

Is Effective Junior Equity Market Regulation Possible?

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The authors examined Canada's Capital Pool Company (CPC) program, a regulated blind pool program, since its inception in 1986. They found that the CPC regulations increased the quality of both the junior equity companies going public and the underwriters taking those companies public and significantly reduced the incidence of fraud in that market. Overall, the authors found that effective regulation can help create a viable junior equity market that facilitates the development of smaller companies.

The development of a viable junior equity market is critical to the economic health of a nation. According to a recent study by Weild and Kim (2009), the well-documented decline in the number of US initial public offerings (IPOs) over the past decade, especially for junior issues of under US\$50 million, has severely affected the ability of smaller companies to raise needed equity capital. This decline in IPOs has significantly slowed the growth of smaller companies and resulted in tens of millions of lost jobs. Several reasons for the decline in US IPOs have been proposed, including changes in market structure, regulatory overreach, a lack of analyst coverage for junior companies, and a structural change in the economy that has lowered the profitability of smaller companies (see Jegadeesh and Kim 2010; Weild and Kim 2010; Gao, Ritter, and Zhu 2013). Whatever the reason, there is a growing recognition that the current US regulatory environment is ineffective for nascent-company financing. As stated by former US senator Ted Kaufman, the issue of market structure revolves around the following question: "How can we create a market structure that works for a \$25 million initial public offering, both in the offering and the secondary aftermarket? . . . If we can answer that question . . . this country will be back in business" (Grant Thornton 2011, p. 4). In response to these concerns, the US Congress recently passed the Jumpstart Our Business Startups (JOBS) Act to facilitate the process of financing emerging growth companies; it is too soon to tell whether this initiative will prove successful.

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It should be noted that the United States is not the only country to experience difficulties with respect to the public financing of junior companies. European countries have been working to develop viable junior equity markets since the 1980s with limited success. As noted in Rasch (1994), such markets were successful in attracting a number of new listings in their first few years of operation, but they began to suffer from illiquidity over time, in both the primary and the secondary markets. More recently, Vismara, Paleari, and Ritter (2012) observed that the four largest European economies have launched 11 second-tier markets since 1995 and only 5 of those markets survive today. A possible reason why the European junior markets have failed to gain traction is that they are regulated by the stock exchanges, which tend to have less stringent rules than markets that are regulated by a securities regulator. Moreover, in most cases, the IPO shares in these junior markets are offered exclusively to institutional investors; thus, companies are rarely able to develop a liquid market for their shares. In addition, the post-IPO performance in these junior equity markets has been much worse than that of the senior market IPOs in the same countries. Therefore, the number of companies raising capital by using these European second-tier markets has declined significantly in recent years.

La Porta, Lopez-De-Silanes, Shleifer, and Vishny (1997) and Shleifer and Wolfenzon (2002) showed that countries with higher levels of investor protection have more-developed capital markets and attract a larger number of IPOs. However, regulators overseeing a junior equity market face the conflicting objectives of protecting the interests of investors while not creating a regulatory regime that is too expensive or cumbersome for the

companies seeking to raise capital. Although the US problem today revolves around a company's access to capital, the problem in the 1980s was securities fraud, particularly in the penny stock market, which caused investors to suffer billions of dollars in losses (Riemer 2007). Many of the penny stock companies began as *blind pool*, or *blank check*, forms of financing.¹ To address the fraud in this market, the US Congress passed the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 (PSRA), greatly expanding the authority of the US Securities and Exchange Commission (SEC). Castelli (2009) noted that the intent of the legislation was not to ban blank check offerings but, rather, to allow investors the opportunity to make more-prudent investment decisions and to improve investors' ability to monitor their investments. In reviewing the changes, however, Lampe (1991) argued that the statutory solution derived for curbing fraud in the penny stock market was too expensive and would serve to limit the ability of legitimate companies to access development capital. Riemer (2007) further noted that because the PSRA provides shareholders with the right to rescind their investment once a potential deal is announced, the issuing company's managers have trouble negotiating deals owing to the lack of certainty about the availability of funds to consummate the deal. Consistent with Lampe (1991) and Riemer (2007), the passage of the PSRA significantly reduced the number of US blank check offerings in the early 1990s; they virtually disappeared from the market in the late 1990s. As Heyman (2007) observed, there were 2,700 US blank check offerings between 1987 and 1990 but fewer than 15 in the early 1990s.²

Further complicating the development of a junior equity market is the fact that large investment dealers are unlikely to underwrite junior equity issues. Wolfe, Cooperman, and Ferris (1994) found that prestigious US underwriters avoid the smaller and riskier new issues owing to reputational concerns. Moreover, because the underwriting commission is typically a function of the issue size, larger and more reputable underwriters prefer to underwrite larger issues. In addition, Rasch (1994) noted that the low share turnover for small companies makes it unprofitable for brokerage firms to research those companies.

The purpose of our study was to determine whether it is possible to develop a regulatory framework that can create or maintain a viable junior equity market that allows companies to access capital while providing an appropriate level of protection for investors.

■ *Discussion of findings.* In our study, we examined Canada's Capital Pool Company (CPC) program, a regulated blind pool program that was initiated in response to junior equity market fraud in a blind pool offering in 1986. When the CPC program began, it was available exclusively to investors in the province of Alberta, but it has since become available to investors across Canada and now attracts listings by companies across Canada and internationally. Our study shows that the regulatory response to fraud has created a viable junior equity market in Canada to such an extent that by 2010, a total of 2,161 companies had used the CPC program to raise C\$726.3 million³ in IPO capital. Remarkably, the number of IPOs has remained high even after the senior market slowdowns during the early 2000s and the 2008 global financial crisis. The success of the CPC program in attracting IPO companies, particularly during the past 10 years, is in stark contrast to the junior market experience in other developed economies.

Our results indicate that more than 93.6% of the population of capital pool companies (CPCs) complete their qualifying transaction (QT) and become regularly listed companies; 72.2% complete their QT and remain listed for five years following this transaction or are delisted because of an amalgamation, a takeover, or a graduation to a more senior exchange. In comparison, prior to the adoption of the CPC regulations, only 38.1% of blind pool companies became regularly listed and remained listed for the next five years.

We further found that an increasing percentage of higher-quality underwriters are willing to take CPCs public, especially since the program was expanded to Canada's major provinces. More specifically, prior to the adoption of the CPC regulations, less than 5% of blind pool offerings were underwritten by a top 20 underwriter from the investment banking league tables; but since the regulations were adopted, over 45% of blind pool offerings have been underwritten by a top 20 underwriter. In addition, although the cash compensation offered to these underwriters is relatively small in dollar terms, they have been remunerated with warrants of up to 10% of IPO shares that, in many cases, have become quite valuable.

Finally, we found that the adoption of the CPC regulations significantly lowered the incidence of fraud in the Canadian junior equity market. Our study thus provides strong support for the effectiveness of the CPC regulations in developing a vibrant junior equity market that strikes the right balance between facilitating a company's development and protecting investors.

Canada's Experience with Junior Equity Markets

Canada's experience with blind pools began in Alberta in 1986, when falling energy prices caused traditional financing to dry up for junior energy companies. Between April and July 1986, a small regional investment dealer took seven companies public as blind pools on the Alberta Stock Exchange (ASE).⁴ The principals of the second such company, Audit Resources Inc., engaged in fraudulent trading practices soon after listing. By the time this fraud became apparent to the securities regulator, the Alberta Securities Commission (ASC),⁵ 14 more blind pools had gone public. As discussed later in the article, almost 20% of these early Canadian blind pools were investigated for fraud during the first eight months of the original program's existence; in half those cases, the company's principals were found guilty of fraudulent behavior. As a result of this fraud, in October 1986, the ASC placed a moratorium on new blind pool stock offerings until the program could be reviewed.

During the review, it was noted that small public companies share many of the challenges facing private companies that seek venture capital (VC) financing. In particular, small public companies have significant product market risk, inexperienced management teams and directors, less established customer relationships, and stock that is closely held by company founders. To address these challenges in the private market, a VC investor engages in extensive due diligence before investing in a company, uses contracting to place strong control mechanisms on the actions of company managers, and engages in ongoing monitoring of the investee company (Gompers and Lerner 1999; Kaplan and Stromberg 2001; Triantis 2001). Such VC mechanisms were considered when designing the new regulations on blind pools, which were adopted in late 1986.⁶

To overcome the negative publicity and connotation associated with the term "blind pool," the program in Alberta was renamed the Capital Pool Company (CPC) program.⁷ The CPC program requires that a company raise capital in two stages. In the first stage, a group of founders acting as managers and directors pools their capital (seed capital) and then raises money from the investing public (IPO capital) to form a shell company. This company then has 18 months to complete the second stage, a QT—a major asset acquisition or a reverse takeover—that transforms the CPC into a regularly listed company.⁸ Before a company can complete its QT, it must provide prospectus-level disclosure about the proposed transaction to investors and

regulators and obtain the approval of both groups before the transaction can proceed. The initial capital raised essentially provides cash for underwriting expenses and some administrative and due diligence expenses incurred to complete the QT within the required 18 months. Although CPCs appear similar to special purpose acquisition companies (SPACs) in the United States, the average size of a SPAC is almost US\$70 million, much larger than the approximately C\$1 million size of a CPC.

Moreover, each CPC must operate as a true blind pool and cannot sign any contracts before becoming listed. But a company may enter into letters of intent prior to listing; thus, some CPCs are used by companies as an alternative method of going public. Clearly, such a program could be subject to large agency costs if appropriate regulatory limitations were not placed on the company founders. To minimize these agency costs, the ASC and the ASE drew on practices from the VC market to ensure that outside investors' capital was protected and to provide the founders with a strong incentive to create value for all shareholders.

A CPC's VC-like governance mechanisms include (1) escrow provisions for the company's founders, which remove the incentives for short-term share price manipulation and early founder exit; (2) limits on the use of the company's capital by the company founders, which prevents the misuse of corporate resources; (3) a veto for the outside shareholders over the use of proceeds,⁹ which helps prevent investing in projects with a negative net present value; and (4) a requirement to initiate the QT within a predefined period, which prevents shirking. Although many of these regulations are similar to those adopted under the US PSRA, there is no right of rescission for CPC purchasers, which provides greater certainty to the issuing company's managers as to the availability of funds when negotiating a QT.

In further contrast to the US PSRA, the ASC and the ASE created additional regulations to protect investors (some of them based on the VC diversification model) and to enhance secondary market liquidity. For example, each company must be taken public by a registered investment dealer that performs extensive due diligence on the company's founders and offers the IPO securities only to suitable investors.¹⁰ In addition, each CPC IPO must attract capital from at least 300 individual shareholders, and no single shareholder can purchase more than 2% of the IPO shares. Finally, although not required by the regulations, many underwriters provide secondary market support to a new CPC issue to enhance its trading liquidity for a short period after its IPO.

Interestingly, the success of Alberta's CPC program has caused other Canadian junior equity markets to lose listings, the most notable being the Vancouver Stock Exchange (VSE). Specifically, VSE IPOs peaked at 346 in 1984, but by 1995, the number was down to 30 (see Canada Stockwatch 1998). Thus, in 1998, the British Columbia Securities Commission allowed the listing of blind pools on the VSE with characteristics virtually identical to those of the ASE's CPCs, calling them "venture capital pools" (VCPs). Another similar blind pool program, the Keystone program, began in 1999 at the Winnipeg Stock Exchange (WSE) in Manitoba. The CPC program remained intact following both the merger of the ASE and the VSE in November 1999, which formed the Canadian Venture Exchange (CDNX), and the acquisition of the CDNX by the Toronto Stock Exchange (TSX) in August 2001, which created the TSX Venture Exchange (TSXV). At that point, however, the CPC program was still available only to investors in Western Canada. In 2002, the regulators in Canada's most populous provinces, Ontario and Quebec, agreed to allow the program to operate in their jurisdictions.

Empirical Examination of the Effectiveness of the Canadian Junior Equity Market

We noted previously that the US regulatory response to fraud in the penny stock market in the late 1980s effectively closed down that market. The fact that Canada adopted different regulations than the United States adopted over the same period creates a natural experiment through which to examine the effectiveness of regulatory responses to fraud in the junior equity market. Note that two prior studies that examined the effectiveness of the CPC program reached different conclusions about it. Robinson (1997) studied the program over 1986–1992 and concluded that it represented an effective program for companies raising capital and provided investors with returns similar to those earned by VC investors.¹¹ In a review of Robinson's work, Kirzner (1997) expressed reservations about whether such a program could exist outside Alberta. Carpentier and Suret (2006) studied the program over 1995–2001 and showed that the performance of companies subsequent to the QT was lower than that of companies of similar size in the same industry. However, no previous study has considered the entire history of the CPC program or documented its impact on the incidence of success or fraud in the junior equity market. In our study, we used both univariate and multivariate analyses to examine these issues.

Data and Methodology

We gathered IPO data for each Canadian blind pool and CPC from a number of sources. In particular, we hand-collected, from ASE printed documents, data on the 21 blind pools that were listed in 1986 and on the CPCs that were listed between 1987 and November 1999 on the ASE. The data on the IPOs that took place on the CDNX and the TSXV between November 1999 and 31 December 2010 and on all the VSE's VCP companies and the WSE's Keystone companies were gathered electronically from the *Financial Post* Infomart database. We relied on ASE printed documents, augmented by data from the Info TSX Venture website,¹² to identify the blind pool companies and CPCs that became regularly listed successful companies. To determine the Canadian blind pools that were the subject of a criminal investigation, we checked each company against the Canadian Legal Information Institute (CanLII) database, which is maintained by the Federation of Law Societies of Canada and documents any criminal investigations and convictions. We further checked the provincial database of the jurisdiction in which the blind pool company was registered and listed to search for regulatory investigations and sanctions. We also conducted a Factiva news search to identify public announcements of fraud investigations or convictions regarding the blind pool companies in our sample. Finally, we gathered data on the reputation of the underwriters from the league tables found in the *Financial Post* Infomart database, augmented with data purchased from the *Financial Post* for IPOs prior to 1993.

Univariate Analysis of the CPC Program

Table 1 provides yearly summary statistics for all blind pools that were taken public in Canada in 1986, prior to the development of the CPC program, and for the entire population of CPCs listed between 1987 and 2010. The summary statistics indicate an increase in both the number of blind pools and the capital raised in 1987 and 1988, after the CPC regulations were adopted in Alberta. The use of the CPC program diminished significantly in 1989 and during the Canadian economic slowdown of the early 1990s; but beginning in 1993, there was a steady rise in both the number of CPCs going public and the capital raised until the bursting of the internet bubble in late 2001. The CPC program saw a significant increase in listings from 2004 until the worldwide economic slowdown that began in late 2008. Note that the growth in the number of CPC IPOs over time supports the findings in La Porta et

Table 1. Yearly Number of Blind Pools and Capital Raised

Year	N	Total Seed	Mean Seed	Total IPO	Mean IPO
1986	21	\$752,500	\$35,833	\$1,416,700	\$67,462
1987	173	6,620,939	38,271	15,836,900	91,543
1988	155	6,251,105	40,330	18,413,000	118,794
1989	24	1,027,322	42,805	3,317,900	138,246
1990	8	456,500	57,063	1,245,000	155,625
1991	9	460,795	51,199	1,380,000	153,333
1992	17	991,750	58,338	2,820,000	165,882
1993	56	3,630,583	64,832	11,000,000	196,429
1994	99	10,237,859	103,413	23,788,975	240,293
1995	91	10,262,894	112,779	22,482,500	247,060
1996	98	13,533,447	138,096	24,485,000	249,847
1997	145	24,067,775	165,985	36,555,000	252,103
1998	123	21,085,230	171,425	30,627,500	249,004
1999	99	16,611,135	167,789	28,100,500	283,843
2000	129	10,570,340	151,708	39,677,400	307,577
2001	105	18,252,146	173,830	36,213,049	344,886
2002	44	8,701,502	197,761	16,794,408	381,691
2003	29	5,108,982	176,172	17,531,535	604,536
2004	87	18,964,583	217,984	76,089,203	874,589
2005	85	18,007,570	211,854	56,812,106	668,378
2006	102	23,533,080	230,716	55,827,296	547,326
2007	181	37,768,434	208,655	84,861,850	468,850
2008	152	30,950,045	203,619	60,382,309	397,252
2009	52	10,588,253	203,620	19,233,001	369,865
2010	<u>98</u>	<u>19,386,095</u>	<u>197,817</u>	<u>42,831,364</u>	<u>437,055</u>
Total CPC	2,161	\$326,068,364	\$150,868	\$726,305,795	\$336,097

Notes: This table reports the yearly number of blind pools (1986) and CPCs (all other years) and the yearly capital raised at the seed stage and the IPO stage of the CPC process. *Total seed* is the total dollar amount invested by the CPC founders. *Mean seed* is the average dollar amount invested by the CPC founders. *Total IPO* is the total dollar amount invested by the IPO investors. *Mean IPO* is the average dollar amount invested by the IPO investors. The year 1986 represents the year in which 21 blind pools were listed prior to the adoption of the CPC program, which began in 1987. Thus, the Total CPC row covers only 1987–2010.

al. (1997) and Shleifer and Wolfenzon (2002) in that higher levels of investor protection attract greater IPO activity.

Table 1 shows that the 21 blind pools listed in 1986 had average seed capital of \$35,833 and average IPO capital of \$67,462, for an overall average post-IPO capital base of just over \$100,000. Moreover, the average seed and IPO proceeds have increased significantly over time. Prior to 1999, the regulations limited the maximum amount that could be raised in seed and IPO capital to \$500,000. Table 1 indicates that the average seed capital increased from about \$40,000 in the early years of the program to around \$170,000 in 1999 and that the average IPO size over the period increased from under \$100,000 to more than \$280,000. Regulatory changes in late 1999 increased the maximum seed and IPO total capital to \$700,000, which resulted in a slight increase in the average IPO size. We found a large

increase in the average IPO size starting in 2003, when regulations increased the maximum amount of seed capital to \$500,000 and the total seed and IPO capital amount to \$2 million. It is interesting to note, however, that the average IPO size peaked at \$874,589 in 2004, before declining in recent years to around \$400,000, which reinforces comments from industry participants that the most important benefit of the CPC program is the public listing that it provides and not necessarily the amount of capital raised initially.¹³ Overall, Table 1 shows that far from shutting down the blind pool market, which was the case with the US regulations, the CPC regulations created a vibrant junior equity market program that has remained strong. From the adoption of the CPC regulations from 1987 to 2010, there were 2,161 new listings on Canada's junior equity exchanges,¹⁴ representing \$326.1 million in seed capital and \$726.3 million in IPO capital.

Table 2 presents summary statistics on the geographical dispersion of the CPCs to show how the program has expanded over time. For summary purposes, the rows in Table 2 correspond to key regulatory changes in the life of the CPC program. The first row (blind pool only) shows that the percentage of non-CPC blind pools from Alberta was high, at 95.2%, and it remained high (75.6%) even after the CPC regulations were adopted and the program was restricted to Alberta investors only, as indicated in the second row (ASE JCP only). The third row (Western Canada) represents the period in which British Columbia and Manitoba adopted competing regulated blind pool programs. The summary statistics show that these new programs were successful in attracting new listings from companies outside Alberta; the percentage of companies from Alberta fell to 33.3%, with 37.8% of such listings from British Columbia, 13.0% from Ontario, 9.3% from Quebec, 5.3% from the rest of Canada, and 1.5% from outside Canada. The fourth row (across Canada) represents the period in which the CPC program was expanded to allow investors from Canada's most populous provinces, Ontario and Quebec, to participate in the CPC program. The results indicate that British Columbia has emerged as the primary source of CPCs (39.9%), followed by Ontario (24.1%), Alberta (19.4%), and Quebec (10.6%). Thus, a program that was originally designed and developed in Alberta has been actively adopted by jurisdictions and companies across Canada, and there has also been an increase in the number of international companies (2.2%) going public by using the CPC program.¹⁵

We further measured the effectiveness of the CPC regulations by examining the quality of companies going public under the CPC program. In **Table 3**, we define a successful blind pool as a

company that completes its QT and remains listed on the exchange for at least five years thereafter or is delisted because the company completes an amalgamation, is taken over, or graduates to a more senior exchange.¹⁶ Before the adoption of the CPC program, only 38.1% of the blind pools were successful, whereas since the adoption of the CPC regulations, the yearly percentage of successful blind pools has varied between 44.4% and 100.0% and in all but one year exceeded 60%—a substantial increase.

Table 3 also provides yearly summary statistics on the percentage of blind pools that graduate to a more senior exchange. Although not all junior companies seek to graduate to a more senior exchange (Jenkinson and Ramadorai 2013), the ability to nurture companies to the point where they are able to graduate is one goal of a junior equity market. We found that less than 5.0% of the blind pools that went public in 1986 graduated to a more senior exchange. The percentage of blind pools that graduated to a more senior exchange rose significantly, to 25.4%, once the CPC program was adopted (in 1987). The percentage of blind pools that graduated to a more senior exchange has varied between 8.3% and 27.3% since 1987, with the exception of 1991, when none of the nine CPCs taken public that year were able to graduate.¹⁷ These results further support the notion that the quality of companies going public as blind pools increased after the adoption of the CPC regulations.

Table 3 also reports whether higher-quality underwriters participated in blind pool offerings once the CPC regulations were adopted. Note that a key reason cited for the negative US experience with blind pools is the lack of reputable underwriters that participated in blind pool offerings. The third column in Table 3 reports the

Table 2. Percentage of Issuing Companies by Jurisdiction in Different Regulatory Environments

	Calendar Period	Jurisdiction of Issuer					
		Alberta	British Columbia	Ontario	Quebec	Rest of Canada	Outside Canada
Blind pool only	18/Apr/86–30/Dec/86	95.24%	0.00%	4.76%	0.00%	0.00%	0.00%
ASE JCP only	31/Dec/86–26/Aug/98	75.55	13.17	7.21	1.99	1.77	0.31
Western Canada	27/Aug/98–14/Jun/02	33.25	37.75	13.00	9.25	5.25	1.50
Across Canada	15/Jun/02–31/Dec/10	19.40	39.93	24.13	10.57	3.73	2.24

Notes: This table reports the percentage of blind pool issuers from a given jurisdiction over a given period. *Blind pool only* includes the 21 blind pools that were listed in Alberta before the development of the CPC program. *ASE JCP only* represents the period in which the Canadian blind pool program was available only to Alberta investors. *Western Canada* represents the period in which blind pool programs that directly competed with the ASE JCP program for listings were initiated in British Columbia and Manitoba, ending when the program was expanded to Canada's largest provinces (this row includes the period when the ASE and VSE merged to form the CDNX and when the CDNX merged with the TSX to form the TSXV). *Across Canada* represents the period starting when the CPC program was made available to investors in Canada's most populous provinces, Ontario and Quebec.

Table 3. Yearly Summary Statistics on the Performance of Blind Pools and the CPC Program

Year	Success	Graduation	Top 20	Fraud
1986	38.10%	4.76%	4.76%	19.05%
1987	67.05	25.43	46.82	7.51
1988	61.94	13.55	72.90	3.87
1989	70.83	8.33	41.67	4.17
1990	100.00	25.00	0.00	0.00
1991	44.44	0.00	0.00	0.00
1992	64.71	23.53	0.00	0.00
1993	83.93	21.43	30.36	0.00
1994	77.78	27.27	40.40	3.03
1995	79.12	21.98	31.87	3.30
1996	71.43	19.39	47.96	1.02
1997	77.24	16.55	34.48	0.69
1998	71.54	19.51	48.78	0.81
1999	66.67	13.13	17.17	1.01
2000	75.19	14.73	32.56	0.00
2001	80.95	12.38	67.62	1.90
2002	72.73	20.45	54.55	0.00
2003	72.41	3.45	48.28	0.00
2004	75.86	16.09	45.98	1.15
2005	62.35	8.24	58.82	0.00

Notes: This table reports yearly statistics on four performance measures of the blind pools and the CPC program. *Success* is the percentage of companies that went public in a given year, successfully completed their QT, and remained listed for at least five years following the QT or were delisted during that period owing to an amalgamation, a takeover, or graduation to a more senior exchange. *Graduation* is the percentage of companies listed in a given year that moved to a more senior exchange at any time since the company completed its QT (which could have taken place more than five years after the QT). *Top 20* is the percentage of companies in a given year that were taken public by an underwriting firm in the top 20 of the league table for the year of the IPO. *Fraud* is the percentage of companies in a given year that were the subject of a criminal or regulatory fraud investigation within five years after the company's QT. The year 1986 represents the year in which 21 blind pools were listed prior to the adoption of the CPC program, which began in 1987. We did not include 2006–2010 in this table because five years may not have elapsed between the time of the company's QT and the end of 2010 (a company has up to two years to complete its QT).

yearly percentage of CPCs taken public by a top 20 underwriter. As discussed earlier, the first seven blind pools in Alberta were taken public by a small regional underwriter that was ranked 55th out of the 72 underwriters on the Canadian league table for that year (a higher number on the league table corresponds to a lower reputation as measured by underwriter market share); during the remainder of 1986, only one blind pool was supported by a top 20 Canadian underwriter. Thus, as shown in Table 3, only 4.8% of the blind pools in 1986 were

taken public by a top 20 underwriter. Following the adoption of the CPC regulations, the quality of underwriters involved in CPC financings increased significantly. In particular, the percentage of top 20 underwriters in CPC financings was quite high over 1987–1989, ranging between 41.7% and 72.9%, but then fell to 0% between 1990 and 1992 (when the number of new issues was quite low). Since 1993, the percentage of IPOs supported by a top 20 underwriter has remained high.¹⁸

Finally, Table 3 reports the incidence of fraud as a further measure of the effectiveness of the CPC regulations. Note that financial fraud can manifest itself in a number of ways, including disseminating false financial or other information to mislead investors, engaging in manipulative stock-trading behavior, and misusing corporate funds. The first two types of misdeeds would likely lead to both criminal charges and regulatory sanctions, whereas the third might lead to regulatory sanctions only. We classified a company as experiencing fraud if it was subject to a criminal or regulatory investigation in the first five years following its QT (or until it was delisted if that date was earlier) because that is the most critical period in the development of a blind pool.¹⁹

Table 3 indicates that 19.1% of the pre-CPC blind pool companies experienced fraud whereas the incidence of fraud decreased significantly for companies listed in the year after the CPC regulations were adopted (7.5%) and for companies listed during the subsequent two years (approximately 4.0%). Table 3 also indicates that after the early years of the CPC program, the incidence of fraud declined significantly, to near zero in most years.

Providing further insight into the incidence of fraud, Table 4 presents average annual fraud percentages for the CPC program over various periods. As a benchmark for fraud, Beasley, Carcello, Hermanson, and Neal (2010) used SEC data to identify 347 cases of financial fraud between 1997 and 2006 out of a population of 9,428 US public companies, for a total fraud percentage of 3.68% over the 10-year period, or approximately 0.37% a year. More recently, Cumming and Johan (2013) documented cases of fraud (their study included all types of fraud, not just financial fraud) investigated by securities regulators in the United States, Canada, and the United Kingdom over January 2005–June 2011; they reported average annual fraud percentages (ignoring delinquent filings) of 1.83% for NYSE companies, 4.41% for NASDAQ companies, 1.99% for US pink sheets, 0.33% for Canadian TSX companies, 0.10% for Canadian TSXV companies, 0.38% for UK London Stock Exchange companies, and 0.10% for UK AIM companies.

Table 4. Percentage of Blind Pools Investigated for or Convicted of Fraud

	Calendar Period	Criminal Charges	Criminal Conviction	Regulatory Hearing	Regulatory Sanction	Criminal or Regulatory Charges	Conviction or Sanction
First Commonwealth	18/Apr/86–10/Jul/86	14.29%	14.29%	14.29%	0.00%	28.57%	14.29%
Blind pool only	18/Apr/86–30/Dec/86	9.52	4.76	14.29	4.76	19.05	9.52
ASE JCP only	31/Dec/86–26/Aug/98	0.04	0.01	0.25	0.17	0.26	0.18
Western Canada	27/Aug/98–14/Jun/02	0.00	0.00	0.20	0.00	0.20	0.00
Across Canada	15/Jun/02–31/Dec/05	0.04	0.00	0.32	0.18	0.35	0.18

Notes: See notes to Table 2. This table reports the percentage of blind pools, or their principals or underwriters, that were the subject of a criminal investigation, criminal conviction, regulatory hearing, or regulatory sanction over a given period. For periods of less than a year (first two rows), the percentages are not annualized, whereas for periods of more than a year (last three rows), the percentages are annualized. *First Commonwealth* and *blind pool only* refer to periods of limited regulations concerning Canadian blind pools. More specifically, First Commonwealth represents the period in which the first seven blind pools were brought to market by the underwriter First Commonwealth Securities, which was forced to cease operations soon thereafter owing to a capital deficiency.

Table 4 reports six columns of fraud measures defined as follows:

1. criminal charges: whether criminal charges were brought against a blind pool or its founders or underwriters;
2. criminal conviction: whether a conviction was obtained on those charges;
3. regulatory hearing: whether a blind pool or its founders or underwriters were the subject of any regulatory hearings;
4. regulatory sanction: whether those hearings resulted in any sanctions;
5. criminal or regulatory charges: a total percentage for criminal or regulatory charges (adjusted for double counting); and
6. conviction or sanction: a total percentage for criminal convictions or regulatory sanctions imposed.

The rows in Table 4 represent the percentage of total blind pools that were investigated for fraud and/or found guilty of fraud within specified periods. The first two rows represent the period in which blind pools were allowed in Alberta but before the CPC regulations were developed. The first row (First Commonwealth) shows the outcome for the first seven blind pools listed—all by the same regional investment dealer, which was shut down because of a capital deficiency soon after the program was initiated. One of the first seven blind pools was the subject of a criminal investigation and conviction for fraud, and one other blind pool was the subject of a regulatory hearing. Thus, almost 30% of the first seven blind pools were investigated for misdeeds, and one of the seven was found guilty. The second row (blind pool only) represents the experience of all 21 of the companies listed as blind pools in 1986 and shows that almost 1 in 5 were investigated for misdeeds, with charges or sanctions imposed on almost 1 in

10. These statistics serve as a base case with which the results following the adoption of the CPC regulations can be compared. Additional base cases can be derived from the previously mentioned studies of fraud in other markets.

The third row in Table 4 (ASE JCP only) represents the period in which the program was restricted to Alberta investors only. The fourth row (Western Canada) represents the period in which British Columbia and Manitoba adopted competing programs. The final row (across Canada) represents the period in which the program was expanded to Canada's largest capital markets, in Ontario and Quebec. For all these periods, we found that the annual incidence of both fraud investigations and fraud convictions decreased significantly once the CPC regulations were introduced. From a benchmark investigation rate of 19.05% for blind pools over eight months, the average annual rate of criminal or regulatory charges was reduced to 0.26% when the CPC program was restricted to Alberta residents and then to 0.20% when the competing programs were introduced in British Columbia and Manitoba. We found that fraud increased slightly, to 0.35% a year, when the program was expanded to Ontario, Quebec, and other provinces. These statistics for the periods after the CPC regulations went into effect are in line with the US statistics documented in Beasley et al. (2010) for the overall equity market and are also consistent with the statistics documented in Cumming and Johan (2013) for Canada's junior equity marketplace. Therefore, the Table 4 statistics suggest that the CPC regulations have helped prevent fraud in Canada's junior equity marketplace by attracting higher-quality entrepreneurs and restricting the ability of fraudsters to gain control of blind pool companies.

Multivariate Analysis of the CPC Program

To confirm our univariate results, we also conducted a multivariate analysis of three aspects of the CPC program that were identified in Table 3. First, we examined whether the CPC regulations increased the quality of companies going public and defined the dependent variable *Success* as an indicator variable equal to 1 if the company completed its QT and remained listed on the exchange for at least five years after completion or if it was delisted during that period because the company completed an amalgamation, was taken over, or graduated to a more senior exchange and 0 otherwise. Second, we examined whether the CPC regulations increased the quality of the underwriters taking blind pool companies public and defined the dependent variable *Top 20* as an indicator variable equal to 1 if the company's underwriter was in the top 20 on the league tables for the year of the IPO and 0 otherwise. Finally, to examine whether the CPC regulations have reduced fraud, we defined the dependent variable *Fraud* as an indicator variable equal to 1 if a company was investigated for fraud or was found guilty of fraud in either administrative or criminal proceedings during the period between its IPO and five years following its QT (or until delisting) and 0 otherwise.

In all the regressions, the key explanatory variable is *CPC Regulations*, a dummy variable equal to 1 for all blind pools completed after the CPC regulations went into effect and 0 for the 21 blind pools completed before the adoption of the CPC regulations. To examine the effect of other important changes in the blind pool market and to control for time effects, we included two additional regulatory dummy variables: (1) *Western Canada*, a dummy variable equal to 1 for the period in which competing blind pool programs were introduced in British Columbia and Manitoba (but before the program was expanded to Canada's largest provinces, Ontario and Quebec) and 0 otherwise, and (2) *Across Canada*, a dummy variable equal to 1 for the period in which the CPC program was expanded to Ontario and Quebec and 0 otherwise. We also included the additional control variables *Percentage Seed*, defined as the percentage of the blind pool company owned by the founders post-IPO (a measure of managerial alignment), and *Resource Firm*, which is an industry dummy variable equal to 1 if the company completed its QT in the resource industry and 0 otherwise.

Table 5 reports the results of a binary logistic regression for all three of the dependent variables: Success, Top 20, and Fraud. The results for the

Success and Fraud variables are based on all CPCs listed between 1986 and 2005 to allow five years to elapse after a company's QT. Focusing on the Success column, we can see a positive and statistically significant (at the 1% level) coefficient on the CPC Regulations dummy variable, providing evidence of a significant increase in the likelihood of success for blind pools after the CPC regulations went into effect. The positive and statistically significant (at the 10% level) coefficient on Western Canada further suggests that the likelihood of success for blind pool companies increased once the program was expanded to investors in other Western Canadian provinces, whereas the statistically insignificant coefficient on Across Canada indicates that the likelihood of success for blind pool companies did not increase when the program was further expanded across Canada (at that point, the program had been in existence for more than 16 years). We also found the coefficient on Percentage Seed to be positive and statistically significant at the 10% level, indicating that a higher percentage of the company that is retained by the founders following the IPO leads to a higher likelihood that the company will be successful, which supports the alignment-of-interests hypothesis in the literature. Finally, the positive and statistically significant coefficient on Resource Firm indicates that resource companies have a significantly higher probability of success than do nonresource companies, which is consistent with the historical genesis of the Canadian junior markets as a market for resource issuers.

Column 2 in Table 5 presents the regression results from examining the determinants of attracting a top 20 underwriter. Because the quality of

Table 5. Binary Logistic Regressions of the Determinants of CPC Performance

	Success (1986–2005)	Top 20 (1986–2010)	Fraud (1986–2005)
CPC regulations (dummy)	1.295***	2.736***	-1.833***
Western Canada (dummy)	0.266*	-0.029	-1.494**
Across Canada (dummy)	0.194	0.276***	-2.319**
Percentage seed	0.916*	1.134***	-2.739**
Resource firm (dummy)	1.211***	-0.211**	0.124
Intercept	-1.283**	-3.484***	-0.285
N	1,597	2,182	1,597
Pseudo R ²	0.097	0.023	0.083

*Significant at the 10% level.

**Significant at the 5% level.

***Significant at the 1% level.

the underwriter is observed at the time of the IPO, this regression is based on the entire set of blind pools from 1986 to 2010. The positive and highly statistically significant (at the 1% level) coefficient on CPC Regulations suggests that the CPC regulations significantly increased the likelihood of higher-quality underwriters' participating in the blind pool market. The statistically insignificant coefficient on Western Canada suggests that the expansion of the program into Western Canada had no incremental impact on underwriter quality. However, the positive and statistically significant (at the 1% level) coefficient on Across Canada indicates that once the program was adopted in Ontario (the location of the head offices of the majority of Canada's underwriters), there was an incremental increase in the likelihood of higher-quality underwriters in this market. The positive and highly statistically significant coefficient on Percentage Seed suggests that the top underwriters are more likely to be attracted to CPCs in which the founders hold a larger percentage of the company post-IPO, although this could be a requirement of those top underwriting firms. Finally, the negative and statistically significant coefficient on the Resource Firm dummy indicates that resource companies are significantly less likely to use a top 20 underwriter, which is consistent with the presence of regional underwriters that specialize in underwriting resource issues.

Finally, column 3 in Table 5 presents the results of a binary logistic regression that examines the determinants of Fraud. The negative and highly statistically significant (at the 1% level) coefficient on CPC Regulations indicates that the likelihood of fraud significantly fell once the CPC regulations were adopted. Moreover, the negative and statistically significant (at the 5% level) coefficients on Western Canada and Across Canada indicate that the likelihood of fraud continued to decline as the program was expanded first across Western Canada and then across the entire country. In addition, the negative and statistically significant coefficient on Percentage Seed indicates that there is significantly less chance of fraud if the founders hold a larger percentage of the company after the IPO. Lastly, the statistically insignificant coefficient on Resource Firm suggests that there is no difference in the likelihood of fraud between resource and nonresource companies.

Conclusion

Blind pools were first listed in Canada in 1986, and in the absence of effective regulations, these blind pools were susceptible to fraud by companies' principals and underwriters. In response

to fraud in the early Canadian blind pools, the Alberta Securities Commission and the Alberta Stock Exchange developed a series of regulations meant to provide sufficient protection to investors without placing an undue burden on reputable junior companies attempting to raise equity. These regulations became known as the Capital Pool Company program. In our study, we found that the CPC program has experienced steady growth over time: As of 31 December 2010, 2,161 CPCs were listed, with IPO proceeds totaling \$726.3 million. Contrary to US estimates that only a small fraction of blind pools would turn into real ventures, we documented that following the adoption of the CPC regulations in Canada, 93.6% of these companies were able to complete their QTs and become regularly listed companies.

Our study also shows that the CPC program has been broadened geographically. In particular, for the first 12 years of the program, only investors in the province of Alberta were able to invest in CPC IPOs. But starting in 1998, other Canadian junior exchanges that were losing IPOs to the ASE created competing programs, and since 2002, the program has been adopted in all the major provinces of Canada. We further found that the CPC program has enabled developing companies to raise an increasing amount of capital over time. It also attracts higher-quality entrepreneurs and underwriters, resulting in greater success for the listed companies and avoiding many of the problems of fraud found in other junior equity markets.

We believe that the CPC program has been successful for several reasons. First, the regulators place VC-like governance mechanisms on the company founders, requiring them to create value for outside shareholders before they can trade their shares. Second, the company founders are constrained in their ability to access the IPO proceeds. Third, outside investors and the regulators require prospectus-level disclosure about any proposed transaction, the regulators must approve any QT proposed by the company founders, and outside investors must approve any non-arm's-length QT. Fourth, the regulators require that the underwriters that take CPCs public ensure that the investment is appropriate for their clients' investment needs and objectives. Fifth, to create secondary market liquidity, the program requires a minimum number of IPO investors and places limits on the maximum ownership percentage of these IPO investors. Finally, the program provides CPC managers with the flexibility to negotiate potential deals without the concern that individual investors could rescind their investment if they do not support the proposed transaction.

Overall, we believe that the success of the CPC program demonstrates that it is possible to develop an effective regulatory regime for the listing of blind pool companies that provides protection for investors without limiting the ability of small companies to raise capital and develop their business. Because our study is an early exploratory attempt to better understand the methods available for small companies to raise capital and finance their growth, we hope that future global studies can provide even more insight into this increasingly important research area. Although it is difficult to say whether the CPC regulations can be successfully adopted in other countries, note that when the program was initially restricted to investors in Alberta, many experts questioned whether the CPC program could be adopted in other Canadian jurisdictions; yet within 16 years, the program has successfully expanded across the country and has also attracted international listings.

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This article qualifies for 1 CE credit, inclusive of 1 SER credit.

Notes

- Heyman (2007, p. 534) noted that many US securities regulations and media reports do not distinguish between the blind pool and blank check forms of offering even though there are significant differences in some instances. For the purposes of this article, we use the terms *blind pool* and *blank check* interchangeably in referring to a shell company with no existing business activities or contracts in place that goes public with the sole purpose of purchasing assets or an existing business to turn the shell company into an operating company.
- This statistic does not include special purpose acquisition companies (SPACs), which have been growing in popularity since 2003. Note that the average size of SPAC IPOs between 2003 and 2008 was US\$69.0 million (Jenkinson and Sousa 2011), much larger than that of earlier blind pools.
- All CPC data presented in this article are in Canadian dollars. The value of the Canadian dollar varied between US\$0.62 and US\$1.09 over the sample period.
- Canada has a long history of junior stock exchanges, with the Vancouver Stock Exchange and the Winnipeg Stock Exchange opening in 1906 and the Alberta Stock Exchange beginning operations in 1914.
- Securities regulation in Canada is a provincial responsibility; however, provincial regulators belong to a national policy group that seeks to harmonize regulations and has developed “national policies” (adopted by all jurisdictions) and “multi-lateral instruments” (adopted by several jurisdictions).
- Although the first IPO under the new CPC regulations occurred on 31 December 1986, it is treated, for ease of exposition, as if it occurred in 1987 in the annual summary statistics presented in Tables 1 and 3.
- The original 1986 Alberta program was called the Junior Capital Pool (JCP) program. When the Vancouver Stock Exchange adopted a similar program in 1998, it was called the Venture Capital Pool (VCP) program; when the Winnipeg Stock Exchange in Manitoba started a similar program in 1999, it was called the Keystone program. The programs were merged to create the Capital Pool Company program in November 1999, when the Canadian Venture Exchange was formed through the merger of the Alberta Stock Exchange and the Vancouver Stock Exchange. For the purposes of this article, we assume that the JCP, VCP, Keystone, and CPC programs are the same.
- When the program was expanded to Ontario in June 2002, the maximum time to complete a QT could be extended to 24 months with the permission of the stock exchange; in April 2005, it was extended to 24 months in all cases.
- The CPC program requires that the issuing company provide prospectus-level disclosure of any proposed transaction and gain the approval of the “majority of the minority” (50.1% of the nonmanagement shareholders) for non-arm’s-length transactions (before 15 January 2003, this approval was required for both arm’s-length and non-arm’s-length transactions). In addition, the ASE must approve the QT before it can be completed.
- Registered investment dealers are bound by “Know Your Client” rules that require CPC IPO investors to have indicated a risk tolerance for equity investments that is consistent with this type of security.
- In our study, we did not examine the long-run performance of CPC shares; note, however, that the program has had a number of spectacular successes. In 1994, the founders of Boardwalk Equities, a real estate and property management company, invested \$75,000 of their own capital and created a CPC shell company by raising an additional \$200,000 in the public equity market. By the end of 2004, Boardwalk Equities was listed on the New York Stock Exchange with assets of \$1.8 billion, revenues of \$282.5 million, and a market capitalization of \$896.6 million; the company’s shareholders experienced a price appreciation of 14,660% from its IPO price of \$0.25. More recently, Celtic Exploration Inc., which started with \$700,000 in capital as a \$0.25 per share CPC in 2002, received a takeover offer of \$24.50 per share in October 2012, which valued the company at \$3.1 billion.
- <http://infoventure.tsx.com/TSXVenture/TSXVentureHttpController?GetPage=LcdbSearch>.
- In many cases, a concurrent financing is conducted at the same time as the QT to increase the company’s capital base.
- To further illustrate the importance of the CPC program to Canada’s junior equity companies, we found in a previous study (Pandes and Robinson 2013) that between 1993 and 2010, a total of 2,629 companies went public on the TSXV

- (and its predecessor exchanges), of which 1,775 (67.5%) were CPCs.
15. When the Delaware-based internet company ePals Corporation decided to go public in the summer of 2011, it raised \$24 million through the CPC program and a concurrent financing at the time of the QT. ePals was an education technology and safe-social-learning-network company with a savvy management team, strategic partnerships with such leading US companies as IBM and Microsoft, and a customer base of 700,000 educators and millions of students in some 200 countries.
 16. One additional measure of company quality that we considered is the ability of a company to complete its QT; however, because there were limited QT regulations in place prior to the development of the CPC program, we concluded that the pre-CPC values were not directly comparable with the post-CPC values. Note that the average rate at which companies have completed their QTs since the CPC regulations were adopted is very high (93.6%). In comparison, Berger (2008) reported that between 2003 and 2008, the average success rate for SPACs in receiving shareholder approval for proposed transactions was 73%.
 17. Because we do not constrain the graduation rate to five years subsequent to the QT, we would expect the graduation rate to be lower for more recent CPC offerings. Also, note that the average time to graduation following the QT in our sample is 5.4 years, with a minimum time of 0.0 years and a maximum time of 22.8 years.
 18. An increase in regulations—and in the quality of underwriters—might be expected to lead to higher underwriter compensation. The cash compensation for underwriters of the first 21 blind pools was very low on a percentage basis (1.2%), and the options granted to underwriters averaged 6.2% of the IPO shares. Immediately following the adoption of the CPC regulations, the average cash compensation increased to 7.5% and the options granted increased to the maximum allowable value of 10.0%, likely a reflection of higher-quality underwriters' entering this market. Since 1998, when competing blind pool programs were initiated in Canada, the average percentage cash compensation to underwriters has been close to the maximum allowable rate of 10%, but with an average IPO size of around \$400,000 in recent years, the dollar amount of compensation is still relatively low. However, the underwriters in this market expect to earn significant compensation from the options they are granted, which have averaged just under 10% of the IPO shares in recent years. In addition, the underwriters also expect to secure future investment banking business from the companies they take public.
 19. In our multivariate analysis, we used this broad definition of fraud, which includes both investigations and convictions of criminal and regulatory violations. We used the broadest definition because convictions are difficult to obtain. Note, for example, that even though one promoter of the second CPC, Audit Resources Inc., pleaded guilty to fraud and conspiracy to commit fraud, seven other defendants were found not guilty even with the cooperating testimony of the convicted promoter.

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