Disclosure of Corporate Governance Practices*, there is proportionate regulation in respect of the amount of disclosure required from non-venture and venture issuers.[85] For example, while both types of issuers are to disclose the identity of independent and non-independent directors, and describe the basis for that determination, the requirements for non-venture issuers are considerably more detailed.[86] Non-venture issuers must disclose board attendance records; and the identity, role and responsibilities of the independent chair or lead director, or, if the board does not have one, how it provides leadership for its independent directors.[87] Non-venture issuers must describe what the board of directors does to facilitate its exercise of independent judgment in carrying out its responsibilities if a majority of directors are not independent; disclose whether or not independent directors hold regularly scheduled in-camera meetings, including particulars on the number of meetings and what the board does to facilitate candid discussion. Venture issuers do not face such requirements. Venture issuers are also not required to disclose the board's written mandate or delineation of board roles and responsibilities; nor required to disclose written position descriptions or delineated roles for the board chair and chair of each board committee, whereas senior issuers are.[88] All reporting issuers must disclose director orientation and continuing education initiatives, but only non-venture issuers must describe how the board ensures that its directors maintain the skill and knowledge necessary to meet their obligations as directors.[89]

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[84] While the exchanges are owned by the TMX Group, the exchanges continue to be called TSX and TSXV.
[85] NI 58-101 *Disclosure of Corporate Governance Practices*, http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule_20050617_58-101_disc-corp-gov-pract.jsp.
[86] Both must also disclose if any of their directors are also a director of any other issuer that is a reporting issuer or the equivalent in a jurisdiction or a foreign jurisdiction; identifying both the director and the other issuer. Form 58-101F1 and Form 58-101F2.
[87] Form 58-101F1, section 1, Board of Directors.
[88] If the board has not developed written position descriptions for the chairs, non-venture issuers must describe how the board delineates the role and responsibilities of each such position, whereas venture issuers do not. *Ibid.,* section 2 Board Mandate and section 3 Position Descriptions.
[89] If the board does not provide continuing education. *Ibid.,* section 4 Orientation and Continuing Education. Director orientation is the amount of information, governance and financial training, meetings with production, financial and other personnel that the director is given exposure to when commencing to serve as director.

While venture issuers must disclose what steps, if any, the board takes to encourage and promote a culture of ethical business conduct,[90] non-venture issuers must provide considerably more detailed disclosure, including adoption and monitoring of a written code of conduct; providing cross-references to any material change report that pertains to conduct of a director or executive officer that constitutes a departure from the code; and any steps the board takes to ensure directors exercise independent judgment in considering transactions where a director or executive officer has a material interest.[91] While both types of issuers must describe how the board satisfies itself that the board and individual directors are performing effectively, non-venture issuers must describe the process used for director and board assessments.[92] Similarly, disclosures in respect of nomination and compensation of directors are more detailed for non-venture issuers than venture issuers.[93]

Hence, in respect of corporate governance disclosures, proportionate regulation involves modified requirements in scope, breadth and detail of required corporate disclosure and systems. Venture issuers must undertake the above-mentioned disclosures, but are not required to provide details. Where a non-venture issuer board does not have formal policies and practices in place, it must disclose initiatives that it has undertaken to ensure independence and objectivity in the process. In a sense, therefore, NI 58-101 has identified the key elements of corporate governance that must be disclosed, regardless of the type of listing or size or sophistication of the issuer. Equally, however, it has recognized that relational management is a feature of many venture issuers, and while there are disclosure requirements in respect of the assurance of board effectiveness, there is no need for the venture issuer to measure itself against more codified best practices that are appropriate for senior issuers, which often require the establishment of systems and controls to encourage the integrity of business conduct.

The initiatives of securities regulators have been adopted by the TMX Group, which has amended its corporate governance disclosure requirements to align with NI 58-101.[94] The TSX is more generally revising its manual to align new regulatory requirements under national instruments with listing requirements.

(ii) Continuous Disclosure Obligations

NI 51-102, *Continuous Disclosure Obligations,* is another example of proportionate regulation by type of listing, recognizing different requirements for venture and non-

[90] Form 58-101F2, section 4 Ethical Business Conduct.
[91] Form 58-101F1, section 5 Ethical Business Conduct.
[92] Form 58-101F1, section 9 Assessment; Form 58-101F2, section 8 Assessment.
[93] Form 58-101F1, section 6 Nomination of Directors and section 7 Compensation; Form 58-101F2, section 5 Nomination of Directors and section 6 Compensation. Under the most recent amendments to NI 58-101 in 2007, there are different requirements for venture and non-venture issuers in respect of officers that solicit a proxy from a securityholder for the purpose of electing directors to the issuer's board of directors (see amendments 2007 Dec) at 2.1(1) and (2), http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule_20050617_58-101_disc-corp-gov-pract.jsp
[94] The TSX Company Manual previously set out a “comply or explain” system, requiring specific reference to each of the 14 TSX guidelines. Summary of 2005 TSX Corporate Governance Disclosure Survey, http://www.tsx.com/en/pdf/TSXCorpGovSurvey2005.pdf, last accessed July 31, 2008.

venture reporting issuers.[95] Proportionate requirements include, most notably, different filing deadlines for annual and interim financial statements and specified exemptions from some disclosure requirements for junior and senior reporting issuers. NI 51-102 specifies that non-venture issuers must file audited annual financial statements within 90 days after the end of its most recently completed financial year; venture issuers have 120 days.[96] Deadlines for filing interim financial statements are 45 days for non-venture issuers and 60 days for venture issuers after the end of the interim period.[97]

This modification of regulation through different reporting timelines, as a policy choice, can be compared with the AIM's frequency of disclosure, where small issuers are required to give only annual and semi-annual financial statements. Frequency is an option to consider, in that if investors are not reading quarterly results, it may be that junior issuers could be exempted. However, any exemption can only be effective if the integrity of the issuer and the market were assured. If it appears to investors that junior issuers are being downgraded in terms of oversight or compliance, then such a change will not meet the express goals of the regulatory system. The issue is what periodic disclosure is really relevant to investors and potential investors and how frequently they want an update on that relevant information.

Venture issuers in Canada are exempted from filing an AIF.[98] Venture issuers are also exempted from specified disclosure requirements under NI 51-102, such as filing a report on matters submitted to a vote at a meeting of securityholders.[99] Under liquidity disclosures, issuers are required to discuss balance sheet conditions or income or cash flow items in a summary and tabular form, but venture issuers do not have to provide the summary and table.[100] Venture issuers do not have to provide an analysis of their critical accounting estimates as non-venture issuers do.[101] Pursuant to Form 51-102F6, *Statement of Executive Compensation,* there are also different disclosure requirements in respect of stock appreciation rights (SAR), in that venture issues do not have to make a number of specified disclosures that non-venture issuers do.[102] However, a venture issuer must disclose which grants of options or SARs result from repricing and explain in reasonable detail the basis for the repricing.[103]

While all reporting issuers are required to file a business acquisition report (BAR) within 75 days after the date of a significant acquisition, NI 51-102 sets different filing deadlines

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[95] NI 51-102 *Continuous Disclosure Obligations,* http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule_20080704_51-102_unofficial-cons-ni.pdf, last accessed July 23, 2008.
[96] "or the date of filing, in a foreign jurisdiction, annual financial statements for its most recently completed financial year"; i*bid.,* s. 4.2.
[97] "or the date of filing, in a foreign jurisdiction, interim financial statements"; *ibid.* s. 4.4.
[98] 6.1 Requirement to File an AIF, *ibid.*
[99] NI 51-102, s. 11.3 Voting Results.
[100] Form 51-102F1 *Management's Discussion & Analysis.*
[101] *Ibid.,* 1.12 Critical Accounting Estimates.
[102] A SAR is a right, granted by a company or any of its subsidiaries as compensation for employment services or office, to receive cash or an issue or transfer of securities based wholly or in part on changes in the trading price of publicly traded securities.
[103] Form 51-102F6, *Statement of Executive Compensation,* Item 13 Venture Issuers.

if the most recently completed financial year of the acquired business ended 45 days or less before the date of acquisition, in which case a reporting issuer must file a BAR within 90 days after the date of acquisition, but a venture issuer has 120 days.[104] There are also different tests for venture and non-venture issuers in respect of what is defined as a significant acquisition; specifically, the asset test, the investment test, or the income test, where 20 per cent is read as 40 per cent for venture issuers.[105]

NI 51-102 also imposes increased disclosure requirements on venture issuers in at least one circumstance. Venture issuers, without significant revenue in the prior two financial years, must disclosure in their MD&A capitalized or expensed exploration and development costs, expensed research and development costs, and deferred development costs.[106] The objective is to focus venture issuers' discussion and analysis of results of operations on expenditures and progress towards achieving business objectives and milestones.[107] Certain venture issuers must provide, in their annual or interim MD&A, a breakdown of material costs whether capitalized, deferred or expensed.[108]

Within the type of listing approach, there is also a demarcation for particular issuers, such as capital pool companies.[109] Regulators have an agreement with the TSXV, which is aimed at addressing barriers to early financing, allowing a capital pool company to list on the TSXV subject to specific conditions.[110] It establishes a program under which a CPC may conduct an initial public offering by prospectus and obtain a listing on TSX Venture's Tier 2. The program requires the CPC to identify and complete a Qualifying Transaction (QT) within a specified period of time after listing.[111] The TSXV administers the CPC program and reviews the prospectuses and QT Circulars. The agreement with regulators sets out the standards that the TSXV will apply.

Hence, this second example illustrates four types of proportionate regulation: exemption from particular disclosure requirements, scaled timing for compliance with periodic disclosure requirements, modified requirements in terms of details to be disclosed, and "tailored" requirements, such as MD&A exploration and development disclosure requirements for venture issuers without significant revenue in the prior two financial

[104] *Ibid.* 8.2 Obligation to File a Business Acquisition Report and Filing Deadline.
[105] *Ibid.* 8.3 Determination of Significance.
[106] *Ibid.,* s. 5.3.
[107] Form 51-102F1 *Management's Discussion & Analysis.* If the venture issuer's business primarily involves mining exploration and development, the analysis of capitalized or expensed exploration and development costs must be presented on a property-by-property basis, NI 51-102, section 5.3.
[108] Unless the information is included in their interim and annual financial statements, a component of cost is generally considered to be a material component if it exceeds the greater of 20 per cent of the total amount of the class; and $25,000; Companion Policy 51-102CP, *Continuous Disclosure Obligations,* 5.2 Additional Information for Venture Issuers Without Significant Revenue.
[109] Capital pool companies are companies that have no assets other than cash and have not commenced business activity.
[110] 41-601 *Capital Pool Companies Amended and Restated CPC Operating Agreement,* April 8, 2005.
[111] After the CPC obtains the necessary shareholder approval, or files the QT Circular on SEDAR, it closes the Qualifying Transaction and submits to TSXV all required post-meeting and post-closing documents. Provided that the Resulting Issuer meets applicable TSXV minimum listing requirements, TSX Venture issues a Final Exchange Bulletin and the Resulting Issuer is no longer considered to be a CPC; *ibid.*

years.[112] The delineation by type of listing does not result in less rigorous requirements; rather, they are proportionate to the type of issuer, its capacity to make periodic disclosure on a timely basis, and more focussed in terms of being aimed at what the particular investor needs to know to make investment choices. In this respect, disclosure requirements could focus more clearly on junior issuers. Given the fact that many junior issuers do not generate much, if any, revenue, timely information such as drill results, clinical trial results, and approval of mineral licenses can be more important than financial statements in making investment decisions.[113]

(iii) Certification of Disclosure

The third and most recent example of proportionate regulation in Canada is the proposed NI 52-109, *Certification Disclosure in Issuer's Annual and Interim Filings*, expected to come into force effective December 15, 2008.[114] Here, after earlier failed attempts to build national consensus on the scope of officer certification and whether Canada should adopt *S-Ox 404* standards,[115] the CSA has succeeded in finding a proportionate response to the need for some sort of assurances by senior officers without the expense of external auditor attestation.

NI 52-109 requires an issuer's chief executive officer (CEO) and chief financial officer (CFO), or persons performing similar functions (certifying officers), to personally certify that the issuer's annual and interim filings do not contain any misrepresentations; and that the financial statements and other financial information in the annual and interim filings fairly present the financial condition, results of operations and cash flows of the issuer. They must also certify that they have designed or supervised the design of disclosure controls and procedures (DC&P) and internal control over financial reporting (ICFR); they have caused the issuer to disclose in its MD&A any change in the issuer's ICFR that has materially affected the issuer's ICFR; and, on an annual basis, that they have evaluated the effectiveness of the issuer's DC&P and caused the issuer to disclose their conclusions in the issuer's MD&A. In anticipation of these changes, in November 2007, nine Canadian regulators issued blanket orders that had the effect of modifying the current certification requirements as they apply to venture issuers as set out in the Instrument.[116]

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[112] *Ibid.* Section 5.3, with particular requirements for mining exploration and development.
[113] TMX Group, *supra*, note 80 at 4.
[114] National Instrument 52-109 *Certification of Disclosure in Issuers' Annual and Interim Filings*; related forms and Companion Policy 52-109CP. The comment period expired on June 17, 2008 and the CSA has issued notice that it does not expect to recommend any material amendments; http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/csa_20080711_52-322_repeal-52-109.jsp, last accessed July 25, 2008.
[115] Section 404 of the *Sarbanes-Oxley Act* requires company management to assess the effectiveness of the company's internal controls over financial reporting, and requires an auditor attestation on management's assessment.
[116] Specifically, venture issuers in those jurisdictions may file interim and annual certificates for periods ending after December 31, 2007 in a form that does not require the CEO and the CFO to certify that they have designed and evaluated the effectiveness of DC&P or ICFR; British Columbia BCI 52-511 *Relief for Venture Issuers from Certain Certification Requirements,* effective November 23, 2007; Alberta MI 52-109 Exemptive Relief, 2007 ABASC 836 *Certain Certification Requirements: Relief for Venture Issuers*, effective November 23, 2007; Saskatchewan GRO 52-905 *Relief from Certification Requirements in National*

The most important aspect of proportionate regulation by type of listing in proposed NI 52-109 is that the instrument creates a new form of certificate for junior issuers, a "venture issuer basic certificate," in which certifying officers of venture issuers are not required to include representations in their certificates relating to the establishment and maintenance of DC&P and ICFR; whereas non-venture issuers are required to use a control framework in the design of ICFR.[117] The venture issuer basic certificate includes a note to investors and others reading the materials explaining how it differs from the full certificate required to be filed by reporting non-venture issuers. A venture issuer filing a basic certificate is not required to discuss in its annual or interim MD&A the design or operating effectiveness of DC&P or ICFR.[118] Venture issuers can still choose to file full certificates. Hence, the venture issuer basic certificate meets the express objectives of securities law, in that it is transparent in terms of disclosures to investors and others as to how it differs from the full certificate. It modifies the certification requirements to recognize the type of issuer and its limited resources, and to recognize what investors are seeking to know about financial controls in assessing potential risk and return. It recognizes that those investing in venture issuers may wish their capital to be directed towards development and economic activity of the issuer, rather than governance or financial assurances, while still imposing a relatively high standard of assurances.

Proposed NI 52-109 also requires that non-venture issuers use a control framework to design their ICFR, whereas venture issuers are not required.[119] The CSA also suggested that smaller issuers can refer to *Internal Control over Financial Reporting – Guidance for*

Instrument 52-109, effective November 27, 2007; Manitoba Blanket Order No. 52-501 *Relief for Venture Issuers from Certain Certification Requirement,* effective November 23, 2007; Québec DÉCISION N° 2007-PDG-0203 *Règlement 52-109 sur l'attestation de l'information présentée dans les documents annuels et intermédiaires des émetteurs*, effective November 23, 2007; Newfoundland Blanket Order 55 *In the Matter of Certain Certification Requirements: Relief for Venture Issuers,* effective December 17, 2007; New Brunswick Blanket Order 52-501 *In the Matter of Certification Requirements: Relief for Venture Issuers*, effective November 26, 2007; Nova Scotia Blanket Order No. 52-501 *In the Matter of Certification Requirements: Relief for Venture Issuers,* effective December 10, 2007; Prince Edward Island Blanket Order No. 52-501 *In the Matter of Certain Certification Requirements:* Relief for Venture Issuers, effective March 17, 2008; NT Blanket Order No. 10 In the Matter of Multilateral Instrument 52-109 Certification of Disclosure in Issuers' Annual and Interim Filings, effective January 23, 2008. CSA Notice Supplement to the OSC Bulletin, April 18, 2008 3 (2008) 31 OSCB (Supp-3), http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule_20080418_52-109_repealreplace-sup3.pdf, last accessed July 24, 2008.

[117] Section 3.1, Proposed NI 52-109. Other proposed major changes include that the threshold for reporting a weakness in ICFR is a "material weakness" rather than the previous concept of "reportable deficiency". In addition, an issuer may limit the scope of its design of DC&P and ICFR to exclude controls, policies and procedures of a business that the issuer acquired not more than 365 days before the end of the financial period.

[118] If a venture issuer files a basic certificate and chooses to discuss the design or operation of one or more components of its DC&P or ICFR in its MD&A, it should include the same note to investors.

[119] However, if a venture issuer files a Form 52-109F1 or Form 52-109F2, the venture issuer must use a control framework to design the issuer's ICFR; Section 3.4, Proposed NI 52-109. Such a control framework may be, for example, the *Risk Management and Governance: Guidance on Control* (COCO Framework) or published by The Canadian Institute of Chartered Accountants; the *Internal Control – Integrated Framework* (COSO Framework) published by The Committee of Sponsoring Organizations of the Treadway Commission (COSO); CSA Notice, OSC Bulletin April 18, 2008 5 (2008) 31 OSCB (Supp-3) at 8.

Smaller Public Companies published by the Committee of Sponsoring Organizations (COSO), for guidance to smaller public companies on the implementation of the COSO Framework.[120] This suggestion raises an important consideration in respect of the venture/non-venture issuer delineation. There are a number of small issuers on the TSX that are subjected to the full regulatory requirements of NI 52-109. If all issuers on the TSX or similar exchanges must comply with the more detailed requirements, such as control frameworks, regardless of capitalization, then it may be appropriate to provide greater guidance in respect of what such frameworks could entail, recognizing that there are different size issuers on the TSX. Here again, there could be a proportionate approach in that smaller issuers listed on the TSX do not necessarily need the "Cadillac" version of control frameworks, given their governance and oversight structure. Rather than a different regulatory standard, it could take the form of assistance in designing a range of control frameworks sensitive to size and sector.

Proposed NI 52-109 also makes a distinction between non-venture issuers and venture issuers in terms of new requirements to report material weakness in internal controls. "Material weakness" means a deficiency or combination of deficiencies in ICFR such that there is a reasonable possibility that a material misstatement of the reporting issuer's annual or interim financial statements will not be prevented or detected on a timely basis.[121] If a non-venture issuer determines it has a material weakness that exists as at the end of the period covered by its annual or interim filings, it must disclose in its annual or interim MD&A a description of the material weakness; its impact on the issuer's financial reporting and its ICFR; and the issuer's plans or actions already undertaken for remediating the material weakness.

A venture issuer is not required to file an AIF; however, if it voluntarily files an AIF, it must file a separate annual certificate signed by a certifying office on the same date that it files the AIF.[122] Under the venture issuer basic certificate, the certifying officer must certify that he or she has reviewed the AIF, if any, annual financial statements and annual MD&A, including all documents and information that are incorporated by reference; and based on the officer's knowledge, having exercised reasonable diligence, certify that these annual filings do not contain any untrue statement of a material fact or omit to state a material fact required to be stated or that is necessary to make a statement not misleading in light of the circumstances under which it was made, for the period covered by the annual filings.[123] The officer must also certify that based on his or her knowledge, having exercised reasonable diligence, the annual financial statements together with the other

[120] *Ibid.* The Committee of Sponsoring Organizations (COSO) is a voluntary private-sector organization, dedicated to guiding executive management and governance entities toward the establishment of more effective, efficient, and ethical business operations on a global basis. It sponsors and disseminates frameworks and guidance based on in-depth research, analysis, and best practices. Its members include the American Accounting Association, the American Institute of Certified Public Accountants, the Institute of Management Accountants, and the Institute of Internal Auditors; http://cc.msnscache.com/cache.aspx?q=coso&d=74049564000408&mkt=en-CA&setlang=en-CA&w=522df382,2c00df4e.

[121] The proposed definition of "material weakness" corresponds to the U.S. definition, facilitating continued MJDS cooperation.

[122] Section 4.1, Proposed NI 52-109.

[123] Form 52-109FV1 Certification of annual filings – venture issuer basic certificate.

financial information included in the annual filings fairly present in all material respects the financial condition, results of operations and cash flows of the issuer.

The proposed note to readers that will be required specifies that, in contrast to the certificate required for non-venture issuers under NI 52-109, the Venture Issuer Basic Certificate does not include representations relating to the establishment and maintenance of DC&P and ICFR, and the certifying officers filing the certificate are not making any representations relating to the establishment and maintenance of controls designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with the issuer's GAAP.[124] The explanatory note is to alert investors that limitations on the ability of certifying officers of a venture issuer to design and implement on a cost effective basis DC&P and ICFR may result in additional risks to the quality, reliability, transparency and timeliness of interim and annual filings and other reports provided under securities legislation.[125] Certification of annual and interim filings following an initial public offering, reverse takeover or becoming a non-venture issuer, contains similar scaled requirements and an abbreviated similar note to readers.[126]

Venture issuers are not required to make representations relating to the establishment and maintenance of DC&P and ICFR. However, a venture issuer may elect to file Forms 52-109F1 or 52-109F2, which include representations regarding the establishment and maintenance of DC&P and ICFR. If a venture issuer files these forms, it is not required to discuss in its annual or interim MD&A the design or operating effectiveness of DC&P or ICFR, but it is suggested by the CSA that it disclose that it is not required to certify the design and evaluation of the issuer's DC&P and ICFR, and set out the inherent limitations and risks. The Companion Policy to NI 52-109 observes that a selective discussion in a venture issuer's MD&A about one or more components of a venture issuer's DC&P or ICFR without these accompanying statements will not provide transparent disclosure of the state of the venture issuer's DC&P or ICFR.[127]

Hence, this example of proportionate regulation illustrates differentiated standards, with a clear caution to investors that a policy line has been drawn in terms of the degree and detail of assurances by certifying officers, depending on whether the issuer is a venture or non-venture issuer. The Venture Issuer Basic Certificate draws a bright line distinction, creating transparency for investors in terms of what expectations they may have about officer assurance.

The modified requirements were responsive to market participants that want venture issuers to place their resources into effective management and good project development, more than highly codified internal corporate governance controls that may not adequately balance access to capital for research and development with investor protection. The

[124] The note specifies that the venture issuer's certifying officers are responsible for ensuring that processes are in place to provide them with sufficient knowledge to support the representations they are making in the certificate.
[125] Companion Policy 52-109CP *Certification of Disclosure in Issuers' Annual and Interim Filings.*
[126] Section 4.5, Proposed NI 52-109. Form 52-109F1 – IPO/RTO; Form 52-109FV2 and Form 52-109F2.
[127] Companion Policy, *supra*, note 125 at 75.

distinction is differently focused regulation, as opposed to less rigorous standards. The underlying policy rationale is that many venture issuers have few employees and limited financial resources, which make it difficult for them to design DC&P and ICFR without incurring significant additional costs, hiring additional employees, or restructuring the board of directors and audit committee. Moreover, the higher risks frequently associated with venture issuers are the quality of the project and personnel; and thus regulatory intervention should be proportionate and responsive to the need for this disclosure foremost.

In summary, the advantage of a type of listing delineation for proportionate regulation is its transparency. Currently, given the structure of the Canadian capital market, 97 per cent of the total aggregate Canadian market capitalization is comprised of issuers listed on the TSX or TSXV.[128] The concentration of the Canadian market on two exchanges allows for ease of demarcation for the purposes of proportionate regulation. Canadian regulators have already opted for this delineation in several national instruments. It creates a measure of fairness in that all issuers on an exchange are treated alike and investors can readily make choices based on the degree of disclosure and compliance assurances. There is also transparency in the delineation for regulators, in terms of monitoring and enforcement. The transition from one set of requirements is clear; specifically, when an issuer moves to a new exchange. Such an approach has not, to date, harmed access to the US market, as overall the size of issuers on the TSXV is considerably smaller than the US delineation of small issuer, discussed below. The venture/non-venture delineation allows issuers the freedom to choose what set of compliance rules they wish, depending on their listing.

The type of listing distinction also recognizes the regulatory oversight of the junior equities market in Canada. The TSXV imposes financial listing tests, ongoing listing rules, audit committee requirements, and thorough background checks on directors and officers, in terms of their relevant business experience, public company experience and history of legal and financial regulatory compliance, offering a more rigorous regulatory oversight than some other junior exchanges.[129] Hence, it is appropriate to adopt regulatory requirements that acknowledge this oversight.

The venture/non-venture issuer delineation is unlikely to create incentive effects in terms of issuers not being willing to move up to the senior exchange. Both the TSX and TSXV have solidly increasing reputations, and institutional and other investors are increasingly willing to invest in venture companies. While the objective of many companies on the TSXV is to move to the TSX, the new proportionate requirements may mean that they remain on the TSXV for a greater period of time, graduating, for example, in a year to 15 months instead of three to six months. However, the fact that they may be in less of a hurry to acquire the additional governance and disclosure requirements could be viewed as a positive aspect of a proportionate approach, in that such issuers are likely to move only when they have appropriate controls and resources in place to comply with the new requirements. Generally, where the venture issuer is qualified to graduate, it will do so, as

[128] TSX listed companies represent 97 per cent of the total aggregate Canadian market capital, ASC, *supra*, note 8.
[129] TMX Group, *supra*, note 80 at 6.

graduation is important to its capital raising activities.[130] Arguably, any additional time that the venture issuer needs to enhance its internal capacity with respect to financial controls, governance and disclosure is also of benefit to investors, who will understand the different risks associated with the issuer, advancing the goals of investor protection.

The disadvantage may be for smaller issuers on the TSX, who may have the same market capitalization as a TSXV issuer, but face a different set of regulatory requirements, thus raising the question of fairness. These issuers may face disproportionate governance requirements in terms of time and resources, when the requirements are not responsive to legislative and regulatory goals.

With this basis for proportionate regulation, as for the options that follow, public education is required for all market participants, particularly potential investors. There needs to be clear understanding of how regulation has been scaled and what it means to investors in assessing their risk capacity. For example, the TSX has continually upgraded its education and mentorship programs, so that issuers meet regulatory compliance and investors understand the market and business risks associated with different kinds of investment.

(b) Market Capitalization or Market Float Approach

A second option is to delineate the type of issuer by size. Such a demarcation for purposes of proportionate regulation could be by market capitalization or public float; or as discussed below, by consolidated revenue. There would need to be a nationally prescribed standardized methodology for computing size, whatever approach adopted.

The market capitalization approach offers some transparency in that market capitalization information is publicly available. The US has adopted the notion of public float, i.e. market capitalization excluding company officers, directors, or controlling-interest investors, for greater ease and transparency, as discussed below. If a market capitalization approach were to be adopted for purposes of proportionate regulation in Canada, there would have to be clear transition rules specifying how companies would graduate from the microcap or smallcap category to non-small company status, in terms of timing, in order to ensure fairness of when exactly a company becomes subject to scaled regulatory requirements, and transparency for investors. Given that market capitalization can fluctuate, companies could arguably hover on either side of a market cap bright line, and thus should be measured as of a specified annual date. While this option would assist with transparency, it may give rise to some incentives to manipulate market capitalization to fall within particular compliance requirements or incentives to not grow the company, creating a measure of unfairness for investors. A key disadvantage of the market capitalization approach is that choice of regulatory regime is removed from the issuer, as the market determines the issuers' value.

[130] From January 2000 to April 2008, 404 issuers moved from the TSXV to the TSX.

(i) Market Capitalization

The SEC Advisory Committee on Smaller Public Companies in 2006 reported that proportionality as an underlying principle of US securities regulation had been underemphasized, and made a series of recommendations for proportionate regulation.[131] It recommended regulating based on a stratification of smaller public companies into two groups, microcap companies and smallcap companies. Its proposed a system of proportionate securities regulation for smaller public companies that would use six determinants to define a "smaller public company": the total market capitalization of the company; a measurement metric that facilitates the scaling of regulation; a measurement metric that is self-calibrating; a standardized measurement and methodology for computing market capitalization; a date for determining total market capitalization; and clear and firm transition rules.[132]

The Committee recommended the use of market capitalization, rather than public float, which US regulators have traditionally used to determine eligibility for smaller public company treatment, because it concluded that market capitalization better measures total financial exposure to investors and the US capital markets than public float. Its view was that market capitalization has the advantage of simplicity, as it avoids the sometimes difficult problem of deciding for legal purposes which holdings are public float and which are not.[133]

The Committee recommended the development of proportionate regulation for companies if they qualify as "microcap companies" because their equity market capitalization places them in the lowest 1 per cent of total US equity market capitalization or as "smallcap companies" because their market capitalization places them in the next lowest 1 per cent to 5 per cent of total U.S. market capitalization.[134] The Committee summarized the US market as follows in its Table 1:

[131] Advisory Committee on Smaller Public Companies, *Final Report of the Advisory Committee on Smaller Public Companies to the US Securities and Exchange Commission* (2006), April 23, 2006, http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf.
[132] *Ibid.* at 24.
[133] *Ibid.* at 19. A public float test is used to determine a company's eligibility to use Form SB-2 *Smaller Reporting Company Form*, Form F-3 *Registration Statement for Securities of Certain Foreign Private Issuers;* and Form S-3 *Registration Statement under the Securities Act of 1933*; and nonaccelerated filer status. However, the committee decided that because public float by definition excludes shares held by affiliates, calculation of public float relies on an accurate assessment of affiliate status of officers, directors and shareholders. As the SEC acknowledged in the Rule 144 context, this requires a subjective, facts and circumstances determination that entails a great deal of uncertainty. Regulation S–B was designed to reduce compliance costs and improve the ability of start-ups and other small businesses to obtain financing through the public capital markets.
[134] *Ibid.* at 15.

Table: Recommendation on Scaled or Proportionate Regulation for Smaller Public Companies

	Market Capitalization Cutoff	Percentage of Total U.S. Market Capitalization	Percentage of All U.S. Public Companies
Microcap Companies	<US$128.2 million	1%	52.6%
Smallcap Companies	US$128.2-US$787.1 million	5%	25.9%
Smaller Public Companies	<US$787.1 million	6%	78.5%
Larger Public Companies	>US$787.1 million	94%	21.5%

Note that its definition of small cap is set at a considerably higher threshold than in Canada, where SMEs are viewed as a market capitalization of CDN$500 million or less.[135] The differences are due to the smaller size of Canada's capital market and the fact that Canadian issuers tend to access the public equity market at a much earlier stage of their growth than companies in the US.[136]

The Committee's rationale for recommending proportionate regulation for companies falling in the lowest 6 per cent of total US equity market capitalization is that 94 per cent of the total US public equity capital market would still have the full benefit and protection of federal securities regulation for companies, limiting risk to investors of serious losses.[137]

The Committee recommended the promulgation of regulations under which all US companies with equity securities registered under the *Exchange Act* would be ranked from largest to smallest market capitalization based on a periodic recalculation date. Companies would self-determine whether they qualify for microcap and smallcap company treatment for the next fiscal year by comparing their market capitalization on the last day of their previous fiscal year. Hence, the measurement metric for determining smaller public company status would be "self-calibrating."[138] The Committee did not recommend the frequency with which the recalculation should occur, but noted that frequent recalculation, even on an annual basis, could introduce an undesirable level of uncertainty into the process for companies trying to determine where they fall within the three categories.[139] However, its view was that the recalculation period avoids the problem of setting a dollar amount standard that needs to be continually revisited, providing a long-term solution to the problem of re-scaling securities regulation for smaller public companies every few years.[140]

The Committee concluded that the benefits of documenting, testing and certifying the adequacy of internal controls, while of importance for large issuers, are of less certain value for smaller public companies, who rely to a greater degree on the "tone at the top"

[135] TMX Group, *supra,* note 80 at 2.
[136] *Ibid.*
[137] Advisory Committee on Smaller Public Cos, *supra,* note 131 at 15.
[138] *Ibid.* at 17.
[139] *Ibid.* at 17.
[140] *Ibid.* at 18.

and high-level monitoring controls to facilitate accurate financial reporting, finding that "the result is a cost/benefit equation that, many believe, diminishes shareholder value, makes smaller public companies less attractive as investment opportunities and impedes their ability to compete".[141] The Committee observed that the primary objective of internal control over financial reporting requirements should be the prevention of materially inaccurate financial statements; however, different sized companies operate differently, and internal control rules should reflect this fact.[142] It recommended that, in implementing new accounting standards, the Financial Accounting Standards Board (FASB) should permit microcap companies to apply the same extended effective dates that it provides for private companies.[143] The Committee recommended implementing a *de minimis* provision in the application of the SEC's auditor independence rules.[144]

In implementing some of the recommended changes of the Committee, the SEC chose to retain public float as the delineation for proportionate regulation, instead of market capitalization.

(ii) Public Float

Public float is largely a US regulatory concept adjusting market capitalization; essentially it is the portion of a company's outstanding shares that is held by public investors, as opposed to company officers, directors or controlling-interest investors. Public float has been used in the US as the delineation for proportionate regulation. Effective February 2008, the SEC has adopted a new system of disclosure rules for smaller companies filing periodic reports and registration statements with the SEC.[145] It has expanded the number of companies that qualify for its scaled disclosure requirements for smaller reporting companies.[146]

Under the new system, smaller reporting companies will prepare and file their SEC reports and registration statements using the same forms as other SEC reporting companies, though

[141] *Ibid.* at 23, citing SEC rules require that a company maintain evidential matter, including documentation, to provide reasonable support for management's assessment of the effectiveness of the company's internal control over financial reporting. See Section II.B. of Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, SEC Release No. 33-8238 (June 5, 2003) [68 FR 36636].

[142] *Ibid.* at 25. The Committee found a lack of any clear definition or guide as to what constitutes adequate internal controls for smaller companies, compounded by the different requirements in Section 404 for management and for their external auditors, *ibid.* at 31.

[143] Recommendation V.P.2.

[144] Recommendation V.P.4.

[145] The SEC adopted its smaller reporting company rules in Release 33-8876 (Dec. 19, 2007) [73 FR 934]. An investment company, asset-backed issuer or majority-owned subsidiary of a parent are not eligible to be a smaller reporting company. http://www.sec.gov/rules/final.shtml. "Smaller Reporting Company Regulatory Relief and Simplification," Release No. 33-8876 (Dec. 19, 2007) Changeover to the SEC's New Smaller Reporting Company System by Small Business Issuers and Non-Accelerated Filer Companies A Small Entity Compliance Guide January 25, 2008: http://sec.gov/info/smallbus/srcoreq.shtml

[146] SEC 17 CFR PARTS 210, 228, 229, 230, 239, 240, 249, 260, and 269 [RELEASE NOS. 33-8876; 34-56994; 39-2451; FILE NO. S7-15-07] RIN 3235-AJ86 Smaller Reporting Company Regulatory Relief and Simplification, Final rule; http://www.sec.gov/info/smallbus/secg/smrepcosysguid.pdf.

the information required to be disclosed will differ.[147] Under the new rules, companies qualify as "smaller reporting companies," and therefore for scaled disclosure, if they have a common equity public float of less than US$75 million, which will be the eligibility for most issuers. Alternatively, for companies that are unable to calculate public float, the SEC has provided a revenue test. If a company has no common equity outstanding or no market price for its outstanding common equity at the time of its eligibility determination, the company would qualify as a smaller reporting company if it had less than US$50 million in revenues in the last fiscal year. These standards differ from the standards that governed eligibility for the SEC's former small company disclosure requirements, which were available to "small business issuers," that had less than US$25 million in public float and less than US$25 million in annual revenue.[148]

Setting the public float ceiling at US$75 million for smaller reporting companies further aligned the smaller reporting company definition with the SEC's non-accelerated filer definition. The SEC has concluded that this standard is appropriately scaled in that it reduces costs to smaller companies caused by unnecessary information requirements, consistent with investor protection.[149] The SEC reports that by eliminating the revenue test for most companies, the new definition of smaller reporting company simplifies and streamlines the definition while expanding the number of companies eligible to qualify.[150] All companies calculate their public float as of the last business day of their second fiscal quarter. The amendments are scaled to reflect the characteristics and needs of smaller companies and their investors.[151]

The SEC rejected the Advisory Committee's recommendation to move to market capitalization as the measure of size, as it concluded that requiring only a public float test for most companies to qualify would provide additional simplicity, consistency and certainty; and that eliminating a revenue test would broaden the category of eligible companies. Its decision to focus on a company's non-affiliate common equity market capitalization or ''public float'' was also consistent with the SEC's current regulatory standards for the purposes of Forms 10–K Annual Reporting and S–3 Registration Statements and the accelerated filer definition.[152]

[147] The SEC reports that, eventually, there will be no special "small business" forms like Forms 10-KSB and SB-2.

[148] The new rules permit foreign companies to qualify as smaller reporting companies if they use domestic forms and if they prepare their financial statements in accordance with US GAAP. Previously, the only foreign companies permitted to use SEC scaled disclosure requirements were Canadian companies.

[149] Part II Securities and Exchange Commission 17 CFR Parts 210, 228 et al., Smaller Reporting Company Regulatory Relief and Simplification; Final Rule

[150] *Ibid.*

[151] The "smaller reporting company" category includes companies that qualified as "small business issuers" before the new rules, as well as most companies that qualify as "non-accelerated filers." In general, companies that enter the system with less than US$75 million in common equity public float qualify as smaller reporting companies. Companies unable to calculate the public float typically qualify if they have less than $50 million in annual revenues on entering the system. To streamline and simplify regulation, the amendments move the scaled disclosure requirements from Regulation S-B into Regulation S-K.

[152] The overlap between reporting companies with US$128 million in market capitalization and reporting companies with US$75 million in public float was approximately 98 per cent in 2006, Part II SEC 17 CFR Parts 210, 228 et al., *Smaller Reporting Company Regulatory Relief and Simplification; Final Rule.* See also US Government Accountability Office (GAO) 2006 report entitled *Sarbanes-Oxley Act, Consideration of Key*

The SEC has also acknowledged the need for proportionate regulation in the context of *Sarbanes-Oxley* section 404, auditor attestation requirements.[153] It accepted, in part, the Committee's recommendation that the SEC provide exemptive relief to microcap and smallcap companies until a framework for assessing the internal control over financial reporting for such companies is developed that recognizes their characteristics and needs.[154] The SEC announced in June 2008 that it has further extended the compliance date for smaller public companies (non-accelerated filers), defined as those with less than US$75 million in public float, to meet the Section 404(b) auditor attestation requirement of the *Sarbanes-Oxley Act* by one year, for annual reports for fiscal years ending on or after December 15, 2009.[155] In the interim, the SEC will collect data on the costs and benefits of Section 404 implementation, focusing on the consequences for smaller companies and the effects of the Section 404 auditor attestation requirements.[156] The extension of the Section 404 compliance date for smaller companies is aimed at reducing unnecessary compliance costs for smaller companies while preserving important investor protections.[157]

One study comparing more than 3,000 small US issuers from 2003 to 2005 and a pre-*S-Ox 404* control period suggests that the exemption has had unintended consequences, specifically, that smaller firms have had an incentive to remain below the public float threshold.[158] It documented that these firms remained small by undertaking less investment, making more cash payouts to shareholders through dividends and share repurchases, and reducing the number of shares held by non-affiliates.[159] The authors also found that, because the testing date of a firm's filing status occurs only once each fiscal year, the nonaccelerated filers post-*S-Ox* have adopted various techniques to exert

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Principles Needed in Addressing Implementation for Smaller Public Companies. Form 10-K *Annual Report pursuant to ss. 13 or 15(d) of the Securities Act of 1934*; Form S-3 *Registration Statement under the Securities Act of 1933.*

[153] Under S-OX 404, issuers are to include in their annual reports a report of management, and an accompanying auditor's attestation report, on the effectiveness of the company's internal control over financial reporting, and to evaluate, as of the end of each fiscal quarter, any change in the company's internal control over financial reporting that occurred during the period that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting; SEC 17 CFR PARTS 210, 228, 229, 240 and 249 [RELEASE NOS. 33–8760; 34–54942; File No. S7–06–03] RIN 3235–AJ64 Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers and Newly Public Companies, 76580 Federal Register / Vol. 71, No. 245 / Thursday, December 21, 2006, http://www.sec.gov/rules/final/2006/33-8760fr.pdf.

[154] It found that with more limited resources, fewer internal personnel and less revenue to offset implementation costs and the disproportionate fixed costs of Section 404 compliance, these companies have been disproportionately subject to the burdens associated with Section 404 compliance, *ibid.* at 23.

[155] June 20, 2008, Release 2008-166, SEC Approves One-Year Extension for Small Businesses From Auditor Attestation Requirement in Sarbanes-Oxley Act; http://www.sec.gov/news/press/2008/2008-116.htm; SEC Staff Gains OMB Approval to Proceed With Data Collection for Cost-Benefit Study of SOX 404 Implementation; http://www.sec.gov/news/press/2008/2008-116.htm.

[156] Larger companies, comprising more than 95 percent of the market capitalization of U.S equity securities markets, have been subject to both provisions since 2004.

[157] *Ibid.*

[158] Gao Feng Wu, Joanna Shuang and Jerold Zimmerman, "Unintended Consequences of Granting Small Firms Exemptions from Securities Regulation: Evidence from the Sarbanes-Oxley Act" (April 2008), Simon School Working Paper No. FR 07-07, online: http://ssrn.com/abstract=1014054 at 31.

[159] *Ibid.* at 4.

temporary downward pressure on share prices before testing their filing status, specifically, actions related to short-term price impact, such as disclosing bad news in the second fiscal quarter and reporting lower accounting earnings in the second fiscal quarter.[160] The study points out the potential incentive effects from a bright line market capitalization delineation.

Overall, the market capitalization approach offers a relatively high degree of transparency, in that market capitalization or public float are publicly disclosed. It offers a high degree of fairness in that the size of the issuer determines what set of regulatory requirements an issuer will have to meet. Its negative features are that it requires constant adjustment in that market capitalization is highly dynamic. There need to be clear rules as to the appropriate valuation date and the appropriate valuing of market capitalization. A date too frequent for recalculating market capitalization or public float could be costly and time consuming for issuers; however, a date too infrequent could create additional risks for the market, in that issuers may have grown such that they should be complying with more extensive requirements, but are not.

There is also the potential for a fairness issue in respect of investors, in the sense that issuers may choose not to grow their market capitalization to remain within the capitalization requirements of a smaller issuer. There may also be fairness issues at the margins, in that those issuers close to the cutoff line may move back and forth over the line under a market capitalization delineation.

The greatest disadvantage of a market capitalization approach may be the lack of choice for issuers. Its practical result is that, if the company grows to a predetermined arbitrary market cap, its regulatory obligations are going to change. If there are serious market swings, issuers could bounce in and out of a category, creating large costs for regulatory compliance. It may also create a stigma associated with such shifts, whereas delineation by venture/non-venture retains an element of choice for the issuer in its own risk/reward calculation. There is also some risk, as the US study found, of issuers making inappropriate choices about the use of capital, in order to retain small issuer status, which could affect investors' interests and the long term interests of the company.

(c) Consolidated Revenue Approach

Another size of issuer approach to proportionate regulation is to use consolidated revenue as the delineation, which can offer some transparency to investors. Fairness is engaged in that all issuers with the same consolidated revenue are treated the same for regulatory purposes. Another advantage is that it can offer strong evidence of issuer's financial status and does not rely on the liquidity of the market to determine size. However, consolidated revenue by itself may not be the most accurate measure.

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[160] *Ibid.* at 5. The authors found that non-accelerated filers' incentives to undertake the above actions are weaker when they are further away from the US$75 million threshold.

In 1996, the OSC Task Force on Small Business Financing concluded that gross revenue was the best vehicle to measure the appropriate size of an enterprise in the financing context because, among other reasons, income and equity may be minimal even for entities of considerable size.[161] It would have supplemented the revenue test by a market capitalization test to recognize issuers with large market capitalizations and insignificant revenues, such as exploration stage resource issuers. The Task Force defined SMEs as enterprises with not more than CDN$10 million in gross revenues in the most recently completed financial year; and market capitalization, calculated on a fully diluted basis prior to the proposed offering, of not more than CDN$35 million.[162]

One example of consolidated revenue being used in conjunction with other tests in Canada is the new National Instrument 41-101, *General Prospectus Requirements*. Canadian regulators expanded the opportunities for issuers to use the short form prospectus process by removing the market capitalization eligibility requirements for reporting issuers, at the same time as setting out specific requirements for junior and IPO venture issuers.[163] NI 41-101 came into force on March 17, 2008, creating a comprehensive and transparent set of national prospectus requirements for all issuers, including certain investment funds. The new rule maintains a high level of disclosure to investors while reducing costs for issuers wishing to offer securities in more than one jurisdiction. The Instrument is based on three general principles: harmonization and consolidation of the general prospectus requirements among Canadian jurisdictions; harmonization of the general prospectus requirements with the continuous disclosure and short form prospectus disclosure regimes; and amendments to the principles underlying the general prospectus requirements identified as a result of regulatory reviews, applications for exemptive relief and public consultation.[164]

NI 41-101 came into force at the same time as Multilateral Instrument 11-102, *Passport System,* and new national policies that streamline Canadian regulatory processes for prospectuses and exemptive relief applications. This change opened up to several thousand more issuers the possibility of using the short form prospectus process. The significance of the de-emphasis on "point of sale" disclosure is in part an attempt to reduce the regulatory burden on issuers raising capital, especially SMEs.[165] The practical effect of the expansion of NI 44-101 is that the traditional long form prospectus document is retained for IPOs only.

NI 41-101 could be viewed as recognition of proportionate regulation in that it removed the previous eligibility requirements, opening up the availability of the short form prospectuses, but at the same time imposed additional disclosure requirements on IPO venture issuers and junior issuers, in recognition that information about them may not be as widely disseminated in the market. A junior issuer is defined as one that files a preliminary prospectus, is not a reporting issuer in any jurisdiction, and whose total consolidated assets

[161] Ontario Securities Commission, Task Force on Small Business Financing, Final report (1996), http://www.osc.gov.on.ca/About/Publications/op_small_business.pdf
[162] *Ibid.* at 4.
[163] National Instrument 41-101 *General Prospectus Requirements* (2008), 31 OSCB (Supp-2), effective March 7, 2008.
[164] Companion Policy *General Prospectus Requirements* 41-101CP.
[165] *Ibid.*

as at the date of the most recent balance sheet of the issuer included in the preliminary prospectus are less than CDN$10 million, whose consolidated revenue as shown in the most recent annual income statement of the issuer is less than CDN$10 million, and whose shareholders' equity as at the date of the most recent balance sheet included in the preliminary prospectus is less than $10 million.[166] Depending on the type of prospectus, the Instrument sets timelines for determining revenue dates.[167]

A junior issuer must disclose additional information; specifically, the total funds available and the following breakdown of those funds: the estimated net proceeds from the sale of the securities offered under the prospectus; the estimated consolidated working capital (deficiency) as at the most recent month end before filing the prospectus; and the total other funds available to be used to achieve the principal purposes identified by the junior issuer.[168] A junior issuer that had negative operating cash flow in its most recently completed financial year for which financial statements have been included in the prospectus, must disclose the period of time the proceeds raised under the prospectus are expected to fund operations, the estimated total operating costs necessary for the issuer to achieve its stated business objectives, and the estimated amount of other material capital expenditures during that period of time.[169]

NI 44-101 also distinguishes IPO venture issuers, meaning an issuer that files a long form prospectus; is not a reporting issuer in any jurisdiction immediately before the date of the final long form prospectus; and, at the date of the long form prospectus, does not have any of its securities listed or quoted, has not applied to list or quote any of its securities, and does not intend to apply to list or quote any of its securities, on the TSX, a US and other foreign marketplace, other than AIM or the PLUS markets. If the issuer is a venture issuer or an IPO venture issuer that has not had significant revenue from operations in either of its last two financial years, it must disclose a breakdown of material components of capitalized or expensed exploration and development costs, expensed research and development costs, deferred development costs, general and administrative expenses, and additional specified information.[170]

Thus, NI 44-101 is a form of targeted regulation, recognizing the need to focus the disclosures of those issuers without a history in the market.

In the UK, the FSA defines small firms in its *Prospectus Directive* as companies, which, according to their last annual or consolidated accounts, meet at least two of the following three criteria: an average number of employees during the financial year of less than 250, a total balance sheet not exceeding €43 million and an annual net turnover not exceeding €50

[166] "taking into account all adjustments to asset, revenue and shareholders' equity calculations necessary to reflect each significant proposed acquisition of a business or related business by an issuer that has progressed to a state where a reasonable person would believe that the likelihood of the issuer completing the acquisition is high, and each completed significant acquisition of a business or related business that was completed', NI 41-101 *General Prospectus Requirements*.
[167] *Ibid.*
[168] Form 41-101F1, s. 6.2.
[169] Form 41-101F1, s. 8.7.
[170] Form 41-101F1, s. 8.6.

million. Small Business is defined as a partnership, body corporate, unincorporated association or mutual association with an annual turnover of less than £1 million or its equivalent in any other currency at the relevant time.[171] In the US, the SEC Advisory Committee on Smaller Public Companies recommended that the SEC provide exemptive relief from the *S-Ox 404* requirements based primarily on a revenue test[172] Small public companies requesting exemption would have to establish that the estimated costs of compliance would overly burden the company. As noted above, the SEC offered smaller issuers some relief in June 2008, but based on the pre-existing non-accelerated filer status.

Thus while a consolidated revenue delineation has been used in combination with other measures of size or sophistication in a few circumstances, it does not align with stock exchange listing requirements. Junior issuers could face differing and perhaps conflicting regulatory requirements if such an approach were adopted as a stand-alone threshold. However, consolidated revenue could be used in conjunction with market capitalization for very targeted proportionate regulation.

An example is the requirement for ICFR under NI 52-109. The TSX, in its submission to regulators regarding the instrument, proposed that smaller TSX issuers should be able to avail themselves of the ICFR design accommodation, based on a threshold of annual audited revenue of CDN$2 million or a market capitalization of CDN$75 million or less, or CDN$2 million in revenue and a market capitalization of CDN$300 million or less.[173] It suggested that rather than creating a system of individual issuers seeking relief from the requirements, the accommodation could be available for issuers below such a threshold. It observed that the available guidance offered by the COSO framework does not take into account the organizational structure and staff complement that characterizes many SME issuers on the TSX and that the CSA should develop a principles-based internal control framework for SME issuers to allow issuers the appropriate tools that will assist them in designing and evaluating ICFR, recognizing multiple sectors and the fact that SME issuers do not have extensive internal control/risk management functions.[174]

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171 FSA Handbook, http://fsahandbook.info/FSA/html/handbook/Glossary/S, last accessed July 31, 2008.
172 Rule 10A-3 under the Securities Exchange Act of 1934 (the "Exchange Act"). Section 404 directed the SEC to adopt rules requiring all reporting companies to include in their annual reports a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting, together with an assessment of the effectiveness of those internal controls. Section 404 further required that the company's independent auditors attest to, and report on, this management assessment, *ibid.* at 25. Most US firms use the internal control framework published by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) (the COSO Framework), *ibid.* at 26. Under the COSO Framework, internal control over financial reporting is defined as a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the reliability of financial reporting. Internal control over financial reporting includes five interrelated components: control environment, risk assessment, control activities, information and communication, and monitoring, http://www.ic.coso.org. *Ibid.* at 26.
173 TMX Group, *supra*, note 80 at 8.
174 *Ibid.* at 9. On July 11, 2006, COSO and its Advisory Task Force issued *Guidance for Smaller Public Companies Reporting on Internal Control over Financial Reporting,* aimed at assisting the management of smaller companies in understanding and applying the COSO framework. It outlines 20 fundamental principles associated with five key components of internal control described in the COSO framework, defines each principle, describes a variety of approaches that smaller companies can use to apply the principles to financial reporting, and includes examples of how smaller companies have applied the principles.

(d) Sector Approach

Another possible point of delineation is by sector, which is another variation on a market capitalization distinction, as particular sectors tend have certain market capitalization characteristics. Canada's capital market has regional markets based on the type of issuer.[175] Based on aggregate public market capitalization, the Canadian capital market is primarily represented by six major industrial groups: oil & gas; financial services; mining; diversified industries; media and communications; and technology. Based on market capitalization, the most significant industries are oil & gas, financial services and mining, in that order. Sectoral proportionate regulation may not be a viable choice, as it lacks fairness and transparency. There are, as noted above, specific disclosure requirements for particular sectors, in terms of mandatory technical information, but these requirements are focused regulation that does not reduce the burden of smaller issuer regulation. The OSC Task Force on Small Business Financing in 1996 concluded that tailoring the thresholds on an industry-by-industry basis would undermine the objective of comprehensible regulation.[176]

In sum, there are a variety of criteria that could potentially serve as the threshold or delineation for purposes of proportionate regulation. A canvass of Canadian securities regulators indicates that most of the provincial and territorial securities regulators view their jurisdiction as not explicitly having proportionate regulation in place, other than through the endorsement of national instruments and policies. Regulators in Saskatchewan, Manitoba, New Brunswick, Prince Edward Island, Nova Scotia, the Northwest Territories and the Yukon have no explicit proportionate regulation based on size or market capitalization unique to their jurisdictions; and no plans to develop and implement proportionate regulation outside of the CSA initiated changes.[177] One regulator suggested that it would be too much of an administrative burden to create different sets of rules for smaller companies.[178] A unique regional or provincial approach to proportionate regulation was viewed as prohibitive on a cost basis. The provinces that have smaller capital markets and regulatory structures advised that they generally follow the lead of Ontario and other provinces with more active capital markets.

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[175] The Alberta Securities Commission has set out the most recent picture of these regional markets, based on TSX and TSXV data ending December 31, 2007. Alberta Securities Commission (ASC). The Alberta Capital Market: A Comparative Overview, 2008 Report, *supra*, note 8.

[176] OSC Task Force on Small Business Financing, *supra*, note 161 at 4.

[177] To-Linh Huynh, Corporate Finance Officer; Donn MacDougall, Manager, Securities & Corporate Registries; Rhonda Horte, Deputy Registrar, Corporate Affairs, telephone interview with B. Lau.

[178] Barbara Shourounis, Director, Securities Division, Saskatchewan Financial Services Commission, telephone interview with B. Lau; Manitoba Securities Act, http://web2.gov.mb.ca/laws/statutes/ccsm/s050e.php;; Manitoba Securities Commission: Policies and Legislation, http://www.msc.gov.mb.ca/securities/policies_legislation/index.html; Manitoba Securities Commission: Continuous Disclosure, http://www.msc.gov.mb.ca/securities/continuous_disclosure/index.html, last accessed July 1, 2008; Steven Dowling, Corporate Counsel, Office of the Attorney General, Consumer, Corporate and Insurance, telephone interview with B. Lau.

Since British Columbia has embraced outcomes-based regulation, the BCSC has observed that it is unclear whether proportionate regulation will play an important role in the province's securities regulation.[179] Under its approach, the tools for firm compliance are tailored according to specific outcomes; hence, there is not much need for size-based regulation.[180] In its submission to the Expert Panel, the BCSC chose not to comment on the issue of proportionate regulation, other than to note that any consideration to expand or limit proportionate regulation should be based on the experience to date with proportionate regulation in Canada.[181]

The Alberta Securities Commission (ASC) has expressed some interest in pursuing proportionate regulation, given the make-up of Alberta's companies.[182] ASC has internally produced some documents considering how it would be structured; however, none of them have been finalized or published.[183] Alberta's capital market represents a mix of senior and junior issuers, and the ASC is considering how one could implement tiered regulation more effectively.

In Ontario, the OSC's Small Business Advisory Committee acknowledged the needs of small issuers, as discussed above.[184] The OSC has been very active in creating more appropriate standards for venture issuers in the national instruments discussed above. It considered asset-based regulation; however, the OSC concluded that such method was not transparent and was too difficult for administrators to apply and investors to understand. For example, the OSC has observed that issuer assets may fluctuate from year to year for the purposes of MD&A; thus, the same issuer could be caught by the rule in one year, but not in the following year.[185] Thus the OSC has concluded that the type of listing approach was the most transparent.[186]

In Québec, l'Autorité des marchés financiers (AMF) reports that it has not published any documents relating to proportionate regulation, and has not taken a public position on this issue to date.[187] However, proportionate regulation may already to some extent be reflected

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[179] Alison Dempsey, Senior Legal Counsel, Corporate Finance, British Columbia Securities Commission (BCSC); Noreen Bent, Manager and Senior Legal Counsel, Legal Services, Corporate Finance, BCSC, telephone interview with B. Lau.
[180] The BC principles-based regulation model was outlined in the Draft Legislation and Commentary on the Draft Legislation, published by the BCSC in April, 2003: http://www.bcsc.bc.ca/uploadedFiles/Draft_Legislation_Commentary.pdf.
[181] BCSC, supra, note 24 at 1, 4.
[182] Tom Graham, Director of Corporate Finance, Alberta Securities Commission, telephone interview with B. Lau, June 23, 2008.
[183] Stephen P. Sibold QC, former chair of the ASC and of the Canadian Securities Administrators (CSA), in "Addressing the Burden of Regulation in Canada: the Case for Proportionate Regulation" (Submission to the IDA Task Force to Modernize Securities Regulation in Canada, 24 October 2005), online: http://www.tfmsl.ca/pages/submissions.html.
[184] Heidi Franken, Senior Accountant, Corporate Finance Group, Ontario Securities Commission (telephone interview with Bernard Lau, June 26, 2008).
[185] Heidi Franken, *ibid*
[186] Heidi Franken, *ibid.* Other Initiatives by OSC: participating at educational workshops for smaller issuers on MD&A.
[187] Catia Bergeron, Conseillère en communication, Direction du centre de renseignements, AMF.

in the efforts undertaken by the AMF to harmonize requirements relating to issuers and registrants with other jurisdictions, including the passport system and national instruments.

Nova Scotia does not have proportionate regulation in the public markets, other than national instruments.[188] However, Nova Scotia has an equity tax credit for small cap companies that issue securities, called the Community Economic Development Corporations Program (CEDCP).[189] Corporations that qualify must complete different filing requirements with respect to financial statements, press release obligations, and other documents.[190] Some key points for corporations that qualify under this program are that issuers must have less than CDN$25 million in assets or revenue including all affiliated corporations or associations.[191] They must use a prescribed Offering Document, and are prohibited from selling more than CDN$3 million in any one offering. The program has prescribed time frames in which to complete the offering, and issuers must obtain a letter of non-objection from the Nova Scotia Securities Commission and a Tax Credit Certificate from the Nova Scotia Department of Finance.[192] Nova Scotia also has some proportionate regulation for its Community Economic Development Investment Fund (CEDIF), which is a pool of capital formed through the sale of common shares to persons within a defined community, aimed at encouraging business investment in the region.[193]

CSA is also assessing the possibility of expanding the scope of proportionate regulation, in terms of testing whether regulators can develop appropriate responses applicable to the entire Canadian capital market each time a regulatory initiative is introduced; if they cannot, considering different regulations for different sized companies.

6. Proportionate Regulation for Seasoned or Larger Issuers

While not the focus of this paper, it merits note that proportionate regulation could benefit more experienced or larger participants in the Canadian capital market. In the US, the SEC has adopted a series of rules for well-known seasoned issuers (WKSIs) that relaxed restrictions imposed on public offerings. The Securities Offering Reform Rules create a new class of WKSIs comprised of issuers that are presumed to be the most widely followed in the marketplace.[194] WKSIs can use a new "automatic shelf registration" process, which allows them to register unspecified amounts of specified types or classes of securities on

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[188] Bill Slattery, Acting Director of Securities, Nova Scotia Securities Commission.
[189] Community Economic-Development Corporations Regulations made under Section 150 of the *Securities Act,* R.S.N.S. 1989, c. 418, O.I.C. 1998-517 (October 15, 1998), N.S. Reg. 79/98; Securities Act, CHAPTER 418, REVISED STATUTES, 1989, amended 1990, c. 15, ss. 19-80; 1996, c. 32; 2001, c. 18; 2001, c. 41, ss. 24-27; 2002, c. 39; 2003, c. 7, s. 6; 2005, cc. 26 & 27, http://www.gov.ns.ca/nssc/docs/check.pdf.
[190] *Ibid.*
[191] Nova Scotia Securities Commission, http://www.gov.ns.ca/nssc/corporatefinance/cedif.htm.
[192] *Ibid.*
[193] Community Economic Development Investment Fund, http://www.gov.ns.ca/nssc/corporatefinance/cedif.htm. A CEDIF must be incorporated either as a corporation or an association, must be for-profit, and must have at least six directors from the defined community. A CEDIF is governed by the CEDC Regulations and the *Securities Act.* The required filing includes the Offering Document and specified forms and documents.
[194] Securities Offering Reform, SEC Release No. 33-8591 (19 July 2005) 70 FR 44722.

immediately effective registration statements, without allocating between primary and secondary offerings and can exclude more information from the base prospectus. It eliminates the delivery requirement for final prospectuses.[195]

The shelf registration rules for WKSIs allow more flexibility and faster issuing. It loosens "quiet period" rules that govern what the issuer can say before and during offering. Communications by issuers more than 30 days before filing a registration statement will be permitted without violating the "gun jumping" provisions, as long as they do not refer to an offering that is the subject of a registration statement. For prospectus delivery, access equals delivery, hence electronic access is sufficient.

The idea of proportionate regulation for seasoned issuers was developed at some length in one of the research studies for the Task Force to Modernize Securities Legislation in Canada. Professor Pritchard recommended that Canada could adopt a version of WKSI status for the top tier of the TSX as part of streamlining the prompt offering prospectus (POP) system.[196] The study suggested that careful consideration should be given to the appropriate standards for WKSI status in Canada, recommending that a standard of CDN$350 million in market capitalization would strike a balance between the need for information for investors and the economies available from streamlined regulation.[197]

The Task Force adopted that recommendation in its final report, recommending that Canadian well-known seasoned issuer (C-WKSI) status be granted based on the CDN$350 million cap standard where issuers meet the qualification criteria for the POP system. The Task Force offered detailed suggestions as to the type of information that would be required for C-WKSI issuers to undertake follow on offerings without regulatory review.[198]

7. Broad Principles and Basic Tools

The above discussion illustrates that there are at least eight principal tools that can be used to implement proportionate regulation:

- Exemption of junior issuers from specific requirements, because the time and resources of imposing such requirements on junior issuers outweighs any benefits of protection of the market.
- Scaled timelines, recognizing that junior issuers must access external resources to comply and thus require longer periods to compile accurate periodic disclosure.
- Transition timelines, which allow junior issuers longer to put in place new required governance, financial controls, or other new standards, where it is determined that they are necessary to advance the public policy goals of the system.

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[195] Janis Sarra, Modernizing Disclosure in Canadian Securities Law: An Assessment of Recent Developments in Canada and Selected Jurisdictions, A research report for The Task Force to Modernize Securities Legislation in Canada.
[196] Pritchard, *supra,* note 26.
[197] *Ibid.*
[198] IDA Task Force, *Final Report, Canada Steps Up*, at 9.

- Different frequency of reporting, such as semi-annually instead of quarterly, where it is determined that investors and other market participants may not be interested in quarterly financial reporting if they are receiving timely, full and accurate material change disclosure.
- Modified requirements in terms of formal governance or internal control requirements and the level of detail of disclosure, by modifying a rule that applies to all issuers for junior issuers.
- Tailored requirements, which set disclosure requirements based on technical information particular to a sector, to the issuer's history in the market, or to its revenue generating capacity.
- Guidance as to best practice, in terms of offering junior issuers information and guidance on a range of compliance options that may be responsive to their capital and operational structure, such as the design of control systems.
- Use of high level principles that should govern the conduct of issuers, and then allow issuers to develop best practices appropriate to their size or resources based on a principles/standards/outcomes based system.

For each of these tools, it is important to consider how they advance the goals of efficient capital markets and investor protection; and to consider what is material and relevant to market participants. Proportionate regulation should be viewed as scaled or focused to a type of issuer, rather than the introduction of less rigorous standards. Investors must understand the difference between market risk, i.e. that although the junior issuer had complied with all regulatory requirements, the business may fail because the resource or technology cannot be developed, and regulatory risk, in terms of whether or not the tools chosen for proportionate regulation minimize the risk of issuer misconduct or shirking.

A key decision is the determination of any threshold. As discussed earlier, the type of issuer (junior or venture) and the size of issuer (by market cap or consolidated revenue) offer different kinds of thresholds. While there may be limited circumstances in which more than one threshold is used, there is a risk of fragmentation where small issuers could fall in different categories for different purposes, adding to cost and confusion. In cases where it is critically important that there be a different threshold, there should be transparency and certainty regarding the threshold and a solid rationale for creating a different bright line. However, there could be instances where there is a single standard, but the resulting practice, such as DC&P or ICFR, are scaled to the size and type of issuer.

Another determination is where securities regulation could benefit from consideration of proportionate regulation in new areas. The exempt market, takeover bid regulation, and continuous disclosure requirements could all be candidates for change. Under a principles/standards/outcomes-based regulatory model, one would have to develop the high level principles first and then allow the development of best practices, which in turn would likely generate a fresh look at proportionate regulation in areas such as officer certification, corporate governance and offering documents. Regulators could examine these areas in considering any guidance they were to issue under a principles/standards/outcomes-based system.

A number of overriding principles or considerations can be drawn from the above discussion, which should be considered in respect of a further move towards proportionate regulation. They include:

- Proportionate regulation must balance access to capital and the long term sustainability of the market; a key objective is maintaining the integrity of Canadian capital markets.

- The benchmark of the regulatory system continues to be materiality, in that while periodic disclosure or other compliance requirements may be proportionate, all issuers must continue to ensure that material change is disclosed to the market in a timely, accurate and comprehensible manner, a requirement that should not be scaled.[199]

- Decision making in respect of adopting further proportionate regulation should be timely, transparent and relevant for market participants and should be implemented only after broad consultation. A possible methodology is to identify a problem or difficulty that may justify a proportionate response and then work with market participants to scale the requirement appropriately, using one or more of the tools cited above or other problem solving strategies.

- There is a need for transparency and bright line delineation in respect of which issuers fall in which category of proportionate regulatory requirements.

- Investors must have a clear understanding of the risk associated with issuers that comply with modified disclosure and governance requirements, including explanatory notes on periodic reporting documents and prospectuses, public education and plain language disclosure.

- If the delineation is venture/non-venture, smaller issuers on the TSX and comparable exchanges must be given guidance regarding compliance with the more extensive requirements.

- If the delineation is market capitalization, at either end of the market size, there is a need for well-founded and transparent criteria on which to make of determination of which category issuers are located.

- Disclosed risk factors should be focused for all issuers, not overly generalized.

- Any proportionate regulation must be accompanied by consistent and rigorous compliance and enforcement, to ensure integrity of the market.

[199] Beyond the scope of this paper is the important issue of whether a more helpful standard would be material information as opposed to material change.

- Proportionate regulation can be used to reduce disproportionate compliance costs by eliminating regulatory compliance requirements where they do not add value to the integrity of the market.

- Any proportionate regulation should recognize the extensive oversight of junior issuers by the TSXV.

- Any proportionate regulation must ensure that the costs of compliance associated with any new requirements do not outweigh the benefits to market participants.

- Under a shift to a principles/standards/outcomes based system, all market participants must have a shared understanding of regulatory expectations, specifically, what broad high level principles mean in practice.

    - Develop high level principles that are universal and allow junior issuers to develop best practices sensitive to their structure and needs.
    - The flexibility of principles/standards/outcomes regulation should be used to focus requirements on junior issuers, rather than create opaque expectations.
    - There should be recognition that there is a continuum of principles/standards and outcomes based regulation, and that any further shifts should occur after measured consideration of benefits to the market, involving broad based and meaningful consultation.
    - Any evolution from existing standards should be measured, in terms of assessing what outcomes a shift from current rules to principles or outcomes is aimed at achieving and measuring the effectiveness of any shifts.
    - Regulators assessing good governance practice should share that experience with other market participants, increasing the overall knowledge base of good practice.
    - Resources need to be directed towards junior issuers in terms of supporting any shift to principles/standards/outcomes-based regulation and transparent and accessible guidance on best practice, so that junior issuers can develop the capacity to meet practice compliance under any adopted principles.
    - Resources are needed to allow junior issuers to participate in a meaningful way with regulators in developing future policy or practice.
    - Set appropriate strategic milestones for junior or small issuers.

- Consultation regarding any shift to proportionate regulation and principles/standards/outcomes-based regulation should be broad, including all market participants, advocacy organizations and exchanges.

- Any further move towards proportionate regulation should engage market participants in consideration of regulatory standards and how they differentially impact market participants.

- There should be wide-spread public education regarding the different risks associated with issuers that are proportionately regulated.

- Evaluation of proportionate regulation, under whatever type of system is adopted, should measure outcomes against clearly articulated goals, including assessing clear milestones, measure the culture of compliance, cost effectiveness, ease of implementation, reduction of investor and market risk, and benefits to market participants.

    - Regulators need to develop tools for assessing compliance if a principles/standards and outcomes based approach is adopted.

8. Conclusion

Particular features of Canada's capital market inform our consideration of moving towards a more proportionate regulatory system, specifically, Canada has a large number of small public companies; its market cap is concentrated largely in four provinces; it has a particular focus on mining, resources and technology; and a significant number of issuers are cross-listed on US exchanges. Any further move towards proportionate regulation must take account of these unique features.

A proportionate regulatory system could adopt broad high level principles, similar to the FSA, as the backdrop for proportionate regulation. These principles could include that an issuer must act with integrity and conduct its business with due skill, care and diligence; it must take reasonable care to control its affairs responsibly, using size-appropriate risk management systems; it must observe proper standards of market conduct and have regard to the interests of its investors, creditors and customers and treat them fairly; it must disclose material information in a timely, accurate and accessible manner; and it must deal with its regulators in an open co-operative manner.

Canadian securities regulators have already recognized some measure of proportionate regulation in their national instruments based on the type of listing, and the process of building consensus allows for further development of proportionate regulation in a manner that is responsive to regional differences and to the unique size of Canadian issuers, the particular sectors, and the earlier periods in which junior issuers come to public markets.

The venture/non-venture distinction for proportionate regulation appears to be the most convenient delineation in Canada, given the high degree of concentration of Canadian listings on the TSX and TSXV. However, a proportionate system could analyse whether there are instances in which market capitalization for junior issuers may be a more appropriate criterion for an exemption from particular regulatory requirements. A market capitalization approach may meet fairness considerations in terms of treating similarly sized issuers the same, but as the discussion of the SEC Advisory Committee on Smaller Public Companies' criteria suggests, using a number of determinants to define a "smaller public company" such as the total market capitalization of the company and a measurement metric that is self-calibrating and facilitates the scaling of regulation, may create considerable transaction costs. If implemented, it will require clear and firm transition rules; and clear rules as to the appropriate valuation date and the appropriate valuing of market capitalization. What the above noted principles suggest is that there are multiple ways in which junior or small issuers can be accommodated through scaled requirements, and there may be instances in which more than one delineation is used.

Canada could possibly benefit from the introduction of a system similar to the NOMAD system in the UK, although there would have to be consideration of the cost consequences to junior issuers, given their size in Canada. There would also need to be an assessment of the risks associated with moving this aspect of the regulatory system into the private sphere. Given that Canadian issuers go to the market earlier in their development, any consideration of such a system would have to measure the risks and benefits that are unique to the size and structure of the Canadian market. Moreover, the slow but steady increase in foreign issuers listed in Canada may raise new questions about accepted levels of internal governance controls and compliance norms that should be carefully considered.

The paper canvasses how proportionate regulation can operate under different regulatory structures. Clearly, it is being introduced within the passport system in an innovative and thoughtful manner, as discussed at length in part 5. A move towards a more principles and outcomes based system would offer opportunities for further development of proportionate regulation under any regulatory structure adopted. In terms of proportionate regulation under a hybrid securities law structure, a common regulator could continue to develop proportionate regulation on a national basis, in a timely fashion, having regard for regional needs and input as discussed above.[200] While national buy-in of all jurisdictions would be the goal of any new regulatory principles or standards for junior or seasoned issuers, all issuers would have the potential to immediately opt into a proportionate regulation system by registering with the common regulator. In essence, there would be a market for registration, as issuers could list with the common regulator or with a passport provincial jurisdiction.

Ultimately, the best approach to further developing proportionate regulation is one that offers a transparent public debate on both its advantages and disadvantages. That debate needs to take place in the context of a move towards greater principles and outcomes-based approaches and within the context of a regulatory framework that is more efficient and effective at regulating Canadian capital markets.

[200] Under such a system, provincial or territorial regulators could opt to authorize the common regulator to undertake all regulation and oversight in their jurisdiction, thus becoming part of a national regulatory system, or could opt to carry on as a regulator under the passport system.

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