6 The Canadian junior IPO market and the Capital Pool Company program

J. Ari Pandes and Michael J. Robinson

1 INTRODUCTION

Entrepreneurial firms are an important engine of growth in most developed economies, and fostering the development of smaller growth firms is an important economic objective. To develop their businesses, entrepreneurs need access to capital, and the debt market is often difficult to access since young firms lack the cash flows and collateral required by lenders. Thus, until a firm has grown to a certain size the entrepreneur must rely on equity capital, which is also difficult to attract due to the high costs of information asymmetry and the agency costs that exist between the entrepreneurs, management, and investors. A substantial body of academic research documents the important role that venture capital (VC) and private equity (PE) investors play in financing entrepreneurial firms.[1] Since these formal investors are specialized investors, they can alleviate the information gaps and costs that are prevalent in the private market. Specifically, VC and PE investors use their expertise to screen, advise, and monitor the entrepreneurial firms. However, only a small fraction of firms can attract VC and PE financing, and some firms might be averse to the strict oversight that accompanies such investment. Angel investors are another source of financing for entrepreneurial firms, but the amount of investment available from an angel investor tends to be lower than from a VC or PE investor in part because it is more difficult for an angel investor to alleviate the costs of information asymmetry and other agency issues.

To expand the pool of equity capital for entrepreneurial firms, many countries have created specialized stock markets that are devoted mainly to the financing of smaller growth companies. These junior, second-tier, stock exchanges apply less stringent listing rules and often do not require firms to demonstrate profitability. However, many of the companies listed on these exchanges are not early stage, and many are venture backed when they go public. Vismara et al. (2012) provide insight into Europe's second-tier markets, which focus on small company listings. Specifically, the authors examine the stock exchanges of the four largest European economics (Germany, France, Italy, and the UK) and note that these exchanges have launched 11 second-tier markets since 1995. Remarkably, only five currently exist. Moreover, the NASDAQ also set up a European market in the late 1990s, which ultimately failed to attract many listings. The recent high failure rate of junior equity markets in Europe suggests that they are prone to fail, for a number of reasons identified in earlier work by MacIntosh (1994) and Rasch (1994). Interestingly, however, Canada has a thriving public venture market that is one of the oldest and largest in the world. For over 100 years, the Toronto Stock Exchange's Venture Market (TSX-V) – the junior exchange of the senior Toronto Stock Exchange (TSX) – and its predecessor exchanges have facilitated the growth of early-stage com-

panies by providing access to capital that is relatively liquid, while also offering institutional and retail investors a well-regulated market for making venture investments that have traditionally been exclusive to specialized VC or PE firms.

A particularly unique feature of the TSX-V is the Capital Pool Company (CPC) program, which is essentially a reverse merger listing vehicle for small-cap companies. The program marries experienced investors (with public markets experience) with private companies seeking capital by dividing the traditional IPO process in two: the creation of the CPC public vehicle shell and the qualifying transaction (QT), that is, the reverse merger or vending of the operating business into the CPC shell. From its inception as a regional development program in the province of Alberta in 1986, the CPC program has expanded across Canada and in recent years has increasingly attracted international listings. A notable example is the US firm ePals Corporation, an education technology and safe learning network firm with a savvy management team and strategic partnerships with leading US firms including Microsoft and IBM, which used the CPC program to go public in the summer of 2011. The CPC program is similar in concept to the US blind-pool programs that experienced a high degree of fraud in the 1980s. However, unlike in the US, the regulations and governance controls adopted in Canada mitigated much of the agency costs and fraud associated with this type of program. Indeed, the US has now adopted many of the features of the Canadian CPC program in what are now known as special purpose acquisition corporations (SPACs). A fundamental difference, however, between the US SPACs and the Canadian CPCs is that the latter is typically used by earlier stage companies in Canada on the TSX-V, whereas SPACs are used by later stage and larger companies listed on the senior US exchanges.

Since its inception in 1986 until 2010, 2090 CPCs[2] have been listed on the TSX-V with over 90 percent completing their QT, and 300 graduating to a more senior exchange – primarily the TSX. The growth of the Canadian CPC program is remarkable in light of the fact that the US blind pool market essentially disappeared following the adoption of strict regulations by the US Securities Exchange Commission (SEC), which passed the Securities Enforcement Remedies and Penny Stock Reform Act on 20 July, 1990.

This chapter describes the Canadian junior market (that is, the TSX-V) and how it has helped emerging private companies finance their growth opportunities through a going-public transaction. We present summary statistics for all TSX-V initial public offerings (IPOs) and show that the number of junior market IPOs in Canada is substantially larger than the number of IPOs in other comparable markets internationally, although the average IPO size is significantly smaller on the TSX-V compared to other international junior markets. We further show that large investment banks from the senior TSX exchange league tables are active participants in the junior market, which helps reduce the information and agency costs that are generally associated with early-stage companies. In addition, to highlight the unique characteristics of the CPC program, and also because CPC firms comprise the majority of all TSX-V IPOs, we examine this program in more detail. In particular, we show that CPC firms exhibit no more fraud than firms in other comparable markets, and that the majority of CPCs grow to become successful public firms. The objective of this chapter is not to provide a rigorous empirical analysis, but instead to provide a more descriptive summary of the Canadian junior IPO market and to highlight the size, scope, and longevity of the market.

2 THE CANADIAN JUNIOR MARKET

2.1 A Brief Background

The junior equity market in Canada has a rich history built on the success of regional stock exchanges that had specific expertise. The three main regional exchanges were the Alberta Stock Exchange (ASE), the Vancouver Stock Exchange (VSE), and the Winnipeg Stock Exchange (WSE), all of which began operations in the early twentieth century.[3] In 1999, the Canadian Venture Exchange (CDNX) was created by the merger of the Vancouver Stock Exchange and the Alberta Stock Exchange. The focus of the CDNX was junior companies, often resource and mining exploration companies, but also technology ventures. The Winnipeg Stock Exchange and the small-cap portion of the equities market of the Montreal Stock Exchange (MSE) were also later merged into the CDNX. In 2001, the Toronto Stock Exchange – specifically, the TSX Group – purchased the CDNX and renamed it as the TSX Venture Exchange (TSX-V). Thus, today the TSX is the senior Canadian equity market, while the TSX-V is a public venture capital marketplace for emerging companies.

An important difference between the TSX-V and the second markets in Europe, such as the Alternative Investment Market (AIM), Alternext by Euronext, the Freiverkehr in Germany, and the Mercato Alternativo dei Capitali (MAC) in Italy, are the different approaches to regulation.[4] The second markets in Europe are exchange regulated, meaning that specific requirements do not have to be met by companies seeking admission. More specifically, admission to the junior exchange requires that the company seeking admission appoints a Nominated Advisor (or Nomad) and a broker. The role of the Nomad is to assess whether the company is suitable for the market, and thus admission to an exchange ultimately rests on the analysis made by the Nomad. In contrast, Canadian stock exchanges, including the TSX-V, are regulated by the provincial securities regulator(s) (equivalent of the US Securities and Exchange Commission). Therefore, detailed requirements on market capitalization, public float, capital structure, and governance, must be met by companies seeking a listing. In addition to admission requirements, the TSX-V imposes stricter ongoing filing requirements compared to their European counterparts. This is perhaps why most of the IPOs on the exchange-regulated markets in Europe are offered exclusively to institutional investors, equivalent to private placements, as noted by Vismara et al. (2012). In contrast, retail investors regularly participate in junior IPOs and follow-on offerings in Canada.

2.2 Capital Pool Company Program

As discussed above, the majority of TSX-V IPOs are CPCs and so it is worthwhile examining this program in more detail. On the surface, the CPC program of the TSX-V[5] is similar to US blind-pool programs that were subject to a number of frauds during the 1980s. The program allows a newly created private company, which has no assets other than cash and no commercial operations, to conduct an initial public offering in order to raise start-up capital and list its securities for trading on the TSX-V. Once the initial public offering is completed, the CPC then has 24 months to identify and acquire a business or pool of assets using the funds raised from the distribution of its seed shares

and from the IPO. The acquisition is called a 'qualifying transaction', and the exchange requires that following the QT, the resulting issuer must meet the TSX-V's applicable minimum listing requirements.

The CPC program had its genesis in a blind-pool program on the Alberta Stock Exchange (ASE) in 1986, at a time when falling energy prices had caused traditional financing to dry up for the junior energy firms, which formed an important part of the province's economic base. Between April and July of that year a small regional investment dealer took seven firms public as blind pools. Unfortunately, the principals of the second such firm, Audit Resources Inc., engaged in fraudulent trading practices that increased the firm's share price from $0.05 to $8.00 over a few months before regulators intervened and the fraud was discovered. Not only did investors lose money, but employees of the investment dealer got caught up in the fraudulent dealings and the investment dealer was permanently shut down later that year. By the time these problems with the program became apparent to the securities regulator, the Alberta Securities Commission (ASC), a further 14 blind pools had gone public. As will be shown below, almost 20 percent of these early Canadian blind pools were investigated for fraud during the first eight months of the program's existence and in half of the cases the firm's principals were found guilty of fraudulent behavior. In addition, only seven of the 21 (33.3 percent) blind pools turned into successful firms.

As a result of these early problems, the ASC placed a moratorium on new blind-pool stock offerings in October 1986 until the program could be reviewed. In November 1986, after a series of public hearings, the moratorium on blind pools was lifted, and a new set of regulations governing this form of financing were imposed. Importantly, the ASC and ASE borrowed VC control mechanisms to ensure the protection of outside investors' capital, and to provide the founders with a strong incentive to create value in the firm for all shareholders. The main governance mechanisms include: (1) escrow provisions for the firm's founders, which removes the incentive for short-term share price manipulation and early founder exit; (2) limits on the use of the firm's capital by the founders to prevent the misuse of corporate resources; (3) a veto provided to the outside shareholders over the use of proceeds to prevent investment in negative net present value (NPV) projects; and (4) a requirement to initiate a QT within a predefined time period to prevent shirking. Other regulations – some based on the VC diversification model – were designed to enhance secondary market liquidity. For example, each CPC is required to have a minimum of 200 arm's length shareholders, each of whom must purchase at least 1000 shares, and no one purchaser can buy more than 2 percent of the IPO shares. Finally, it was not a requirement of the regulations, but many underwriters provide secondary market support to a new CPC issue to enhance its trading liquidity for a short period following its IPO.

One key aspect of the long-term success of the CPC program has been the careful ongoing monitoring of the program's effectiveness and timely modifications to the regulations by the regulators and the stock exchange. For example, as the program was adopted by different jurisdictions across the country,[6] the maximum amount of post-IPO capital (that is, the sum of the seed and IPO capital) has been increased several times. From an initial value of $0.5 million, it was raised to $0.7 million on 1 March 2000, to $2.0 million on 15 January 2003, and to $5.0 million on 14 June 2010. As larger deals may take longer to complete, the CPC program increased the maximum time to complete

a QT from 18 months to 24 months on 13 April 2005. Finally, to further increase the incentive of firm founders to complete a QT, the rule changes on 1 March 2000 required that all escrowed seed shares be cancelled if the firm was delisted before completing its QT.

3 DATA AND DESCRIPTIVE STATISTICS

Data on TSX-V IPOs are collected from the Financial Post (FP) Infomart database for the period 1 January 1993 to 31 December 2010. The FP database includes detailed offer characteristics, such as the offer price, the size of the offering, the book-runners in the offering, and the industry Standard Industrial Classification (SIC) code. In Table 6.1 we provide a yearly breakdown of the number of IPO offerings and IPO proceeds. We present the statistics for all IPOs, regular TSX-V IPOs, and for CPC IPOs. While there is variation in the number of offerings through time, with marked drops during the 1993

Table 6.1 Yearly number of IPOs and aggregate proceeds on the TSX Venture Exchange

	Total		Regular IPO		CPC IPO	
	N	Proceeds (MM$)	N	Proceeds (MM$)	N	Proceeds (MM$)
1993	110	152.09	54	141.14	56	10.95
1994	166	102.25	67	78.56	99	23.69
1995	152	128.24	61	105.85	91	22.38
1996	170	436.77	72	412.28	98	24.49
1997	264	219.77	119	183.18	145	36.60
1998	184	124.41	61	93.73	123	30.69
1999	142	111.71	43	83.78	99	27.93
2000	167	139.45	38	100.32	129	39.13
2001	124	83.08	19	47.26	105	35.82
2002	63	35.02	19	18.23	44	16.79
2003	52	72.64	23	55.31	29	17.33
2004	110	140.06	23	64.35	87	75.72
2005	123	150.07	38	93.26	85	56.81
2006	152	232.08	50	176.63	102	55.45
2007	239	436.15	58	350.51	181	85.64
2008	194	185.06	42	125.80	152	59.26
2009	74	77.64	22	58.41	52	19.23
2010	143	273.96	45	231.13	98	42.83
Total	2629	3100.46	854	2419.71	1775	680.75

Notes:
This table presents the yearly number of IPOs, which comprise regular IPOs and CPC IPOs, and the yearly aggregate proceeds from the IPOs on the TSX Venture Exchange (TSX-V) during the sample period, 1993–2010.
The data are collected from the Financial Post (FP) Infomart database.
N is the number of IPOs and Proceeds (MM$) is the aggregate IPO gross proceeds in millions of Canadian dollars.

Table 6.2 TSX Venture IPOs compared to European second market IPOs

	TSX-V	Reproduced from Vismara et al. (2012)			
		Paris B./Euronext	Deutsche Borse	Borsa Italiana	London
Panel A: Number of IPOs					
1995–97	586	121	22	1	175
1998–2000	493	324	328	37	274
2001–03	239	87	20	5	218
2004–06	385	102	49	15	786
2007–09	507	91	42	24	189
1995–2009	2210	725	461	82	1642
Panel B: Mean (median) IPO proceeds					
Commission-reg	1.16 (0.35)				
Seasoning		20.41 (11.14)	58.77 (32.79)	44.85 (27.84)	
New		29.08 (17.17)	99.44 (58.15)	169.66 (66.81)	
Exchange-reg		48.10 (2.32)	22.89 (15.47)	13.61 (13.15)	22.58 (10.67)

Notes:
This table compares the number of IPOs and the mean and median IPO proceeds on the TSX Venture Exchange (TSX-V) to the corresponding statistics reproduced from Vismara et al. (2012).
Panel A presents the number of IPOs for select time periods as in Vismara et al. (2012), and Panel B presents the mean (median) IPO proceeds for the different types of junior markets as defined in Vismara et al. (2012) for the period 1995–2009.
'Commission-reg' refers to a market that is regulated by the securities commission, which refers to the TSX-V in our sample.
'Seasoning' refers to the sequential segmentation model as defined in Vismara et al. (2012), for which small companies are expected to go public on a second-tier 'seasoning' market and, if the company is successful, move to the main market.
'New' refers to the sectorial exchange that only allowed admission to companies in the high-technology sector.
'Exchange-reg' refers to an exchange-regulated market as defined in Vismara et al. (2012), of which London's Alternative Investment Market is most commonly associated with.
In an exchange regulated market, the national listing authorities (equivalent to the US Securities and Exchange Commission) does not regulate the market.
The IPO proceeds from Vismara et al. (2012) are converted from euros to Canadian dollars at the average exchange rate in the respective year.

economic downturn and the post-Internet bubble downturn, 2002–04, the number of junior market IPOs has shown significant activity. Over the entire 1993–2010 sample period, there have been 2629 IPOs on the TSX-V, raising a total of $3.10 billion in proceeds. The sample comprises 854 regular IPOs and 1775 CPC IPOs, indicating the popularity of the CPC program in the Canadian junior market. The aggregate proceeds raised from regular IPOs during the sample period is $2.42 billion, while the aggregate proceeds raised from CPC IPOs is a substantially lower $680.75 million. This is consistent with the regulatory restrictions on the amount of proceeds raised in CPC IPOs, which as noted above has increased over time.

Table 6.2 compares the TSX-V with the second markets in Europe. To draw the comparison, we reproduce the statistics on the number of IPOs from Table 6.2 in Vismara et al. (2012) and the statistics on IPO proceeds from Table 6.3 in Vismara et al. (2012). To be consistent with Vismara et al. (2012), we have included – from their tables – statistics

Table 6.3 Industry distribution of the frequency and aggregate proceeds of TSX Venture Exchange IPOs

Industry	N	Proceeds (MM$)
Agriculture	1	0.45
Food products	3	3.23
Candy and soda	3	3.77
Beer and liquor	4	19.55
Tobacco products	–	–
Recreation	6	9.86
Entertainment	11	40.52
Printing and publishing	1	0.68
Consumer goods	3	4.01
Apparel	3	40.18
Healthcare	2	3.00
Medical equipment	11	28.00
Pharmaceutical products	28	134.33
Chemicals	3	5.79
Rubber and plastic products	3	3.59
Textiles	1	0.25
Construction materials	5	21.29
Construction	6	9.35
Steel works	2	5.38
Fabricated products	–	–
Machinery	11	18.12
Electrical equipment	1	35.00
Automobiles and trucks	2	2.02
Aircraft	1	0.90
Shipbuilding and railroad equipment	–	–
Defense	–	–
Precious metals	9	279.14
Non-metallic and industrial metal mining	413	797.82
Coal	–	–
Petroleum and natural gas	105	452.57
Utilities	4	12.43
Communication	10	35.04
Personal services	6	6.84
Business services	31	79.54
Computer hardware	7	11.33
Computer software	64	157.46
Electronic equipment	17	37.93
Measuring and control equipment	15	37.63
Business supplies	–	–
Shipping containers	–	–
Transportation	7	11.43
Wholesale	16	37.65
Retail	7	13.70
Restaurants, hotels and motels	–	–
Banking	3	3.50

Table 6.3 (continued)

Industry	N	Proceeds (MM$)
Insurance	3	8.44
Real estate	2	0.75
Trading	10	18.44
Other	14	28.82

Notes:
This table presents an industry distribution of TSX Venture Exchange (TSX-V) regular IPOs, that is, it does not include CPC IPOs.
Industry definitions are available on Professor Kenneth French's website.
N is the number of IPOs and Proceeds (MM$) is the aggregate IPO gross proceeds in millions of Canadian dollars.

on the different segmentation models that have existed in Europe over their sample period (1995–2009). In Table 6.2 we also restrict our sample period to 1995–2009, which is the same sample period used by Vismara et al. (2012), and we also convert their statistics on proceeds from euros to Canadian dollars. Panel A presents the number of IPOs and Panel B presents the mean (median) IPO proceeds.

The results in Table 6.2 are quite striking; Panel A shows that the number of IPOs on the TSX-V outnumber the number of IPOs in each of the four European countries examined by Vismara et al. (2012). Over the 1995–2009 period, TSX-V IPOs outnumber the Paris B/Euronext IPOs by 3.05×, the Deutsche Borse by 4.79×, the Borsa Italiana by 26.95×, and the London AIM by 1.35×. The results in Panel B are also telling; the mean proceeds for an IPO on the TSX-V is $1.16 million, and the median proceeds is $0.35 million. Of course, this includes both regular IPOs and CPC IPOs. While not reported in Table 6.2, we find the mean (median) proceeds for regular IPOs is $2.86 million ($1.13 million) and the mean (median) proceeds for CPC IPOs is $0.40 million ($0.30 million). Nevertheless, these values are significantly lower than the mean and median proceeds on each of the European second markets. In particular, the mean IPO proceeds on the Paris B/Euronext ranges from $20.41 million to $48.10 million depending on whether the market is seasoning, new, or exchange regulated. The median IPO proceeds ranges from $2.32 million to 11.14 million, depending on the market. For the Deutsche Borse, the mean IPO proceeds ranges from $22.89 million to $58.77 million and the median proceeds ranges from $15.47 million to $32.79 million, depending on the market. The Borsa Italiana also exhibits higher mean and median IPO proceeds compared to the TSX-V, with the mean proceeds ranging from $13.61 million to $44.85 million and the median proceeds ranging from $13.15 million to $27.84 million, depending on the market. Finally, the mean IPO proceeds on the London AIM market is $22.58 million and the median IPO proceeds is $10.67 million. Therefore, the Panel B results suggest that the TSX-V attracts companies that are much earlier in their development stage, which is consistent with a public venture market. In contrast, the European second markets appear to be tailored more for later stage companies, and as pointed out by Vismara et al. (2012), many of the companies listed on the European junior markets are venture-backed, which is not the case for TSX-V IPOs. Interestingly, many of the companies on the European second markets resemble the small-cap stocks on the senior TSX Exchange.

In Table 6.3 we provide an industry breakdown of the frequency and aggregate proceeds of TSX-V regular IPOs.[7] The industry of CPCs is only known at the time of the QT, and thus we do not know the industry of a CPC at the IPO.[8] Not surprisingly, given the mining and resource focus of the Canadian economy, 413 of the 854 IPOs (about 48.36 percent) are in the non-metallic and industrial metal mining industry. The second largest industry is the petroleum and natural gas sector, with 105 IPOs (about 12.30 percent). However, the junior market does not only attract mining and resource companies. In particular, the third, fourth and fifth most frequent IPOs are in the computer software, business services, and pharmaceutical products industries, respectively. We find a similar pattern in terms of proceeds, which are quite substantial in dollar terms. During our sample period (1993–2010), the non-metallic and industrial metal mining sector raised a non-trivial $797.82 million on the junior exchange. Interestingly, while the precious metals sector only had nine IPOs during the sample period, the proceeds are $279.14 million. Furthermore, the petroleum and natural gas sector raised $452.57 million, while the computer software sector raised $157.46 million.

One of the main challenges facing the success of a public venture market is attracting large and reputable underwriters to participate in junior equity issues, which is especially important since information and agency costs are so severe in this market. For example, several papers show that prestigious underwriters avoid the smaller and riskier new issues (for example, Beatty and Welch, 1996; Chemmanur and Fulghieri, 1994; Wolfe et al. 1994; Carter and Manaster, 1990) for several reasons. First, underwriters have reputational concerns, since they earn a return on built-up reputational capital. Second, the underwriting commission is typically a function of the issue size and larger underwriting firms are incentivized to participate in only the larger IPOs. Finally, as Rasch (1994) further notes, the low stock turnover of the smaller firms makes it unprofitable for brokerage firms to research these companies, since the costs associated with collecting and processing a firm's information is not recovered by brokerage commissions. Therefore, attracting high-quality underwriters is important to the success of a junior equity market.

In Table 6.4 we examine the underwriters participating in TSX-V IPOs. We assume that underwriters that are book-runners in the equity offerings of companies listed on the senior TSX exchange are larger and more reputable. Thus, we determine the underwriter rank from the league tables of underwriters participating in equity offerings on the senior TSX market. In Panel A we examine the number of IPOs underwritten by the 'Top 10' underwriters, the 'Top 20' underwriters, by underwriters appearing on the league tables ('On league'), and underwriters that do not appear on the league tables ('Off league'). In Panels B and C we examine the same categories but our variables of interest are the mean (median) IPO proceeds and mean (median) underwriter commission, respectively.

Focusing on Panel A, we find that 88, or 10.30 percent, of the regular IPOs are underwritten by investment banks that are among the ten largest on the senior TSX exchange, implying that there are some large underwriters from the TSX that are underwriting IPOs on the junior market. When we broaden the underwriter rank definition, we find that this number increases, where 287, or 33.61 percent, of the regular IPOs are underwritten by the largest 20 investment banks from the TSX league tables. We further find that 524, or 61.36 percent – well over half – of the regular IPOs are underwritten by an investment bank that at least appears on the league tables from the senior TSX market. Interestingly, when we turn to the CPC IPOs, which are perhaps the riskiest and certainly

Table 6.4 Underwriter characteristics of TSX Venture Exchange IPOs

	Regular IPOs	CPC IPOs
Panel A: Number (percent) of IPOs		
Top 10	88 (10.30)	182 (10.25)
Top 20	287 (33.61)	682 (38.42)
On league table	524 (61.36)	1241 (69.92)
Off league table	330 (38.64)	534 (30.08)
Total	854	1775
Panel B: Mean (median) proceeds ($MM)		
Top 10	5.59 (2.00)	0.52 (0.40)
Top 20	3.74 (1.28)	0.41 (0.30)
On league table	3.72 (1.26)	0.39 (0.30)
Off league table	1.43 (0.96)	0.37 (0.30)
Total	2.83 (1.07)	0.38 (0.30)
Panel C: Mean (median) commission (percent)		
Top 10	7.70 (8.00)	9.71 (10.00)
Top 20	8.55 (8.00)	9.81 (10.00)
On league table	8.59 (8.00)	9.83 (10.00)
Off league table	9.36 (10.00)	9.84 (10.00)
Total	8.88 (8.65)	9.84 (10.00)

Notes:
This table presents the number (percent) of IPOs in Panel A, the mean (median) IPO gross proceeds in Panel B, and the mean (median) underwriter commission in Panel C for regular IPOs and CPC IPOs for various underwriter rank classifications and for the full sample.
'Top 10' refers to the top ten underwriters from the TSX league tables of equity offerings.
'Top 20' refers to the top 20 underwriters from the TSX league tables of equity offerings.
'On league table' refers to an underwriter that appears on the TSX league tables of equity offerings.
'Off league table' refers to an underwriter that does not appear on the TSX league tables of equity offerings.
'Total' refers to the full sample.

the smallest IPOs, participation from the more reputable underwriters is just as high or even slightly greater than for the regular TSX-V IPOs. In particular, 182, or 10.25 percent of the CPC IPOs are taken public by an underwriter that ranks in the top ten from the TSX league tables; 682, or 38.42 percent of the CPC IPOs are taken public by an underwriter that ranks in the top 20 from the TSX league tables; and 1241, or 69.92 percent of the CPC IPOs are taken public by an underwriter that ranks on the TSX league tables. The strong participation by these large underwriters and the governance controls put in place by the regulators on blind pools are likely why the CPC program has exhibited such phenomenal growth over its 25-year history.

In Panel B we examine the mean and median proceeds for regular and CPC IPOs by underwriter type. Given the incentive structure for underwriting firms (that is, the dollar fee is a function of offer size), we would expect larger and more reputable underwriters to be associated with larger IPOs. Indeed, in Panel B we find that the mean and median proceeds are larger for underwriters that rank higher on the league tables for both regular IPOs and CPC IPOs. For regular IPOs, the mean and median proceeds for an IPO taken public by a 'Top 10' underwriter are $5.59 million and $2.00 million, respectively. For a 'Top 20' underwriter, the mean and median proceeds are $3.74 million and

$1.28 million, respectively. For an underwriter that appears on the TSX league tables, the mean proceeds is $3.72 million and the median proceeds is $1.26 million, while for an underwriter that does not appear on the TSX league tables, the mean (median) proceeds is substantially lower at $1.43 million ($0.96 million). Turning to the CPC IPOs, we find a very similar pattern. For a CPC IPO taken public by a 'Top 10' underwriter the mean and median proceeds are $0.52 million and $0.40 million, respectively; and for a CPC IPO taken public by a 'Top 20' underwriter the mean and median proceeds are $0.41 million and $0.30 million, respectively. More generally, for a CPC IPO taken public by an underwriter that appears on the TSX league tables, we find the mean proceeds to be $0.39 million and the median proceeds to be $0.30 million; and for a CPC IPO that is taken public by an underwriter that does not appear on the TSX league tables, the mean (median) proceeds is $0.37 million ($0.30 million), which is again consistent with the idea that larger and more reputable underwriters are associated with larger IPOs.

In Panel C we examine the commission (as a percentage of proceeds) charged by underwriters for TSX-V regular IPOs and CPC IPOs by underwriter type. For both the regular IPOs and the CPC IPOs, we find that the larger underwriters charge a lower commission than smaller underwriters. Focusing on the regular IPOs, we find that 'Top 10' underwriters charge an average commission of 7.70 percent and a median commission of 8.00 percent. For the 'Top 20' underwriters the mean commission of 8.55 percent is higher and the median commission of 8.00 percent is the same as for the 'Top 10' underwriters. Moreover, for an underwriter that appears on the TSX league tables, the mean and median commissions are 8.59 percent and 8.00 percent respectively, while for an underwriter that does not appear on the TSX league tables, the mean and median commissions are 9.36 percent and 10.00 percent, respectively. These findings suggest that more reputable underwriters tend to charger lower fees, which could be due to the fact that more reputable underwriters are associated with larger IPOs and hence there is an economies of scale effect. Alternatively, this could be due to the fact that more reputable underwriters take less risky firms public. We find the mean and median commissions to be higher for CPC IPOs compared to regular IPOs. Specifically, the 'Top 10' underwriters charge a mean commission of 9.71 percent and a median commission of 10.00 percent, respectively, and the 'Top 20' underwriters charge a mean commission of 9.81 percent and a median commission of 10.00 percent, respectively. For an underwriter that appears on the TSX league tables, the mean (median) commission is 9.83 percent (10.00 percent) and for an underwriter that is not on the TSX league tables, the mean commission is 9.84 percent and the median commission is 10.00 percent. The higher commission for CPC IPOs is consistent with an economies of scale effect, since CPC IPOs are generally smaller. The higher commission can also be due to the greater risk associated with CPC IPOs, since they are public shells with no operating history.

4 AN EXAMINATION OF THE CPC PROGRAM

As discussed above, the CPC program began in 1986, and since this program is so unique for a regulated stock market, and because it has been in existence for over 25 years, we have gathered detailed data for all blind pools prior to the program's inception, and

for CPC firms that were listed on the ASE and its successor exchanges (the CDNX and TSX-V) since the program's inception. Therefore, the sample period in this section is from 18 April 1986 to 31 December 2010, which includes 21 blind pools before the CPC program's inception and 2,090 CPCs since the program's inception.

The CPC program actually developed as a regulatory response to a series of frauds in the then less-regulated blind-pool program between April and October of 1986, and so we first examine the effectiveness of the CPC regulations in reducing fraud in this market. Fraud can manifest itself in a number of different ways, including disseminating false financial or other information, otherwise manipulating the firm's stock price, or misusing corporate funds. The first two types of acts are criminal that are also subject to regulatory review, while the latter is likely more regulatory in nature. To determine which blind pools and CPC firms in our sample were the subject of a criminal investigation, we checked each firm against the Canadian Legal Information Institute (CanLII) database. This data source is maintained by the Federation of Law Societies of Canada and reflects any criminal investigations and/or convictions within Canada. Any regulatory investigations and/or sanctions were found in the provincial database for the jurisdiction in which the firm was registered and for the province in which it was listed. Finally, we also conducted a Factiva search of the overall Canadian blind-pool program. We restrict our analysis to the first five years following the listing of a firm as this is the critical period in the development of a blind-pool. The results on fraud are presented in Table 6.5.

Each row in Table 6.5 represents the percentage of total firms investigated and/or found guilty of fraudulent behavior within a given time period.[9] Specifically, First Commonwealth represents the period when the first seven blind pools were brought to market by the underwriter, First Commonwealth Securities, which was forced to cease operations soon after. Blind Pool Only includes all 21 blind pools that were listed in (Alberta) Canada before the development of the CPC program. ASE JCP Only represents the period of time when the CPC program was only available to Alberta investors. CDNX/TSXV CPC includes the period when the program was expanded to include other provinces in Canada. TSXV CPC is the period of time over which the program has been made available to investors in Canada's largest province, Ontario. Moreover, the first four of six columns in Table 6.5 capture whether criminal charges were brought against a firm or its founders or underwriters; whether a conviction was obtained on those charges; whether a firm or its founders or underwriters were the subject of any regulatory hearings; and whether those hearings resulted in any sanction. Finally, the last two columns provide a total percentage for both criminal or regulatory charges (adjusted for double counting), and a total percentage for criminal convictions or regulatory sanctions imposed.

One way of setting a benchmark level of fraud is to compare the Canadian blind pools with US blind pools during the same time period. Riemer (2007) notes that securities fraud in the US increased significantly in the 1980s, particularly in the penny stock market, where investors suffered billions of dollars in losses. Many of the penny stock firms went public using a blind-pool form of financing. Furthermore, in an early study of US blind pools, Stern and Bornstein (1986) show that out of 68 blind pools, only 23, or 33.8 percent, traded at a price above the initial subscription price, and the authors note that one blind-pool underwriter estimated that only 2 percent of these blind pools would

Table 6.5 Percentage of blind pools investigated for fraud and found to engage in fraudulent practices

	Calendar period	Criminal charges (%)	Criminal conviction (%)	Regulator hearing (%)	Regulator sanctions (%)	Criminal or regulator charges (%)	Conviction or sanctions (%)
First Commonwealth	04/18/1986–07/10/1986	14.29	14.29	14.29	0.00	28.57	14.29
Blind Pool Only	04/18/1986–12/30/1986	9.52	4.76	14.29	4.76	19.05	9.52
ASE JCP Only	12/31/1986–02/29/2000	0.38	0.09	2.72	1.78	2.82	1.88
CDNX/TSX-V CPC	03/01/2000–06/14/2002	0.00	0.00	0.85	0.00	0.85	0.00
TSX-V CPC	06/15/2002–12/31/2005	0.00	0.00	0.47	0.47	0.47	0.47

Notes:
This table reports the percentage of blind pools, or their principals or underwriters, which were the subject of a criminal investigation, criminal conviction, regulatory hearing or regulatory sanction, over a given period.
First Commonwealth and Blind Pool Only refer to periods when there were limited regulations on Canadian blind pools.
More specifically, First Commonwealth represents the period when the first seven blind pools were brought to market by the underwriter, First Commonwealth Securities, which was forced to cease operations soon after.
Blind Pool Only includes all 21 blind pools that were listed in (Alberta) Canada before the development of the CPC program.
ASE JCP Only represents the period of time when the CPC program was only available to Alberta investors. CDNX/TSX-V CPC includes the period when the program was expanded to include other provinces in Canada.
TSX-V CPC is the period of time over which the program has been made available to investors in Canada's largest province, Ontario. This later time period is restricted to the end of 2005 to allow there to be an examination of five years of trading subsequent to the IPO.

Source: Pandes and Robinson (2013).

ultimately become successful. By way of comparison, in Canada, Table 6.5 indicates that the rate of criminal or regulatory charges is 28.57 percent and the conviction or sanction rate is 14.29 percent over the less than three months of blind-pool offerings by First Commonwealth Securities, and the rate of criminal or regulatory charges is 19.05 percent, and the conviction or sanction rate is 9.52 percent for the first 21 blind pools before the development of the CPC program.

Table 6.5 further shows that the incidence of fraud in the blind pool market decreased significantly once the CPC regulations were enacted on 21 November 1986.[10] In particular, following the adoption of the CPC regulations, the annual rate of criminal or regulatory charges declined significantly to 0.21 percent, 0.37 percent and 0.13 percent for the next three time periods, respectively, and the conviction or sanction rates also dropped to 0.14 percent, 0.00 percent and 0.13 percent for the next three time periods, respectively. Thus, the CPC regulations significantly reduced the level of fraud in Canada's blind pool market. In fact, the CPC regulations lowered the level of fraud to the levels reported in other markets. Cumming and Johan (2013) report average annual fraud (ignoring delinquent filings) of 1.83 percent for NYSE firms, 4.41 percent for NASDAQ firms, 1.99 percent for US pink sheets, 0.33 percent for Canadian TSX firms, 0.10 percent for Canadian TSX Venture firms, 0.38 percent for UK LSE firms, and 0.10 percent for UK AIM firms.

As noted above, Stern and Bornstein (1986) estimated that only about 2 percent of US blind pools would turn into successful firms. Therefore, in Table 6.6 we provide further insight into the CPC Program by examining the percentage of successful CPCs during the sample period, 1986–2010. We measure success in two ways in Table 6.6: (1) success – the percentage of firms that completes a qualifying transaction and is either still listed on the exchange for the next five years, or if it is delisted due to an amalgamation, a takeover, or a graduation to a more senior exchange within five years following its QT; and (2) graduation – the percentage of CPCs that graduate to a more senior exchange at any time after its QT. The results in Table 6.6 show that prior to the adoption of the CPC regulations (on 21 November 1986) only 33.3 percent of the blind pools became successful public firms and less than 5 percent graduated to a senior exchange. Following the adoption of the CPC regulations, it can be seen that in most years the success rate is at least 70 percent, and the graduation rate is at least 15 percent. The Table 6.6 results thus indicate that the program has become viable from the perspective of both issuers and investors.

In Table 6.7 we present an industry breakdown of the frequency of CPCs at the time of the completion of the QT, when the reverse merger or amalgamation between the publicly traded CPC shell and the private operating company takes place, so that the industry is that of the operating company. Table 6.7 also presents the industry distribution of the aggregate proceeds at the CPC IPO. Since we do not have SIC codes for the firms, we categorize industries more broadly. The descriptive statistics show that while the program has attracted a large number of firms from the resource based industries, it has also been extensively used by firms from other industries. More specifically, while the energy industry and the mining industry both account for over 400 firms and over $140 million of IPO capital, there are over 300 industrial firms, 180 firms in high-technology industries, and over 100 manufacturing, services, and real estate firms. Overall, only 131 CPCs failed to complete a QT, which gives a QT completion rate (ignoring the 66 CPCs

Table 6.6 Percentage of CPCs that are deemed to be successful and have graduated to a senior exchange

Year	Success (percent)	Graduation (percent)
1986	33.33	4.76
1987	67.05	25.43
1988	61.94	13.55
1989	70.83	8.33
1990	100.00	25.00
1991	44.44	0.00
1992	64.71	23.53
1993	83.93	21.43
1994	77.78	27.27
1995	79.12	21.98
1996	71.43	19.39
1997	76.55	16.55
1998	70.94	20.51
1999	74.60	15.87
2000	74.58	13.56
2001	79.80	11.11
2002	70.00	15.00
2003	69.57	4.35

Notes:
CPCs are deemed to be successful if they remain listed for at least five years following the QT, or if they are delisted due to an amalgamation, a takeover, or a graduation to a more senior exchange within five years following the QT.
Graduation is defined as a CPC graduating to a more senior exchange at any time after its QT.
The year 1986 only includes blind pools listed prior to the adoption of the CPC program.
The years 1987 and onward include only blind pools under the CPC program.
The years 2004 to 2010 are not included in this table since we require five years after the QT to compute the success rate, and a firm has up to two years to complete the QT.

Source: Pandes and Robinson (2013).

that are still actively seeking a QT) of 93.5 percent. Thus, the CPC program has been used by firms drawn from a wide variety of industries.

5 SUMMARY AND CONCLUSIONS

The junior equity market in Canada, the Toronto Venture Stock Exchange, has evolved over the past 100 years to become one of the world's largest markets for development oriented, early stage firms to go public. While the average IPO size of TSX-V firms is small compared to IPOs in other international junior markets, the absolute number of firms going public on the TSX-V is substantially higher than the number of IPOs in these other junior markets. One key aspect of Canada's junior market has been the development of its Capital Pool Company (CPC) program, which is a highly regulated blind-pool program. Unlike the blind-pool experience in the US, where significant fraud

Table 6.7 Industry distribution of the frequency and aggregate proceeds of TSX Venture Exchange CPC IPOs

Industry	N	Proceeds (MM$)
Petroleum and natural gas	492	146.8
Manufacturing	114	52.6
Services	134	40.3
Real estate	103	34.1
Financial	35	11.1
Mining	438	140.3
Life sciences	76	36.8
Computer and other high technology	180	74.4
Industrial and other	321	96.6
Failed to complete a QT	131	34.1
Still a CPC (No industry yet chosen)	66	22.2
Total	2090	689.1

Notes:
This table presents an industry distribution of ASE, CDNX and TSX-V CPC IPOs where the industry is determined following the CPC firm's QT.
N is the number of firms.
Proceeds (MM$) is the aggregate IPO gross proceeds at the time of the CPC in millions of Canadian dollars.
The industry definitions are hand-collected.
The sample period is from 31 December 1986 to the end of 2010 (it ignores the 21 firms that went public as blind pools before the adoption of the CPC program).

was followed by the adoption of regulations that effectively shut down the market, the Canadian experience with blind pools illustrates how effective regulation through the enactment of VC-like governance mechanisms and the consequent presence of high-quality underwriters can balance the capital needs of early stage, entrepreneurial firms, while still serving to protect the interests of investors.

NOTES

1. See some excellent survey papers by Da Rin et al. (2013), Metrick and Yasuda (2011), and Gompers (2008).
2. In our analysis, we discriminate between the 21 blind-pool offerings that occurred before the CPC regulations were adopted in 1986, and the 2090 CPCs that occurred subsequent to the regulations being implemented. We further note that the 2090 CPCs in our sample are those that were listed on the Alberta Stock Exchange (ASE) and its successor exchanges, the Canadian Venture Exchange (CDNX) and the Toronto Venture Stock Exchange (TSX-V).
3. The Alberta Stock Exchange began operations in 1914, while the Vancouver Stock Exchange and the Winnipeg Stock Exchange opened in 1906.
4. The second markets in Europe have evolved over time and hence have had different names over time. We use the most recent exchange names. See table 6.1 in Vismara et al. (2012) for a detailed description of the evolution of the structure of European stock markets.
5. In the early years, the ASE program was called the Junior Capital Pool (JCP) program, but following the merger of the ASE and the VSE to form the CDNX, the program name was changed to the CPC program.
6. The program was expanded to British Columbia in 1999, to Manitoba and Saskatchewan in 2000, to Ontario and Quebec in 2002, and to Nova Scotia and New Brunswick in 2005.

7. Industry classifications are obtained from Professor Kenneth French's website: http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html (accessed 17 May 2013).
8. In section 4 we document the industry of a CPC at the time of the QT.
9. Owing to the need to examine a firm for five years after listing, our final time period ends on 31 December 2005.
10. Blind pools firms, which had begun their listing process prior to October, were allowed to go public in November and December and the first CPC firm was listed on 31 December 1986.

REFERENCES

Beatty, R.P. and I. Welch (1996), 'Issue expenses and legal liability in initial public offerings', *Journal of Law and Economics*, **39**, 545–602.
Carter, R.B. and S. Manaster (1990), 'Initial public offerings and underwriter reputation', *Journal of Finance*, **45**, 1045–64.
Chemmanur, T.J. and P. Fulghieri (1994), 'Investment bank reputation, information production, and financial intermediation', *Journal of Finance*, **49**, 57–79.
Cumming, D.J. and S.A. Johan (2013), 'Listing standards and fraud', *Managerial and Decision Economics*, forthcoming, available at: http://ssrn.com/abstract=2242449 (accessed 5 May 2013).
Da Rin, M., T. Hellmann and M. Puri (2013), 'A survey of venture capital research', in G. Constantinides, M. Harris and R. Stulz (eds), *Handbook of the Economics of Finance*, vol. 2 (part A), Amsterdam: North Holland, pp. 573–648.
Gompers, P. (2008), 'Venture Capital', in E. Eckbo (ed.), *Handbook of Corporate Finance*, vol. 1, Amsterdam: North Holland, pp. 481–509.
MacIntosh, J.G. (1994), 'Legal and institutional barriers to financing innovative enterprises in Canada', discussion paper, Government and Competitiveness Project, School of Policy Studies, Queen's University, Kingston, Ontario.
Metrick, A. and A. Yasuda (2011), 'Venture capital and other private equity: a survey', *European Financial Management*, **17**, 619–54.
Pandes, J. Ari, and M.J. Robinson (2013), 'Effective junior equity market regulation', unpublished working paper, SSRN website.
Rasch, S. (1994), 'Special stock market segments for small company shares in Europe – what went wrong?', Discussion Paper No. 94-13, Centre for European Economic Research (ZEW), Mannheim, Germany.
Riemer, D.S (2007), 'Special purpose acquisition companies: spac and span, or blank check redux?', *Washington University Law Review*, **85**, 931–67.
Stern, R.L. and P. Bornstein (1986), 'Ethereal equities', *Forbes*, **137** (6), March 24 40–42.
Vismara, S., S. Paleari and J.R. Ritter (2012), 'Europe's second markets for small companies', *European Financial Management*, **18**, 352–88.
Wolfe, G.A., E.S. Cooperman and S.P. Ferris (1994), 'An analysis of the underwriter selection process for initial public offerings', *Journal of Financial Research*, **17**, 77–90.