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Introduction

Small- and medium-sized business enterprises (SMEs)[1] have consistently encountered difficulties in tapping into the public equity markets in Canada. This problem has been shaped by a number of economic, regulatory and functional barriers to full participation by smaller issuers in the Canadian capital market.

The fundamental dilemma involves reducing the informational asymmetries between the private business enterprise and its prospective public investors. For smaller firms, the costs of disclosing firm-specific information to potential investors is substantial in relation to the size of the investment.[2] Given the fundamental precept of securities regulation that investors must be capable of making decisions based upon efficient, accurate and timely information,[3] it is necessary to consider the sources through which information pertaining to specific issuers is processed and distributed to the atomistic group of individuals and firms investing in the capital markets.

In the public offering context, a range of intermediaries are involved in filtering large volumes of information about the corporate issuer. The participation (or lack thereof) by these intermediaries creates a number of costs and other barriers to effective participation. The most problematic of the traditional intermediaries for small business finance has been the investment bank.

Significant attention has recently been directed to the possibility that the Internet can operate as an effective vehicle for small business financing. Setting aside the excessive hyperbole concerning the "Internet revolution", it has nevertheless been consistently argued over the preceding two decades that advances in information technology will significantly impact the activities of the institutions and private actors operating in the capital markets.[4] Indeed, the technological disintermediation of the capital markets should not be viewed as a revolution, but rather as an evolutionary process that remains a potentiality instead of a fully-developed instrumentality. Whereas the process of financial intermediation was once human capital and relationship intensive,[5] it is now heavily influenced by technological innovation and consumer demand, factors which have tended to disrupt the monopoly power of financial intermediaries.

Technological innovation alone, however, is not sufficient to replace the institutions and actors that previously dominated the market for public offerings; rather, the concept of disintermediation by definition creates a vacuum that must be filled. Law firms and other intermediaries can create additional value for their clients by assuming some or all of the tasks currently apportioned to investment bankers in the public offering process.

Theoretical models created within the field of behavioural economics are useful in guiding securities regulators, lawyers, and academics to a fuller understanding of the current limitations inhibiting the realization of a functioning disintermediated marketplace for securities. Ultimately, the argument calls for the creation of a market environment where the decreased cost component of a disintermediated offering is complemented by reputational elements that import legitimacy into the offering. As technology and the presence of other intermediaries have replicated or avoided many of the justifications for direct underwriter involvement in smaller public offerings, it remains to be considered whether such instruments and institutions are capable of nurturing and sustaining the trust-based attributes of traditional reputational intermediaries. Effective disintermediation in the securities markets will remain an elusive objective as long as the impediments to the development of trust remain in place.

At a broader level, a responsible approach to the access to capital problem should reflect the belief that a properly functioning market is an instrument of social control capable of influencing broader social objectives (as opposed to being an institution with an insular focus responsive only to the needs of its participants).[6] A more efficient capital market providing enhanced access for smaller issuers can contribute meaningfully to the eco-

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nomic welfare of the greater society. A coherent proposal for regulatory reform and institutional development must balance the competing objectives of offering enhanced access to capital for small businesses while not exacerbating the market risk posed to investors by such developments.

A brief examination of the problem of informational asymmetry is followed by a look at the economic and regulatory costs imposed upon smaller issuers. This paper then turns to an examination of the "functional" inhibitors to growth posed by the role of traditional market intermediaries and reviews the concept of disintermediation, focusing on the promise of the Internet direct public offering as a means of achieving a functionally disintermediated securities market and the obstacles currently impeding the realization of that goal. Finally, this paper looks at the lack of trust as the "weakest link" in the disintermediation edifice, and proposes a workable means for establishing trust in the disintermediated marketplace.

Informational Asymmetry

Although present in numerous types of markets, informational asymmetries are particularly pronounced in financial markets. The information asymmetry dilemma attempts to explain and confront the potential for distorted incentives in the capital markets where one party to a financial transaction has information that another party is lacking.[7] The classic exposition of the theory considers the process of exposing "lemons" in a group of used automobiles.[8] The automobile market is one in which goods are sold both honestly and dishonestly, with the seller being the only party who has true knowledge of the quality of the automobile. The individual purchaser may or may not be cheated, depending on the honesty of the seller and/or the purchaser's ability to identify quality in such an environment. Moreover, the process has broader implications for the entire market. The existence of sellers capable of exercising dishonesty in their dealings tends to drive honest dealers and their automobiles out of the marketplace.[9]

In the public offering context, the problem of information asymmetry arises when prospective investors are faced with incomplete information about a company in which they must decide whether to invest. For SMEs, information about the company typically remains in the hands of company insiders. This circle of knowledge may be more or less exclusive depending on the size, corporate governance structure, and previous financing activities of the enterprise. Indeed, the problem faced by new issuers lies somewhere along the informational efficiency continuum between a market in which buyers must attribute value to a nebulous "black box"[10] and that of an efficient, well-informed marketplace for the prospective issuer's capital. Without credible sources of information about the company's past performance and future prospects, or some objective mechanism for measuring the quality of information disclosure, the investor is left without a legitimate basis for attributing value to the company's securities. The result is a tendency for investors to discount credible information and place a relative premium on corrupt sources of information, with securities prices ultimately reflecting the average (lower) quality of information.[11] The choices available to the issuer may therefore be predetermined by the degree of information "opaqueness" that confronts the investor: small, start-up enterprises tend to be most informationally opaque while larger, more seasoned issuers gravitate toward more transparent positions on the continuum.[12] Larger issuers with public share listings are the most informationally transparent, having expanded their formal corporate governance structure and increased their level of market disclosure, first through private sources of finance and later through the public offering process.

A more benign manifestation of the informational asymmetry problem exists in the secondary markets. Assuming one accepts the postulates of efficient capital market theory,[13] existing market disclosure contributes to the accurate pricing of securities, at least partially negating the problem of informational asymmetry. Informational efficiency is presumed to be more pronounced in the market for seasoned offerings, a finding that has been reflected in the reduced regulatory burdens of "POP"[14] and Shelf[15] offerings.[16]

The information asymmetry inherent in the bilateral relationship between issuer and investor has mandated the intervention of third party intermediaries to temper the impact of informational deficiencies in the market for initial public offerings. Issuers must therefore encounter direct and indirect costs and other barriers in attempts to utilize the resources provided by the various intermediaries. The following sections examine the various "inhibitors" to public financing that confront the prospective issuer in its attempt to raise capital.

The Small Business Capital Barrier: Regulatory and Economic Inhibitors to Growth

The small business capital barrier

Small businesses in Canada have faced significant difficulties in maintaining adequate levels of capitalization to finance their operations.[17] Commonly referred to as the "small business capital barrier", the phenomenon has inhibited the growth of SMEs in Canada. Indeed, undercapitalization has been cited as one of the primary causes of business failure in start-up enterprises.[18] Small businesses face disproportionately high barriers to public equity financing than larger issuers. This is reflected in the higher marginal cost of capital for small offerings[19] based upon the high fixed costs of the offering process and the costs associated with satisfying the regulatory burdens of a public offering.

For the purposes of this article, the traditional attributes of the small business capital barrier are divided into three categories, which are referred to as "inhibitors". The first is composed of regulatory inhibitors and is comprised of the numerous obstacles presented by the existing regime of securities regulation. The second focuses on economic inhibitors, which involve the direct and indirect costs imposed upon an issuer who attempts to "go public". Finally, there are what can be termed "functional" inhibitors. This category examines the functions of the IPO process traditionally delegated by issuers to third party intermediaries. After this paper presents some insight into the new technologies that have acted to "disintermediate" the market for initial public offerings, a fourth category is revealed: the "reputational" inhibitor.

Regulatory inhibitors

The securities regulation regime in Canada has created some significant regulatory barriers that have traditionally prevented or otherwise discouraged smaller companies from successfully raising funds on the public markets.

Before being permitted to distribute[20] securities to the public, a prospective issuer must satisfy a number of regulatory requirements, including the provincial registration[21] and prospectus[22] requirements,[23] which can be expensive and time consuming and typically require the retention of outside experts.[24] The process can be long and sometimes tedious, as the drafters must attempt to assuage the competing demands of the parties to the transaction as well as the regulatory authorities. There may be several drafts of a prospectus document before the filing of the preliminary prospectus as well as during the period between the filing of the preliminary prospectus and the approval of the final prospectus by provincial securities regulators.[25]

The registration and prospectus requirements must be satisfied in all provincial jurisdictions in which the securities will be distributed.[26] The issuer is also expected to satisfy the listing requirements of the exchange on which the securities will be listed.[27]

The requirements pertaining to the disclosure of audited financial statements have also had an impact upon smaller issuers, although securities regulators have exhibited some flexibility in this area.[28]

Satisfaction of the various regulatory provisions contributes significantly to the second inhibitor, which focuses on the costs of the process.

Economic inhibitors

Issuers planning to conduct a public offering are subject to significant financial expenses, many of which relate to satisfying the regulatory requirements of the offering process. It is important to recognize that many of these expenses are fixed costs and as such disproportionately impact upon smaller issuers. The various economic inhibitors can be broken down into direct and indirect costs.

Direct costs

Direct costs to an issuer in a traditional public offering consist of the costs incurred by the retention of intermediaries (lawyers, auditors, underwriters, etc.), and other miscellaneous direct expenditures necessary to complete the offering. Legal and accounting costs have been estimated at approximately $200,000 to $400,000.[29] The issuer also faces direct expenses in the form of the printing costs associated with a paper-based prospectus and other offering materials.[30] The largest single expense, however, is that levied by the underwriter, which typically charges a variable amount determined as a percentage of the offering price, usually in the range of 4 to 9 per cent , along with additional fees for disbursements and other matters.[31] The total direct costs to the issuer for a public offering of less than $5 million have been estimated to be 22.6 per cent of the issue proceeds.[32] This can be contrasted with the average total cost for IPOs between $5 million and $10 million, which have been estimated to amount to approximately 12 per cent of the offering.[33] Larger offerings feature even smaller proportions of the total cost being devoted to underwriting fees.[34]

Indirect costs

One of the largest indirect costs to an issuer is created by the tendency for new issues to be underpriced. In essence, the problem explains the prevalent practice in which the offering price for securities is artificially set below the anticipated equilibrium price in the aftermarket.[35] Initially understood as an anomaly, the underpricing phenomenon has consistently found empirical support in financial and legal literature,[36] and has been widely recognized as a selling technique by underwriters attempting to sell the maximum amount of securities possible. The technique has been criticized as one of the more potent manifestations of the short-term incentive structure of the contemporary capital markets.[37] The problem is most prevalent when the offering is distributed to the public in a firm-commitment,[38] fixed-price offering. The dynamics of this form of offering create incentives for the underwriters to sell underwritten securities as soon as possible in order to shield themselves from adverse market or issuer-related developments that can affect the price of the securities.[39] As a result, the securities are typically sold to institutional investors upon whom the underwriters and their brokerage appendages can rely as an expedient source of high-volume sales. Compounding the problem for SMEs is the fact that underpricing tends to be most acute in the case of "riskier" offerings.[40] In Canada, the problem has been verified by a number of researchers, whose findings have for the most part mirrored those in other industrialized countries.[41]

Brief mention should also be made of the long-term correlate of the underpricing phenomenon: underperformance. Empirical studies have shown that the long-run performance of IPOs has tended to be weak,[42] often underperforming against non-IPO securities when both classes of investments are tracked over the same time period,[43] although recent studies have indicated otherwise.[44] The long-run performance question nevertheless remains important, given that the long-term performance of the equity markets has been found to influence the investing patterns of most investors.[45]

The combined effect of underwriter influence in short-term underpricing and long-term underperformance is that issuers receive a lower receipt price for their securities,[46] institutional investors (and other highly sophisticated actors) are permitted to benefit at the expense of ordinary investors,[47] and underwriters retain supranormal profits. The inefficiencies in the IPO market can also act to discourage privately-held companies from making the jump to the public equity markets. It has been suggested that if IPOs were priced at closer to their expected long-term value, the market would be hospitable to greater IPO activity, since public offerings would be willingly undertaken by issuers *and underwriters at more points in the market cycle.* [48] Ultimately, the inefficiencies represent a distortion of the productive allocation of goods and services in the economy.[49]

Another indirect issuer expense relates to the opportunity cost of diverted management time and effort. The company's senior management must devote a significant volume of manpower to the task of preparing the company for the offering. Recent estimates have suggested that an IPO can consume approximately 20 weeks of senior management time, which can be calculated as costing up to an additional 7 per cent of the offering price.[50] This diversion of management attention often occurs during a crucial stage of the company's development,[51] and can have a significant negative impact on a small company that does not have sufficient management depth to simultaneously attend to other important aspects of the company's operations.

Moreover, smaller companies are often subject to costs arising from structural and other changes to the business prompted by comments in "deficiency" letters drafted by securities regulators in the prospectus approval process, a factor that can also create substantial delays in the offering process.[52] Finally, a company that successfully completes a public offering becomes immediately subject to the ongoing costs of regulatory compliance stemming from the continuous disclosure obligations of the securities regulatory regime.

In sum, the public offering process is a costly burden that many small businesses cannot afford to bear. Such concerns prompted the recent OSC Task Force on Small Business Financing to conclude that the offering process "cannot be a cost-effective way of raising less than $2-3 million".[53]

The preclusive nature of IPO expenses for smaller issuers also has impacts that can be felt beyond the individual issuer. Viewed through a financial growth cycle paradigm in which different capital structures and financing strategies are optimal at different points in the life cycle of a business,[54] the effects of the current model of small business financing also have potential negative effects on the welfare of market intermediaries. Successful small business ventures may ultimately require intermediated sources of capital. As a business venture matures beyond the point at which early-stage small business loans, "angel" financing,[55] and venture capitalist funding can provide sources of capital that are adequate to their current or expected needs, the next logical step is to take the company public. The preclusive nature of the current process acts to dissuade contemplative issuers from attempting to go public. This contributes to the stultification of the new issues market for SMEs, and creates fewer opportunities for the market intermediaries who might otherwise assist such an endeavour. Moreover, the availability of a vibrant IPO market for SMEs has been proven to stimulate the involvement of early-*stage financing intermediaries by providing them with a* viable exit strategy, which is an attractive feature for private equity investors who may be concerned about being locked into a particular investment for an extended period of time.[56] This factor in turn contributes to lowering the cost of capital during the earlier stage.

More importantly, the chilling effect on the IPO market can have much broader effects on the economy as a whole, given the fundamental importance of small businesses in innovation, job creation, and the general health and stability of the economy.[57] Small businesses are vital to economic development and contribute disproportionately to employment and growth.[58] As a result, the availability of cost-effective public equity financing and the institutions that are capable of facilitating this form of fundraising can contribute meaningfully to the long-run performance of the economy.[59]

"Functional" Inhibitors: Market Intermediaries

As the previous section has identified, the direct costs incurred by issuers in a public offering are heavily influenced by the retention of certain types of intermediation services that have traditionally been considered a functional necessity in overcoming informational asymmetries in the capital markets. While acknowledging that financial market intermediaries fulfill a range of functions in the public offering process, the focus here is on the effects of these third-party institutions in reducing the informational barriers between the primary participants. Third party intermediaries fulfill two inter-related functions in redressing the problem of informational asymmetry: first, by facilitating the flow of information about a particular security, and second, by confirming the credibility of information flowing from the prospective issuer to the investing public. It must also be recognized that the various market intermediaries perform other functions that are not directly related to overcoming informational barriers, and brief mention is made of such functions where appropriate. After exploring the general role of intermediaries in the capital markets, the focus of this part shifts to the role of the underwriter in the offering process, given that the costs incurred by their participation or, paradoxically, their refusal to participate in the process, has traditionally presented the most significant impediment to capital raising by smaller issuers. Brief mention is also made of the role of other intermediaries in the offering process.

The criticisms pertaining to the costs and other inefficiencies engendered by the participation of various market intermediaries in the public offering process have often been accompanied by suggestions to alter the traditional roles played by these actors. Indeed, it has been suggested that issuers can benefit from the elimination of third parties who are positioned between the enterprise and its investors. The Internet direct public offering has received great attention as a potential means of achieving that end. Before examining the utility of the Internet offering process, it is necessary to explore the functional rationale for third party intermediation in the market for public offerings.

Intermediation

The traditional rationale for intermediation is based upon the simple fact that an issuing company cannot be entrusted to fulfill certain core functions of the offering process. Although it can attempt to produce and disseminate information intended for investors, it cannot provide an objective measure of certification. In other words, aside from the securities law requirement that the issuer provide a certificate pronouncing full, plain and true disclosure,[60] it cannot credibly prove to investors that the company's disclosure data is reliable and accurate before the information is disseminated to solicit interest in the company's securities. Moreover, the problem facing the issuer can be deeper than mere certification. The incentive for truthful disclosure might not only be lacking, but there might actually be perverse incentives to misrepresent the true state of the company's affairs in order to reap the benefits of an inflated offering price. Simply stated, there can be tangible benefits to the issuer for exaggerating the positive attributes of the company's finances and operations, and similar rewards for minimizing the true value of liabilities and other negative aspects of the business. The absence of credible information about the prospective issuer or some objective mechanism for measuring the quality of information disclosure prevents investors from making informed decisions about the company's securities.[61] Credible information transfer therefore emerges as a prerequisite to an efficient and effective securities market.

Intermediaries have traditionally assumed an important role in transferring information from the issuer to the investor, thereby rectifying the incapacity of the corporate principal to screen for quality. The intermediary possesses the capability to impartially evaluate issuer data and can assume a prominent position between issuers and investors. The existence of a credible intermediary can emit a "signal" to investors that the issuer for which it has processed and certified information exhibits quality and thus its securities are a worthy investment (relative to the investment preferences of the investor). The process contributes to substantially reducing the search costs faced by investors.

A crude analogy in the strict bilateral context might be drawn to the consumer product warranty, where the existence of a warranty, and moreover, its terms (in comparison to the warranty terms of other similar products), can reduce the ultimate costs of assessing product quality for consumers wishing to purchase the product.[62] Warranties have proven to be an effective alternative method of signaling quality in situations where verifiable disclosure is costly or impossible in a marketplace of risk averse consumers.[63]

To the extent that the intermediary possesses the capabilities and incentives to accurately evaluate the informational and behavioural components of the issuer's business, investors will be willing to pay a premium for the issuer's securities, and issuers will be willing to compensate the intermediary accordingly.[64] It has been suggested that an issuer will therefore be willing to pay a premium for certification services where the revenue arising from the market's acknowledgment of certified (and therefore presumably accurate) information exceeds the cost difference imposed on the issuer by retaining the services of the intermediary.[65] In reality, however, the choice is not that simple. As a subsequent section of this paper makes apparent, the market for intermediary services does not always permit the issuer to make that choice.[66]

While the terms "intermediary" and "gatekeeper" are often used interchangeably, the two functions have distinct characteristics. An "intermediary" is a more generalized concept, referring simply to third parties that perform intermediation services between two or more actors. The process may be passive or active, but does not require the formal participation of the third party in influencing the behaviour or disclosure of the principal. The term "gatekeeper", however, connotes a more active and participatory role for a third party intermediary. As gatekeeper, the intermediary moves beyond the role of mere middleman to become an active guardian of the rights and interests of other actors that are external to the immediate intermediary — principal relationship. The gatekeeper positions itself between the principal and other actors and exercises its power to intervene or efuse to intervene in an attempt to alter the incentives f the principal or protect the interests of others. The ncept of responsibility is therefore coincident with the fillment of the gatekeeping role. The gatekeeper is ponsible for maintaining the principal's compliance accepted norms and quality standards. These norms standards are context specific and are as much a tion of the particular market for gatekeeping ser- as the market for the goods or services of the prin-

effective third party enforcement strategy of successfully certifying the informational r altering the behaviour of the principal must an enforceable duty upon the intermediary s it to avert misconduct by the principal when [67] or, in the alternative, disavow their role as gatekeeper. In the presence of an enforceable duty, the necessary *ex ante* gatekeeper enforcement/certification strategy can therefore be understood as a more benign variant of the primal "fight or flight" mechanism in which an organism is forced to respond when thrust into ituations that heighten its exposure to dangerous consequences.[68] Intermediaries faced with a poor quality (or corrupt) issuer can either cope with the situation by forcing the principal to conform to their expectations, or the third-party can withdraw its services.[69] For example, an accountant or lawyer can withhold an audit letter or legal opinion, or the underwriter can refuse to distribute the offering.[70] The existence of an enforceable duty introduces the notion that gatekeeper responsibility necessarily incorporates a substantial element of self-interest, as the gatekeeper must protect itself from externalized threats posed by the behaviour of the principal or risk the possibility of sanction.

Moreover, the existence of an intermediary need not necessarily be an accurate signal of quality. While intermediation has the capacity for redressing the informational barriers in the securities markets, the presence of intermediation *per se* is not sufficient to conclude that the problems have been resolved.[71] Indeed, there remain a number of potentialities that are capable of lessening the ultimate credibility of the gatekeeper function. The first is the possibility that a corrupt principal can "shop the market" for a compliant gatekeeper or otherwise attempt to corrupt an otherwise legitimate gatekeeper.[72]

Second, the possibility exists that the principal can dupe an unsuspecting intermediary. In such a case, the gatekeeper might have been duly diligent in its inspection of the principal, but has been misled or otherwise deceived into certifying information that is false. This type of occurrence falls somewhere on a spectrum of behaviour that can range from "fraud-on-the-intermediary" to third-party negligence, and formal *ex post* sanctions for this form of gatekeeper failure should attempt to reflect its true nature. This problem invites a consideration of whether liability should appropriately shift to the party whose acts are most culpable, with formal or informal sanctions dependant on the position of the negligent or malfeasant intermediary on the liability continuum.

Finally, there remains the ultimate intangible variable: gatekeeper fallibility. Even an underwriter's or auditor's most innovative financial modelling and accounting practices might attribute an inaccurate value to an issuer and its financial position, and a securities lawyer's most comprehensive due diligence investigation can overlook a crucial liability issue. The intermediary must be understood as the aggregate of its human and technological components. Human error, while to be strenuously avoided, can ultimately occur. This cannot be easily accounted for in evaluating the services of the intermediary, lest the fallibility of an individual firm or source of intermediation be frequently manifest. Similarly, the integrity of a technological system or device is rarely beyond reproach. Faced with the inevitable absence of human and technological perfection, the appropriate system of gatekeeper protection must be capable of tolerating some deviation from absolute accuracy.

It also bears mention that the *ex ante* gatekeeping function is not limited to the private sphere. Rather, a range of public and quasi-public institutions, including securities regulators, stock markets, self-regulatory organizations, and the courts continue to play a meaningful role in exercising the gatekeeping function in contemporary securities markets. Unlike private intermediaries, the gatekeeping functions of public intermediaries fulfill both *ex ante* and *ex post* functions. Examples of *ex ante* gatekeeping include such functions as prospectus review by securities regulators and the listing standards and application procedures enforced by stock exchanges. Obvious examples of *ex post* gatekeeping include regulatory sanctions such as the broad public interest sanctions,[73] statutory civil liability for misrepresentation in a prospectus,[74] common law causes of action,[75] and the delisting and cease-trade orders imposed by stock exchanges. Their formal roles remain essential to an effective gatekeeping strategy and must be adapted to any revised gatekeeper strategy that might be devised.

Gatekeeper liability regimes

It is important to emphasize that the enforcement and certification functions of gatekeeping services can be enhanced through the imposition of juristic and/or private liability mechanisms. While gatekeepers are intended to monitor and alter the behaviour of the principals under their watchful eye, an appropriate gatekeeper liability regime must also exist to monitor the imperfections that have been internalized within the various intermediary functions.

Where the threat of direct sanction against the principal proves to be an ineffective deterrent, collateralized liability regimes (both formal and informal) can compensate the ineffectual mechanisms for enforcing primary liability. Direct deterrence, for example, is often conceived as a poor strategy for enforcing legal norms where the principal actors lack the capacity to make self-interested compliance decisions.[76] Furthermore, the principal actors may plot their present and future course of action with reference to a risk–reward paradigm in which the potential benefits to be gained from inarticulate disclosure or other variances from expected standards of behaviour are calculated to outweigh the potential sanctions arising from detection. Although it has been suggested that the imposition of a regime featuring severe penalties is the obvious choice for countering such imperfections, a variety of constraints militate against the effectiveness of severity.[77] Severe penalties might appear to be an effective deterrent, but the residual value of a principal entity's assets might effectively preclude recovery (absent a persuasive case for piercing the corporate veil in the most egregious of cases or the imposition of criminal or quasi-criminal sanctions against the directing or managing minds of the corporation), and the imposition of severe punitive measures might disproportionately harm the "innocents": the employees, creditors, and other stakeholder groups that constitute the wider constituency of the principal.[78]

Moreover, a singular reliance on *ex post supervision of issuer disclosure and behaviour ignores the positive incentives that an ex ante gatekeeping strategy can encourage prior to the commission of activities that might ultimately be subject to an ex post sanction, possibly exposing the "victims" of such behaviour to unnecessary loss and little chance for restitution. The liability imposed upon gatekeepers coincides with their responsibility for monitoring the behaviour and informational integrity of the issuer, recognizing potential failures within the issuer's own internal procedures, and pressuring the issuer to forego misleading investors or otherwise obfuscating the quality of information or behaviour of the corporation.*[79] This form of *ex ante screening* mechanism is preferable to a singular reliance on liability mechanisms that target the issuer *after an investment has been made in its securities.*

The primary foundation for a gatekeeper liability egime is grounded in the regulatory environment hrough which the intermediaries operate. Simply put, atekeepers are constrained from absolving themselves their responsibility to monitor and enforce the actions the principal actors by the protections afforded to the ividuals situated externally to the principal and interliary relationship. As mentioned previously, the regu- y state ensures that investors are afforded a mod- of protection against gatekeeper negligence. Equally important, however, are the private inducements to gatekeeper responsibility, forces that impose a private sphere of gatekeeper liability upon market intermediaries.

Ultimately, the success of an intermediary in disclosing analytical information about the issuer permits other market participants to make an *ex post determination of the intermediary's credibility.*[80] Herein lies the most effective and most persistent means of ensuring that the gatekeeper fulfills its responsibilities to external actors. The credibility of the intermediary's past provision of gatekeeping services becomes reconstituted into gatekeeper reputation, properly understood as a valuable yet intangible measure of accuracy and credibility.

Because the issuer and the intermediary make significant investments (each within their own sphere of expertise) in informational credibility, each hold a reputational stake in the outcome (measured through the ultimate valuation of the principal entity's securities, relative to the quality of initial and subsequent informational disclosure), and each would be expected to gravitate toward openness and integrity. Principal actors invest in firm-specific reputational investments, such as advertising and brand identification,[81] while intermediaries invest in reputation through a self-perpetuating cycle of credible commitments to informational integrity.[82] However, as the previous discussion has outlined, there is a disjuncture between the incentives and corresponding reputational sanctions for the principal and intermediary in this context. Given that an intermediary *exists solely to assist principal entities in accessing the resources of participants that are extraneous to the principal — intermediary relationship, the reputational costs to the intermediary for improperly screening the principal are ultimately higher. In the capital markets context, an intermediary (such as an investment bank), by its very nature intends to be a repeat player in the capital markets, and thus bears the risk that its reputation will be tarnished through improper ex ante screening leading to negative ex post results for investors. Their market reputation thus acts as a conditional surrogate for credibility; the reputation of the intermediary is strategically held as a "hostage" in exchange for assurances of quality.*[83] A veneer of gatekeeper vulnerability is therefore exposed, as its reputational capital becomes *interwoven with the credibility of the principal. The failure of the principal to uphold its end of the informational bargain (as verified by the intermediary), subjects the hostage to reputational sanction. Simply stated, the services of the intermediary are subsequently devalued, reducing its utility as a gatekeeper in an informationally asymmetrical marketplace, with the ultimate penalty being the reluctance of ostensibly credible principals from retaining its services.*

It must be remembered that the formal liability regime does not disappear, but is rather reduced to a secondary role limited to other forms of ex ante deter-

rence and *ex post policing efforts. The principal (issuer) and intermediaries remain subject to liability for misrepresenting the quality of the principal. Nevertheless, the reputational argument illustrates that the private sphere* may in fact be the primary ordering mechanism that "regulates" the market for gatekeeper services. Any responsible recommendation for reform must therefore be predicated on altering the private incentive structures that predominate in the market for intermediary services. This subject is explored in greater detail later in this paper, where it is revealed that other intermediaries are capable of developing sufficient reputational capital to act as a surrogate for existing gatekeepers currently entrenched in the market for advisory services relating to public offerings.

The analysis in this section first provides a brief glance at the specific services provided by intermediaries currently operating in the capital markets. The primary emphasis is on the role of investment banking services, although the services of other intermediaries such as lawyers and auditors are also discussed.

Investment banks and the underwriting process

The underwriter's role

An "underwriter"[84] can be defined as the division of an investment banking firm that assists a prospective issuer in the process of distributing its securities in the public market through either purchasing the issuer's securities with a view to selling them (a firm-commitment underwriting) or by entering into a negotiated agreement to assist the issuer in selling the securities (an agency underwriting). The process itself may be undertaken by a single investment banking firm or a group of firms led by a managing or lead underwriter operating as a syndicate.[85] In essence, the retention of investment banking services by companies seeking access to funds in the capital markets is a matter of "hiring the money".[86] Underwriters are subject to the registration requirements under provincial securities legislation,[87] and are independently regulated by self-regulatory organizations. In Canada, they are regulated by the Investment Dealers' Association and must conduct their business in a manner consistent with the by-laws, rules and regulations of the Association.[88]

A range of functions have been accorded to the underwriter in the public offering process. Two such functions are most important for the purposes of this paper: the agency function and the due diligence function. The agency function refers to the underwriter's role in pricing, marketing, and selling the offering.[89] The agency function also involves the provision of advisory services for companies contemplating an offering, which includes an initial "merit review" on behalf of the company to determine whether its securities are worthy of a public offering.[90] The initial advisory assistance provided *by an intermediary such as an investment bank can be essential for SMEs, since such companies typically lack the necessary sophistication to price and otherwise structure deals.* [91]

The agency function also contemplates the actual selling of the company's securities, a process that includes marketing activities such as "road shows" in which the investment bankers and senior executives of the company travel to significant markets in order to extol the virtues of the offering to potential investors.[92] This is an important event in the life cycle of the offering, as it is at this stage that the investment bankers solicit interest from (predominantly institutional) investors. In firm-commitment offerings, the agency activities also contemplate a "risk-bearing" function, through which the underwriter assumes the risk of not selling the full complement of securities subject to the offering.[93]

The due diligence function focuses on the ability of the underwriter to certify the "veracity" of issuer disclosure under the securities laws.[94] It is at this stage that the reputational element of the intermediary's services plays a prominent role. In offering its "seal of approval"[95] to the issuer by certifying its informational disclosure, the investment bank contributes to the success of the offering by "renting" its reputation to the issuer.[96]

An additional function performed by the underwriter in the public offering context is the provision of after-market support following the offering. After-market support services include the creation and maintenance of liquidity in the market for the issuer's securities, the preparation of research reports, and the encouragement of ongoing analyst coverage of the securities by the research appendages of the investment banking institution.

Problems for SMEs arising from the underwriter's role

The traditional need for underwriter participation in the public offering process is highly problematic for SMEs hoping to raise public funds. Beyond the purely economic issues raised earlier in this paper,[97] a number of other factors suggest that the participation (or lack thereof) by an underwriter places substantial limitations on the ultimate success of the financing activities of a smaller corporate entity.

Perhaps foremost among such factors is the reluctance of investment banks to underwrite smaller issues of securities.[98] This problem is most acute in the case of "prestigious" investment banking institutions,[99] which are least likely to devote human resources and reputational capital to a smaller offering.[100] Empirical studies have proven that competition among investment banking firms is relatively weak,[101] and that there is even less competition in the market for smaller offerings. Compounding the problem is the lack of a developed distribution network of dealers specializing in smaller-scale financings.[102] A corresponding problem from the point of view of the ordinary investor relates to the inability of unpreferred retail investors to have any meaningful participation in underwritten IPOs.[103] Most retail investors are limited to purchasing the shares of IPOs of any sized company in the secondary market.

The net effect of the various factors is the creation of an enormous barrier to entry into the market for public equity capital. This ultimately forces smaller firms either to abandon the prospect of public equity fundraising or to accept an inefficient outcome in the event that they are able to secure the support of an investment bank.

Other intermediaries

A range of other intermediaries exist in the new issues market that attempt to create value[104] for prospective issuers. This section will briefly review the current role of lawyers, auditors, and private equity in the public offering process.

Securities lawyers create value for their clients (which can be either the investment bank or the issuer in a public offering) by conducting a due diligence investigation and advising on what constitutes acceptable disclosure.[105] The responsibilities coincident with such a role extend beyond fidelity to the client to an appreciation for the role of disclosure in a fair and efficient securities market, a factor that has been reflected in the following statement by Stanley Beck, a former Commissioner of the Ontario Securities Commission:

> . . . the securities lawyer is arguably enforcing the terms of the Act and is clearly the person upon whom the Commission, the financial community, and the investing public is heavily dependent. I am sure that there are many practitioners that do not care to have the matter put quite that way, but I suggest that it is in fact the truth of the matter.[106]

The securities lawyer plays a central role in the preparation of the prospectus document, which forms the ultimate basis for disclosure in the offering. The exercise of the due diligence investigation by a sophisticated securities lawyer has been honed into model verification procedures which have been described as being "almost as operational as the bouncer's duty to check the identification of underage patrons".[107] The ability to create value for clients has been described as an important attribute of a skilled business lawyer,[108] and it is in the public offering context that the securities lawyer consistently achieves this objective.[109]

Auditors also fulfill a gatekeeping role in the public offering process. The auditor is typically the first intermediary to develop a relationship with a prospective issuer, having performed a variety of accounting tasks for the company long before the decision to go public. Even if the auditor has no such long-term relationship with the company, it is nevertheless one of the first parties to inspect the financial affairs of the company. An initial public offering cannot proceed without the existence of an auditor's opinion in the formal disclosure documents, and the underwriter typically requires a comfort letter from the auditor to provide assurances in respect of the prospective issuer's financial condition.[110] Lawyers and auditors are subject to similar statutory sanctions as underwriters in respect of the disclosure of information to investors.

Finally, the role of private equity should not be discounted in any consideration of intermediaries in the public offering process for SMEs. Private sources of equity investment, such as venture capital firms and angel investors, can operate as a springboard to the eventual acquisition of funds in the public equity markets. Venture capitalists (VCs) provide more than financial support to start-up entities; rather, they provide substantial managerial guidance in the early stages of the life cycle of the business. Like the investment banker, auditor and business lawyer, the VC is a repeat player in the capital markets and furthermore has a high degree of specialized expertise at small-firm finance and development. The venture capital firm typically makes a substantial investment in a start-up company, nurturing it throughout its incubation stages and preparing it for an eventual public offering through which the VC can realize the full potential of its investment.[111] The prior existence of venture capitalist funding in an SME can have a tremendous impact on certifying the initial disclosure of a prospective issuer, given the VC's investments in reputational capital and the financial guidance and information production previously undertaken on behalf of the issuer.[112]

Disintermediation and the Internet DPO

The problems inherent in the current institutional structure of the capital markets presents significant barriers for SMEs seeking to tap the public equity markets and has led to suggestions that alternative methods of fundraising must be developed. The elimination or reduction of the small issuer's dependence on intermediaries through technological disintermediation is often cited as a workable solution. The most recent manifestation has been the Internet direct public offering (DPO). This section examines the rationale for disintermediation and explores the possibility that an Internet DPO can mitigate many of the current economic and functional barriers to growth.

Disintermediation

A commentator recently defined disintermediation as "the rather ungainly term that is used in cyber circles to describe the bypassing of middlemen that technology allows, the circumventing of those who traditionally stand between us and the things we desire".[113] The term has found application beyond the capital markets context in areas ranging from e-commerce,[114] banking[115] and advertising, to the music industry,[116] higher education,[117] the provision of health care services,[118] and the ability of governments to accurately tax their residents.[119] The concept contemplates the elimination or reduction of barriers to entry and transactional expenses imposed upon parties by the necessity to transact through the services of an intermediary. Its current popularity is owed to the promise of technological progress as the instrumentality for realizing its objectives.

Gatekeeping services create a series of costs that must be borne by the principal actors operating within the marketplace for gatekeeper services. Although their purpose is to create the conditions for the positive development of their principals, the services of the intermediary can also operate to the detriment of the principal. Direct costs must be incurred as a matter of course, but adverse indirect costs also result from the provision of gatekeeping services. In Akerlof's market for "lemons", the private market intermediaries created to increase the welfare of market participants have adverse social costs. Through their attempts to centralize information for the atomistic market participants, these private institutions become concentrations of power.[120] Other indirect costs are incurred as a result of the liability regime underlying the market for gatekeeping services. These costs are ultimately passed on to the beneficiaries of the regime.[121] There also remains the possibility of screening error or the existence of improper incentives on the part of intermediaries. Certification services are never perfect, and rational purchasers may not be capable of properly assessing the value of such services.[122]

The basic argument for disintermediation in the capital markets takes as its starting point the problems underlying intermediated sources of capital and, in turn, suggests that principal actors now have the technological capacity to internalize many of the functions traditionally performed by market intermediaries.[123] By reducing their dependence on intermediaries, it is presumed that prospective issuers can overcome many of the economic and functional barriers that previously impaired their ability to raise public equity funds.

To briefly recap the rationale for technological disintermediation in the capital markets context, the provision (or lack thereof) of underwriting services by investment banks creates serious economic and functional impediments to capital raising by smaller issuers. The typical SME lacks the resources to make significant direct investments in reputational capital, while also suffering from a lack of access to the services of intermediaries capable of operating as functional surrogates for reputational capital. Introducing a third variable of lingering suspicion concerning the credibility of new issuers creates a tripartite barrier that effectively discourages the raising of capital in the public equity markets.

It is important not to fall victim to the excessive yperbole concerning the "promise" of technological distermediation. The concept cannot be perceived as a nacea; rather, it is a potential tool for realigning the ditional institutional structure of the offering process into a reconstituted version of itself. Technology alone cannot resolve the numerous obstacles to small business development posed by the small business capital barrier. Instead, institutions and actors must be realigned in order to assist smaller ventures in achieving their ultimate objectives. The technological promise of the Internet is therefore best seen as a tool for shaping the parameters of functions that are to be ultimately fulfilled by human agents.[124] For this reason, it might be more accurate to describe the desired environment as "reintermediated"[125] rather than disintermediated.

In a functionally reconstituted securities market, the services traditionally provided by one type of intermediary can be unbundled and subsequently rebundled into a broader array of "mix-and-match" service bundles that correspond with the needs of start-up enterprises in search of financing.[126] As Professor Langevoort accurately predicted almost two decades ago, the principal actors in the capital markets are apt to pursue services that provide an efficient means of reducing dependence on an intermediary. He argued that issuers "will use underwriters only to the extent that underwriting serves one or more of the [underwriting] functions more efficiently than do other methods of achieving the same objectives, such as direct distribution by the issuer".[127]

The Internet direct public offering

The Internet direct public offering (DPO) has recently garnered significant attention for its potential to reconstitute the functional roles performed by intermediaries within the contemporary capital markets. In the last several years, small issuers have attempted to distribute securities directly over the Internet without the intermediation of a traditional investment bank. It is clear that Internet technology can have a significant impact on redressing the informational asymmetries in the market by reducing the cost of gathering, analyzing and disseminating information.[128] However, its effects on other functional elements of the offering process must be subject to greater scrutiny. It is generally agreed that the Internet presents advantages to smaller companies by reducing offering costs and providing access to investment opportunities heretofore reserved for larger issuers and investors.[129]

The DPO process: new technology and new techniques

Electronic disclosure, the Web-based prospectus, and Internet roadshows

Perhaps the most obvious benefit of the use of the Internet in the public offering process is its capacity to disseminate information to large numbers of prospective investors instantaneously. The Internet not only provides investors with expanded access to free or low-cost information, but it also greatly enhances the information provided in traditional disclosure documents. The limitations inherent in paper-based prospectuses have been revealed through multimedia disclosure documents that permit investors to easily proceed from one reference point to another (including external references) through the use of hypertext links.[130] The ability to produce and subsequently amend an electronic prospectus when significant changes occur in the disclosure material can greatly reduce the cost of producing, printing and distributing paper-based versions of the various documents.[131] Securities regulators have already taken a step in the direction of electronic disclosure with the introduction of the SEDAR[132] system, which provides a centralized database of public disclosure information. Annual general meetings are also now frequently conducted in multimedia format, with live meetings being simultaneously broadcast over the Internet. The Web-based prospectus is the next logical step in electronic disclosure.

The regulatory response in the United States is to accept the use of electronic media as "an equal alternative to the use of paper-based media",[133] so long as it conforms with the general disclosure rules. In Canada, two National Policies promulgated by the Canadian Securities Administrators[134] attempt to clarify how market participants can introduce electronic disclosure options that comply with existing securities laws. The approach of both countries has been described as "regulation by analogy":[135] regulators simply apply existing securities laws to the new electronic delivery mechanisms without drafting substantive alterations to the system of securities regulation. There has been some controversy in Canada regarding whether such an approach is ultimately appropriate, or whether more fundamental legislative recognition of the electronic disclosure process is warranted.[136]

Another key development has been the use of the electronic roadshow. The concept refers to the Web-based format of the travel-based marketing and solicitation campaigns undertaken by company executives and traditional investment banks. The first electronic roadshow occurred in the United States in 1997,[137] while the first Canadian attempt occurred in 1998.[138]

The advent of the electronic version of the roadshow has partially eroded some of the traditional barriers that previously hampered smaller companies in the public offering process. The technique potentially allows the issuer to reach large numbers of investors, analysts and money managers at one time without having to make multiple presentations in disparate locations.[139] It can be transmitted to its intended audience in either real time or on a delayed transmission basis, and can incorporate the traditional question and answer sessions through multiple modes of interaction, including phone-ins and e-mail.[140] The process greatly expands the outreach potential of the roadshow process, opening up the formerly closed-doors of the traditional roadshow to retail investors and other individuals who are otherwise unable to physically attend.[141]

More important to the present discussion is the ability of this new medium to reduce the reliance of issuing companies on the traditional underwriter. Company executives can largely bypass the investment dealer at this stage, instead offering their own version of the marketing technique using company executives to convey the intended message. In larger offerings, the issuer may nevertheless wish to retain an underwriter for this process. In such instances, the Internet version of the roadshow should ultimately reduce the cost of the underwriter's services, omitting the time and expense devoted to travel and the production of multiple presentations.

The Canadian Securities Administrators have responded by including provisions regarding Internet roadshows in National Policy 47-201, which permits roadshows to be conducted over the Internet provided that the waiting period requirements of the *Securities Act* are satisfied, and that copies of the preliminary prospectus are made available to each viewer prior to the transmission of the roadshow. Moreover, it provides for safety features such as password protection and restrictions against retransmission.[142]

It is important to note that modern public offerings will often combine Web-based and traditional activities. For example, Web-based marketing and solicitation might be accompanied by traditional marketing techniques such as the publication of a tombstone advertisement in a newspaper; oral presentations to potential investors might be used in combination with Internet roadshows and other multimedia presentations.[143]

Impact of the Internet on other innovative financing techniques

The use of the Internet as a vehicle for public offerings also enhances the applicability of other innovative financing mechanisms. Foremost is the dutch auction, which is not new, but does receive additional support through the Internet. The technique allows investors to make bids on securities, subject to an offering at the maximum amount they are willing to pay for the stock. The auctioneer then allocates the securities to the highest bidders, gradually moving down the bid scale until the full allocation is sold.[144] The dutch auction model typically increases both the level of transparency in the setting of security prices and the efficiency of the offering process (compared with the firm-commitment underwriting) for issuers, factors which have led some to consider the practice a thorn in the side of the investment banks. In the words of one commentator, "[t]he auction process takes away the smoke and mirrors of the investment bankers, and they don't want to lose their smoke and mirrors".[145] The process has been greatly facilitated by the growth of Internet-based "auctioneers" who conduct the auctions on behalf of issuing companies.[146]

Institutions and actors: new and reconstituted

The institutions and actors operating in the capital markets have been forced to adapt to advances in technology. New institutions have emerged to fulfill some of the market openings presented by the disintermediated financial environment. Moreover, existing actors have been forced to reconceptualize their role in the new marketplace for intermediary services.

New institutions

New services have arisen to fill the partial void created by the disintermediated space. The most common are the new "information merchants", Web sites created to advertise a company's securities in the hopes of soliciting support for a public offering or private placement. [147] Most prominent in the United States, these centralized repositories provide a platform on which individual users can post standardized information for electronic distribution.[148] Perhaps the most recognized institution in this regard has been the Angel Capital Network (ACE-Net), a listing service for small corporate issuers to advertise and solicit accredited investors for private placements of securities.[149] Another popular site in the United States is run by the Grant Street Group, which "creates and maintains customized Web sites for auctions and other transactions of fixed-income and equity securities that serve the particular needs of issuers, dealers, institutional investors, treasurers and global financial institutions". The site has proven to be an effective forum for linking investors with issuers of government debt.[150] The Group has been particularly successful at linking investors and issuers in purchases of U.S. municipal and state-level government debt securities.[151]

Similar Internet "matchmaker" services have been created which compile company business plans and attempt to "match" them with potential investors. These "cyber-middlemen"[152] take on a more active role than the passive bulletin-board style of other information merchants by actively attempting to link investors with investment outlets. Innovations in software technology can eliminate the free-rider problems previously associated with the profitability of information merchants.[153]

Another proposal involves the creation of new stock markets devoted entirely to the smallest of issuers. For example, in 1997 the Australian Stock Exchange "floated" a proposal for the creation of an alternative capital market where unlisted small businesses could solicit investments.[154]

The other major development has been the advent of Internet-based investment banks, which have attempted to respond to the demand for direct public offerings with specialized services for SMEs attempting to take the plunge.[155] These services challenge the monopolistic dominance of the traditional investment banks by charging lower fees and creating other value-added services that have begun to alter the previous necessity for relationship-based banking services.[156] Internet investment banking institutions, while prevalent in the United States, have not yet taken a firm root in Canada.

Other institutions have emerged that offer to conduct comprehensive marketing and advertising campaigns for prospective issuers, a service that sometimes extends to assistance with the preparation of the issuer's offering materials.[157] Finally, there are also a number of technology-based companies whose sole objective is to facilitate the electronic aspects of the Internet DPO, including the preparation of company Web pages and *the development of Web casts for electronic roadshows.*

New roles for traditional actors

Capital market intermediaries, such as securities lawyers and auditors, should witness their roles expand beyond the traditional functions accorded to them in the market for initial public offerings. The ability to effectively disintermediate using technological advances and other innovative mechanisms to reduce or eliminate the role of the underwriter in the process requires other intermediaries to assume greater responsibilities. The absence of the most costly intermediary does not preclude the need for gatekeeping services; indeed, the provision of intermediation services remains a functional necessity. Small issuers still require legal and technical advice to enable them to complete a successful offering. Moreover, the provision of gatekeepng services is essential to provide a minimum level of protection for investors that intend to participate in the offering. The practical difference is that now lawyers and auditors must now undertake the signaling of quality through legal and informational certification services to a greater degree. Their ability to successfully fulfill the role of reputational intermediary is explored in greater detail later in this paper.

Limitations

A number of problematic issues surrounding the Internet direct public offering must be acknowledged. Two of the most prominent involve retail investor protection and the lack of demand for DPO securities. Because DPOs are undertaken by smaller, unproven companies — a category which has been historically over-represented in the area of business failures and fraudulent market activity — it has been suggested that the risks of a DPO outweigh the potential benefits. Moreover, the Internet's facilitative effect on other forms of fraudulent business activity has further stigmatized attempts to conduct an Internet-based offering. Indeed, the Internet has become a virtual haven for "pump and dump" operators, who attempt to artificially inflate share values in order to capitalize on the vulnerability of less-sophisticated investors who have been deceived into purchasing the shares at artificially high levels.[158]

It has also been suggested that there is simply a lack of demand for this type of security.[159] An argument can be made, however, that the lack of demand correlates with the perceived absence of an adequate intermediary-certification presence. In other words, there may be a problem of "negative signaling" in offerings that do not feature traditional underwriting services. The absence of an underwriter in a particular offering can be seen to connote that the offering has been rejected by underwriters due to the perceived substandard quality of the issuer. This is an argument which is addressed in greater detail in the final section of this paper, where it is argued that the negative reputational signaling problem can be addressed through positive inducements to investor trust.

Perhaps the greatest impediment to utilizing the Internet DPO as an innovative and cost-effective financing method is the increased regulatory burden faced by issuers who attempt to complete such a transaction. In the recent Canadian attempts at Internet DPOs, the issuers were required to go through the process of registering in every province in which the securities were to be distributed, a factor which added additional fees and labour to the cost of the offering. Moreover, its very novelty created regulatory obstacles because cautious provincial securities regulators reviewed potential DPOs with enhanced scrutiny. Uniform procedures among the various jurisdictions for obtaining regulatory approval for a financing mechanism of this variety do not exist and securing regulatory approval in each jurisdiction proved to be an arduous task. The issue became particularly problematic when smaller provincial securities regulatory agencies were called upon to review the transactions.

Finally, it must be recognized that most offerings of this type are typically "one-off" transactions, whereby the company conducts a single financing transaction. The result is that the prospective issuer depends on its own Web-based promotional materials to attract investors. This form of promotional activity relies heavily on a passive medium: the company Web site. To create a more vibrant marketplace for new issue DPOs, Canada would benefit from the establishment of indigenous third party technology providers such as those that have proliferated in the United States.

The record (thus far)

To date, only two Internet DPOs have been conducted in Canada.[160] This may be partially due to the limitations outlined above. However, a broader argument can be made that the appropriate conditions for a fully-developed market for Internet-based public offerings have not yet been nurtured. The following section explores the possibility of creating a more hospitable environment for Internet-based offerings in Canada. It is argued that other market intermediaries are capable of developing sufficient reputational capital to act as a surrogate for existing gatekeepers currently entrenched in the market for advisory services relating to public offerings.

The "Weakest Link": Establishing Trust in the Disintermediated Marketplace

The expected benefits of technological innovation must not be permitted to obscure the problems that remain within the disintermediated marketplace. Indeed, as the previous part highlighted, a number of obstacles currently impede the development of an active market for Internet direct public offerings. The most pressing problem surrounds redressing the perceived deficiency in reputational capital among the new and existing intermediaries that are attempting to fill the void created by technological disintermediation.

This part argues that the establishment of trust is an essential component in achieving the full status of reputational intermediary. The disintermediated space need not be devoid of trust and reputational inducements to investment. Although the issue of cost is an important component of the innovative financing techniques, it is important to iterate that the introduction of Internet direct public offerings must be about more than simply reducing costs. Instead, it calls for the creation of a market environment where the decreased cost component of a disintermediated offering is complemented by reputational and certificational elements that import legitimacy into the offering. It is possible to envision a regulatory regime that permits and supports greater flexibility in accessing public equity financing — a regime that reduces costs while simultaneously signaling quality.

Other intermediaries are capable of developing sufficient reputational capital to act as a surrogate for existing gatekeepers currently entrenched in the market for advisory services relating to public offerings. Securities lawyers and auditors are the most prominent examples of intermediaries that are deserving of trust in a "reintermediated" environment.

In order to establish this proposition, it is necessary to expand the scope of analysis beyond the economic and legal literature to embrace an interdisciplinary perspective informed by the intersection of law and the behavioural sciences. As an increasingly varied array of legal academics have sought recourse to the behavioural sciences for its predictive and explanatory reach,[161] corporate and securities law scholars have turned to the social sciences for the empirical grounding of normative claims concerning the functioning of market institutions. While economic and financial theory has consistently been imported into contemporary legal scholarship, the behavioural theories of cognitive and social psychologists have recently challenged some of the orthodox economic presumptions pertaining to rational human behaviour.[162] While not purporting to discount the value of orthodox economic analysis, this paper attempts to highlight how several components within the field of behavioural economics can prove useful in guiding securities regulators, lawyers, and academics to a fuller understanding of the current limitations on the realization of a functioning disintermediated marketplace for public offerings of securities.

The concept of trust

The concept of trust is readily comprehensible, yet difficult to reduce to an accurate narrative description. The early economic literature on the subject recognized that informal, unwritten guarantees are preconditions for trade and production. As Akerlof described in respect of the market for "lemons", "[w]here these guarantees are indefinite, business will suffer".[163] Although intelligent contracting agents are adept at introducing specific contractual provisions to compensate for perceived indeterminacies in the law pertaining to implied contractual terms, large gaps nevertheless remain in the system of trust-based protective mechanisms that simply cannot be closed by drafting terms into agreements or applying econometric formulas.[164] These issues are relational in nature and depend on a range of factors that typically cannot be reduced to writing or legislated into effect. They require solutions that extend beyond substantive law to issues of human cognition and behaviour.

The concept of trust is multifaceted and interdisciplinary. In the words of one scholar surveying the various disciplines:

> To trust is ... to organize our world. This must be at least partly correct for ... in the absence of trust a person would not get out of bed in the morning. Economics teaches us that trust saves transaction costs. Sociology, politics, and psychology teach us that to trust is to be willing to enter into relationships and accept the authority and will of others. To trust is, in my own field of corporate law, to be willing to invest your money in a corporation managed by people you have never seen, you have never met, about whom you know very little, and some of whose names you may not know at all.[165]

Although the various disciplines approach the topic from differing perspectives, there are several general points of agreement. The first is that by definition, the concept of trust is concerned with the intentions and incentives of the trusted.[166] The second is that trust's basic function is to reduce the uncertainty and complexity of life; the mechanisms of trust assist us by extrapolating from previous experiences when faced with new situations[167] and guide us in making rational choices based upon those prior experiences.

The creation of trust involves impounding past practices and decisions into current and anticipated life experiences. To create trust is therefore to establish a system of norms and values, grounded in patterns of social interaction that are conducive to cooperation rather than conflict.[168] Groups of people who are capable of "embedding" such norms are more capable of trusting than those that are not, or they will at the very least create a system of beliefs that enables them to make certain judgments concerning whether or not to trust.[169]

A problem arises because the process of establishing trust can be costly. The establishment of trust imposes costs; however, the introduction of cost-saving measures can increase efficiency and ultimately reduce long-term costs. In order to reduce the ultimate costs of trusting, private sector institutions operating as professional gatekeepers have been established to uphold the norms and values that are important to the immediate society. However, to be effective and legitimate, these gatekeeping institutions must be regulated by higher-order gatekeepers. In essence, public law supports private trust by punishing deviations from trustworthy behaviour.[170] In turn, trustworthy behaviour is rewarded, both privately through the creation of the trustworthy "reputation", and publicly through the institutionalization and legalization of gatekeeping norms. In essence, therefore, the dilemma can be reduced to one of organizing the public and private provision of gatekeeping services into a system of public and private incentives that is optimal to the establishment of trust in a given environment.

In the context of the present discussion, further variables must be considered that do not mitigate but rather add dimensions to the problems underlying the concept of trust. First, it must be recognized that the establishment of trust in the securities law context can be particularly "expensive". In securities law, the concept of trust is fiercely interwoven with the ingrained issues of informational asymmetries and the gatekeeping intermediaries that are responsible for transforming the informational opacity of a particular issuer into a transparent and therefore calculable variable. Of particular concern is the insecurity engendered by the inability to accept the role of particular intermediaries in rectifying informational deficiencies. Moreover, there is a select group of market actors who thrive on the absence of trust. These individuals specifically attempt to capitalize on the standard dialectic of risk and return (i.e., the "possibility of above-average return inevitably carries with it above average risk"), a factor that can compromise the foundations of trust.[171]

Second, the variable of transacting in cyberspace adds a further element of expense. In cyberspace, the rule of law is not fully entrenched. The cyberspace domain has also not yet witnessed the introduction of fully-enforceable non-legal sanctions. "Reputation" does not yet carry the same pedigree in the world of cyberspace as it does in the tangible world of shopping centres, automobile dealerships or investment banks. Reputation cannot easily attach to an entity that is devoid of a tangible (or at least readily-identifiable) personal identity.[172]

Developing trust-based intermediaries for Internet DPOs: The gatekeeper liability regime revisited

There is no uniform prescription for establishing trust.[173] Because the concept is fluid and case-specific, the appropriate trust-building mechanisms are malleable and contextual in nature. However, because the establishment of trust is largely dependent on the intentions of the trusted, a reconstituted gatekeeper liability regime will be most effective where the intermediary has a stake in the process, measured as the threat of formal or informal sanction for non-trustworthy behaviour.

Devising the appropriate gatekeeper liability regime requires the efficient reorganization of public and private incentives and sanctioning activity in order to establish an environment conducive to trust-building. Reputational sanctions should be the primary device for "regulating" the market for gatekeeping services, but they should be supported by public law mechanisms that punish those that deviate from trustworthy behaviour.[174] The formal regulatory regime should remain responsive to investor fears of negligent and malfeasant behaviour on the part of issuers and intermediaries, and should continue to afford statutory civil liability for misrepresentation and the various other regulatory sanctions currently in place. The statutory due diligence requirements should not be relaxed, as this would negate the role of the gatekeeper's role of investor protection. Rather, the due diligence standard should reflect the context of the new investigatory environment and attempt to balance the competing policy factors of investor protection and small business development.[175] It is also important to recognize that statutory liability regimes are imperfect, and carry the baggage associated with the possibility of mistake, inflexibility, and regulatory capture.[176]

Common law rules, although imprecise and subject to abuse should nevertheless remain a secondary component of a responsible gatekeeper liability regime. These public sector roles are not fully adequate in their current form. The common law standard for determining negligent misrepresentation claims[177] must be refined through continuing judicial interpretation to import greater certainty to the question of gatekeeper liability. It is not acceptable that auditor liability for negligent misstatements be precluded solely on the basis of policy concerns such as the spectre of indeterminate liability. Indeed, the common law must incorporate the policy objectives of investor protection and greater access to capital for SMEs. On the other hand, expanded common law causes of action against gatekeepers are also open to abuse. Access to civil actions against gatekeepers can create a surge in opportunistic behaviour by disgruntled investors. While protection must be afforded to investors who have suffered at the hands of a negligent gatekeeper, unscrupulous investors must not be provided with the ability to opportunistically initiate groundless claims against intermediaries that have not breached their professional or transactional responsibilities. Enhanced judicial scrutiny of existing intermediaries will be necessary to stimulate positive incentives to investment in a reintermediated space. This is a topic that is deserving of specific attention and is one that cannot be adequately addressed within the parameters of this paper. It is deserving of mention, however, that the Ontario government has recently responded to concerns over inadequate public regulation of capital market intermediaries by drafting a proposed statutory cause of action against "experts".[178]

Establishing (private) trust in market gatekeepers

Private sector gatekeepers such as lawyers and auditors are sophisticated actors that are deserving of trust in a reintermediated capital market environment. It is difficult to prescribe concrete mechanisms for signaling their quality to the investing public, but several factors that contribute to their reputable stature can be highlighted.

First, securities lawyers and auditors, like investment banks, have an existing reputation in the capital markets. As repeat market participants, they have developed the necessary knowledge and skills to perform a vast array of complicated tasks and are sensitive to reputational sanction. They have consistently acted both to counsel the actions of clients and to certify information emanating from the client. Moreover, their extensive knowledge of the offering process combined with legal and non-legal sanctions for negligence have created a practice environment in which they are willing to outsource services for which their current skill-levels prove inadequate to accommodate. Hubris will be checked by the spectre of liability, measured in reputational and other forms of public and private sanctions. Moreover, because they are repeat players in the markets and therefore have a vested interest in maintaining their reputational character, they are less likely to participate in the unscrupulous acts that are of foremost concern to the investing public.

Second, the specific codes of professional conduct and general ethical obligations of lawyers and the accounting profession are recognized "reputation-forming devices", and reduce the risks associated with trusting.[179] Mandatory participation in a provincial law society or accreditation with the Canadian Institute of Chartered Accountants carries with it a number of ethical and professional requirements that members must uphold. The legitimacy of these self-governing organizations is anchored in their ability to monitor and alter the behaviour of their members.

Finally, there are an increasing number of forums that monitor the credibility and trustworthiness of these intermediaries. In addition to the existing informal channels through which the existence (or lack) of "reputation" and "quality" indicators are communicated between private parties, specialized publications track the intermediary industries in great detail. Moreover, the Internet provides generalized access to a wealth of information on the behaviour and reputations of lawyers and law firms through various Web sites and bulletin board services.

Additional steps are necessary to fulfill the role of gatekeeper in the public offering process. For example, securities lawyers must begin to accept the risk of expanded legal liability and reputational sanction by providing more comprehensive due diligence opinions in offering documents. Under normal circumstances, lawyers typically refrain from offering "negative comfort" opinions[180] and other expansive positive factual representations in the context of rendering an opinion. In a disintermediated offering, the lawyer's expanded role requires that the positive factual representations remain in the disclosure materials. The opinions must be honest and forthright, and they must be present in the offering materials. Without such representations, the spectre of mistrust might loom large over the offering. The lawyer's traditional stamp of approval provides a positive statement to investors that there has been "no cheating", a factor which is "an important and direct supplement to the other means of verification offered to the buyer".[181] Lawyers must therefore begin to cross over into uncharted territory — assuming a greater level of responsibility by making more positive factual representations regarding the issuer. Such representations must be grounded in their investigation of the issuer and subject, of course, to protections for the lawyer in the case of the issuer's intentional misrepresentations or other misleading practices during the investigation. Such protections are similar to those afforded to auditors who disclaim against direct internal misrepresentations on the part of clients.

It is expected that law firms with the ability to make such representations will charge a premium fee for such a service[182] in order to compensate for their increased exposure to sanction, although the cost value of the service will remain substantially lower than the costs levied for similar services by an underwriter.

Moreover, it is expected that the reputational quality of some lawyers will be naturally discounted. For example, in-house counsel will be seen to lack the necessary level of independence[183] required of an effective gatekeeper, and the trust value of their services will be discounted accordingly. Also, non-specialists (i.e., lawyers that do not concentrate on corporate and securities law matters) will not be capable of signaling trust in the same manner as specialists.

Although it has been suggested that the natural result of this reputational shift is that law firms will exclude higher-risk clientele from the services that they provide,[184] an argument can be made that this position is short-sighted. The function of the intermediary is to attest to the quality of information disclosure, not the quality of the issuer as an investment vehicle; as long as the information disclosed is accurate and not misleading, the intermediary has performed its role in reducing the informational asymmetry between the issuer and investor. The decision of whether to invest thereafter rests on the investor and/or its professional advisors.

Accountants similarly must be prepared to expand their functional role and accept responsibility for more intensive analysis and discussion regarding the financial affairs of the issuer, where available and applicable.[185] Indeed, recent events in the United States have highlighted the role of auditors in precipitating calamitous economic events.[186] Overt malfeasance among a select group of malefactors has led to enhanced scrutiny of auditor behaviour by public and private sector actors.

Finally, we must not forget that other intermediaries (i.e., venture capital firms) may have played a prominent role in the development of an SME prior to its public-offering phase. Their role must not be discounted and must be taken into consideration when the quality of the offering is in question. Individual VCs and other private equity firms may be subject to differing reputational or quality characteristics, but their presence in nurturing the prospective issuer throughout its gestation period provides an additional valuable resource, and provides a further grounding upon which to found a solid bedrock of trust.

Conclusion

The prospect of enhancing access to the capital markets for SMEs is within reach. Achieving this objective would contribute meaningfully to the productive allocation of resources in the national economy. The technological disintermediation of the capital markets has been described as an evolutionary process that has the power to reduce many of the barriers currently impeding access to capital. Technological innovation alone, however, is not sufficient to effect such change. To be ultimately successful, a reconstituted capital market for SME finance must permit new and existing intermediaries to step in and partially fill the vacuum left by the reduction or elimination of the functional role of the underwriter. To accomplish this goal, an environment of trust must be nurtured, in which these newly reconstituted intermediaries are capable of achieving sufficient reputational status to signal to investors the requisite level of quality and confidence in the investment securities under consideration. Capital market participants that are unable or unwilling to foster the conditions necessary to establish trust must be prepared to accept the alternative for smaller offerings: added costs, underpricing, inefficiency, and ultimately, lack of access to the capital markets.

Notes:

1 There is no universal definition for SME. At the expense of methodological certainty, this paper will not attempt to provide a specific definition of SME, but will defer to the various definitions provided below as constitutive of an acceptable range of possible indicators. As the recent Ontario Securities Commission Task Force on Small Business Financing has noted:

> SMEs are variously defined by reference to their revenues, assets, debt facilities, length of operating history, ownership structure and/or number of employees. For example, the Canadian Chamber of Commerce has defined a "small firm" as one with less than $2 million in annual sales or fewer than 100 employees, and a "medium-sized" firm as one with $2–20 million in annual sales and 100–499 employees. Statistics Canada, in its work related to SMEs, uses asset and/or employee tests: for example, for certain purposes Statistics Canada defines a small firm as one with between $5–25 million in assets, and for other purposes defines a small business as a business with fewer than 50 employees and defines a medium-sized business as one with between 50 and 100 employees. The Canadian Federation of Independent Business uses a definition of fewer than 20 employees and/or a chartered bank lending Facility of less than $500,000 . . . In a recent study completed by the Conference Board of Canada, SMEs were defined as corporations with fewer than 100 employees and a bank borrowing facility of less than $1 million. In other cases, size limitations have been tailored to specific industries. (Ontario Securities Commission, Task Force on Small Business Financing, Final Report (Toronto: Ontario Securities Commission, October 1996) at 18-19.)

2 C.J. Milhaupt, "The Small Firm Financing Problem: Private Information and Public Policy" (1998) 2 J. Small & Emerging Bus. L. 177 at 181.

3 Section 2.1.2 of the Ontario *Securities Act, R.S.O. 1990, c. 5*, states that, inter alia, "[t]he primary means for achieving the purposes of this Act are,

> (i) requirements for timely, accurate, and efficient disclosure of information . . ."

4 See, for example, D.C. Langevoort, "Information Technology and the Structure of Securities Regulation" (1985) 98 Harv. L. Rev. 747 [Langevoort, "Information Technology"]. Writing long before the advent of Internet use by private actors, Langevoort recognized that information technology had the capacity to increase the efficiency of the investment process, thereby disrupting the position of traditional intermediaries in the marketplace for securities.

5 W. Wilhelm, "Internet Investment Banking: The Impact of Information Technology on Relationship Banking" (1999) Journal of Applied Corporate Finance 25.

6 This proposition was presented by Professor Merritt Fox as an alternative to two other positions describing the various approaches to understanding the role of the securities market. The first described the market as embodying a form of casino-capitalism, where the market is "simply a place to speculate", while the second viewed the market as an instrument for individuals to safely deposit their savings. Both have been construed as an application of the efficient market hypothesis and come to the same conclusion: that the due diligence process does not lead to valuable improvements in informational efficiency. Fox supported a third and enlarged conception of the securities markets in which "[s]ecurity prices and the information that is used to establish them are central to the working of the three mechanisms that limit the discretion of management faced with these choices: the cost of capital to individual corporations, the market for corporate control, and stock price based management compensation schemes". This contention led Fox to conclude that informational improvements arising from the due diligence process produce a series of benefits which contribute to the efficient allocation productive resources. See M.B. Fox, "Shelf Registration, Integrated Disclosure, and Underwriter Due Diligence: An Economic Analysis" (1984) 70 Va. L. Rev. 1005 at 1009–1010, 1015. Fox was explicitly disputing the position of Barbara Banoff, who argued that the due diligence process is unnecessary in an efficient market, because it is not capable of producing superior information or applying more accurate analytical techniques. Banoff goes so far as to suggest that investors, if provided the opportunity to unbundled investment banking services, would choose not to pay underwriters a premium to insure against company-specific risk (although she is somewhat repentant in the case of certain new issuers and "novel" securities). See B.A. Banoff, "Regulatory Subsidies, Efficient Markets and Shelf Registration: An Analysis of Rule 415" (1984) 70 Va. L. Rev. 135. Fox has correctly identified such views as being too narrow.

7 E.P. Davis, "The Role of Institutional Investors in the Evolution of Financial Structure and Behaviour" (paper presented to the Reserve Bank of Australia Conference on The Future of the Financial System, July 8-9, 1996) 49 at 64, online: http://www.rba.gov.au/PublicationsAndResearch/Conferences/1996/Davis.pdf.

8 G.A. Akerlof, "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism" (1970) 84 Quarterly Journal of Economics 488. Regarding the tendency to drive quality dealers out of the market, see *infra* note 12.

9 *Ibid.* at 495.

10 Levmore presents the idea of a "black box" to describe a market for a product in which the contents of the "box" are unknown to both the buyer and the seller, with prospective investors limited to the knowledge that the property is worth something between zero and a very large value. Given that no more information is forthcoming, the market is considered to be efficient insofar as the ultimate price is reflective of everything that is known about the box. Moreover, the market for the box is also reflective of the risk attitudes of the market actors who are willing to bid "virtually blindly" on the box. See S. Levmore, "Efficient Markets and Puzzling Intermediaries" (1984) 70 Va. L. Rev. 645 at 647–648.

11 H.E. Leland & D.H. Pyle, "Informational Asymmetries, Financial Structure, and Financial Intermediation" (1977) 32 Journal of Finance 371 at 383.

12 L.J. White, "Market Failure and Government Failures: Some Cautionary Implications for Financial Reform" in A. Harwood & B.L.R. Smith, eds., *Sequencing?: Financial Strategies for Developing Countries* (Washington, D.C.: Brookings Institution Press, 1997) 66 at 70. The choices may be further limited by an additional side-effect of the information asymmetry dilemma: if investors are unable to properly determine which companies are truthful or otherwise informationally efficient in their disclosures, investors may tend to discount the prices for the securities of all of the issuers in the marketplace. This "adverse selection" problem has the potential for driving quality issuers out of the marketplace in search of other financing options, leaving the lower-quality issuers in the market. See B.S. Black, "The Legal and Institutional Preconditions for Strong Securities Markets" (2001) 48 UCLA L. Rev. 781 at 786–787. As Akerlof has described, one might envision a worst-case scenario featuring a spiraling series of events where "it is quite possible to have the bad driving out the not-so-bad driving out the medium driving out the not-so-good driving out the good in such a sequence of events that no market exists at all." Akerlof, *supra* note 8 at 490. Fortunately, however, the Canadian securities market features certain regulatory protections that insure against the occurrence of an adverse selection "death spiral". Nevertheless, the fact remains that the informational asymmetry problem continues to discourage the capital raising efforts of SMEs.

13 In rather simplistic terms, efficient capital market theory can be defined as the existence of informational efficiency in the pricing of securities. It describes a capital market in which all of the relevant and ascertainable information in the marketplace is directly impounded into the price of the securities. The theory has several permutations and is not without its detractors. One of the interesting questions posed by the efficient capital markets hypothesis asks whether the effects of efficient market theory contribute to supporting or disputing the case for mandatory disclosure laws. For a brief overview of the theory from a Canadian perspective, see M. Gillen, "Capital Market Efficiency Assumptions: An Analytical Framework with an Application to Disclosure Laws" (1994) 23 Can. Bus. L.J. 346; and C.C. Nicholls, *Corporate Finance and Canadian Law* (Scarborough: Carswell, 2001) at 89-101.

14 "POP" refers to a prompt-offering prospectus prepared and distributed under the Prompt Offering Qualification System for short form prospectus distributions pursuant to National Instrument 44-101 and 44-101 CP (2000) 23 O.S.C.B. (Supp) 447.

15 National Instrument 44-102 and 44-102CP, Shelf Distributions, (2000) 23 O.S.C.B. (Supp.) 571.

16 The Shelf and POP offering systems provide an accelerated process whereby the issuer can rely substantially on disclosure documents that had been previously prepared and distributed to the public. The issuer can thereby prepare and distribute a shorter and more cost effective version of the prospectus document. The modified procedures for POP and Shelf distributions have been described as one manifestation of a shift in Canadian securities regulation from a transaction-based system to an issuer-based system. See Nicholls, *supra* note 13 at 191. On the efficiency aspects of the different prospectus disclosure regimes, see Gillen, *supra* note 13 at 365–77. The debate over the two systems of disclosure and their effects on informational efficiency has been visited in greater

detail in the American literature. See, for example, the articles by Banoff and Fox, *supra note 6 and A.R. Palmiter, "Toward Disclosure Choice in Securities Offerings" (1999) Colum. Bus. L. Rev. 1.*

[17] The results of a recent report have indicated that small businesses have been unable to obtain adequate capital to fulfill their need for working capital and capital for buildings, production, machinery and research and development, with an estimated 28 per cent of companies being unable *to obtain any outside funding. Canadian Labour Market and Productivity Centre, Canadian Business Speaks Out on Access to Capital (March 1995)* at 1.

[18] J.L. Seglin, *Financing Your Small Business (New York: McGraw-Hill, 1990) at 41.*

[19] M.A. Allebach, "Small Business, Equity Financing, and the Internet: The Evolution of a Solution?" (1999) 4 Va. J.L. & Tech. 3 at 15.

[20] "Distribution" is defined broadly in section 1(1) of the Ontario *Securities Act, supra note 3, to include, inter alia, "(a) a trade in securities of an* issuer that have not been previously issued". "Trade" is also defined broadly in section 1(1) of the Act to include such activities as "(a) any sale or disposition of a security for valuable consideration . . ." and "(e) any act, advertisement solicitation, conduct or negotiation directly or indirectly in furtherance of any of the foregoing". The definition can therefore be interpreted to capture any of the marketing, advertising or other solicitation efforts that an issuer or its agents might undertake prior to the sale of securities.

[21] In a typical offering, it is the investment dealer (the investment bank), which must be registered to distribute the securities of the issuer. In Ontario, the registration requirement can be found in section 25 of the *Securities Act, ibid. Subsection (1) states that no person or company shall,*

> *(a) trade in a security or act as an underwriter unless the person or company is registered as a dealer, or is registered as a salesperson or as a partner or as an office of a registered dealer and is acting on behalf of the dealer; or*
>
> . . .
>
> (*c) act as an adviser unless the person or company is registered as an adviser, or is registered as a representative or as a partner or as an officer of a registered adviser and is acting on behalf of the adviser,*
>
> *and the registration has been made in accordance with Ontario securities law and the person or company has received written notice of the registration from the Director and, where the registration is subject to terms and conditions, the person or company complies with such terms and conditions.*

[22] The prospectus requirement can be found in section 53–64 of the Act. *Section 53(1) states that: "No person or company shall trade in a security on his, her or its own account or on behalf of any other person or company where such trade would be a distribution of such security, unless a preliminary prospectus and a prospectus have been filed and receipts therefor obtained from the Director". Pursuant to section 56(1) a prospectus must provide "full, true and plain disclosure of all material facts relating to the securities issued or proposed to be distributed . . .".*

[23] Certain exemptions have been carved out to permit private placements to certain classes of investors. These exempt distributions are subject to additional restrictions. For example, there are "hold periods" on the resale of such securities wherein investors must refrain from trading the securities obtained under the exemption for a specified period of time. See OSC Rule 45-501, Exempt Distributions (2001) 24 O.S.C.B. 7011.

[24] In a typical offering, the issuer must retain legal counsel and hire an underwriter to distribute the securities. An auditor must also be retained to prepare audited financial statements.

[25] Pursuant to section 61(1) of the Act, the Director "shall issue a receipt for a prospectus . . . unless it appears to the Director that it is not in the public interest to do so". Subsection 61(2) contains a long list of reasons which would enable the Director to refuse to issue a receipt. The drafting process has been described as "an intensive coordinated process in which the participants meet for many hours at a stretch and discuss in detail *and line-by-line the draft prospectus circulated to them prior to the meeting". Goulet adds:*

> *Sometimes a participant may be pejoratively called a nit-picker for picayune quibbles over grammar or punctuation (e.g., a comma should be a semicolon, etc.) but on the whole cavils are few and participant input is on a more elevated level. At a drafting session the draft is edited and revised as a result of discussions and prior investigations, inspections and research by the parties in anticipation* of the meeting . . . It is not unusual to have six or more drafting sessions on different days to review succeeding revised drafts before a preliminary prospectus is in a form to be signed and filed. There *are a similar number of subsequent drafting sessions to put the final prospectus in a form to be signed and filed. The prospectus-drafting process is a labour-intensive exercise during which copious cups of* coffee are consumed amid a vacillating oxymoronic atmosphere of leisurely discussion and impatient haste.
>
> G.R.D. Goulet, *Public Share Offerings and Stock Exchange Listings in Canada (North York: CCH Canadian Limited, 1994) at 137.*

[26] The various provincial securities regimes may have different requirements than Ontario, a factor which could cause some additional time *and expense. There are procedures, however, that will permit a streamlined process in all of the jurisdictions in which the issuer is to distribute the securities. See National Policy 43-201, Mutual Reliance Review* System for Prospectuses and Annual Information Forms and National Policy 12-201, Mutual Reliance Review System for Exemptive Relief *Applications.*

[27] The listing requirements of the various exchanges differ, and can also differ from provincial securities regulations. The listing requirements of the Toronto Stock Exchange requirements can be found in Part II of the Toronto Stock Exchange Company Manual, online: http://www.tse.com/en/pdf/CompanyManual.pdf. See also the Toronto Stock Exchange Filing Guide, online: http://www.tse.com/listed/index.html (prepared for informational purposes only). The requirements of the TSX Venture Exchange ("TSX-V") are found in the TSX-V Corporate Finance Manual, online: http://www.tse.com/en/pdf/manual.pdf. It should also be noted that there are prescribed fees that must be paid to the exchanges on an annual and per application basis. For example, the TSX-V currently charges an annual fee set at a minimum of $2,050 plus $50 per every $5 million in *market capitalization to a maximum of $5,000 in addition to listing fees, which are set at a minimum of $5,000 plus an additional 0.25per cent of the proceeds raised (to a maximum of $15,000) and a public offering fee calculated at $500 plus 0.25 per cent of the amount raised to a maximum of $15,000. See TSX-V Policy 1.3, Schedule of Fees.*

[28] Subsection 53(6) of the Regulations allow the Director to permit the omission of any of the required financial statements. As the OSC Task *Force has noted, the Director has exercised this discretion in the past "to waive, in the case of SMEs, the requirement for audited financial statements for the three or four of the least current of the five required financial years so that the issuer need only incorporate an audited balance sheet as at the end of the previous fiscal year and audited statements of operations and deficit, surplus and changes in financial position for the two most recently completed financial years". The Task Force explicitly recognized "that historical audits for SMEs, which are often performed ex post facto, are difficult, time consuming and expensive and do not provide materially better disclosure for SMEs than auditor comforted statements", concluding that "the principal benefit of auditor involvement is the discipline of the process rather than the production of financial statements". OSC Task Force, supra note 1 at 72. Similarly, the proposed OSC Rule 52-101 has attempted to relax some of the requirements in National Policy 48 concerning the disclosure of future-oriented financial information (FOFI). The proposed rule will provide certain exceptions for start-up issuers (defined as issuers whose business has been conducted for* 24 months or less).

[29] A.L. Riding, "Financing Entrepreneurial Firms: Legal and Regulatory Issues" (research paper prepared for the Task Force on the Future of the Canadian Financial Services Sector, September, 1998) at 69, online: http://finservtaskforce.fin.gc.ca/research/pdf/rr9_e.pdf. As an illustration of how the non-underwriter direct costs also disproportionately affect small issuers, it has been estimated such costs represent approximately 8.5 per cent of the issue price for offerings of less than $1 million, whereas the same costs represent only 0.9 per cent of the issue price for offerings of $100–200 million. See S. Rousseau, "Internet-Based Securities Offerings by Small and Medium-Sized Enterprises: Attractions and Challenges" (2001) 35 Can. Bus. L.J. 226 at 231.

[30] An American source has suggested that printing costs for an IPO can range from $75,000 to $150,000. See D.P. Sutton & M. Willian Benedetto, *Initial Public Offerings: A Strategic Planner for Raising Equity Capital (Chicago: Probus Publ., 1988) at 85. Printing costs for an offering that is distributed only in Canada are substantially lower, depending on the size of the deal and the number of intended recipients of the prospectus. The price will range from $15–20,000 for a small to mid-sized Canadian offering. The price will be raised substantially if the offering extends to the United States.*

[31] It should also be noted that underwriting rates for smaller offerings fall within the higher range, which is partially reflective of the higher risk of the offering. OSC Task Force, *supra note 1 at 33.*

[32] M.J. Robinson, "Raising Equity Capital for Small and Medium-sized Enterprises Using Canada's Public Equity Markets" in P.J.N. Halpern, ed., *Financing Growth in Canada* (Calgary: University of Calgary Press, 1997) 593 at 599, citing a study by Jeffrey MacIntosh, "Legal and Institutional Barriers to Financing Innovative Enterprise in Canada" Discussion Paper, Queen's University School of Policy Studies (1994).

[33] *Ibid.* at 600. A recent example can be found in the December 12, 2002 Prospectus for the recent IPO conducted by Metallic Ventures Inc., which raised $24 million. In that deal, the underwriting fees were equal to approximately 10 per cent of the offering price. (Online on SEDAR at http://www.sedar.com/csfsprod%2Fdata34%2Ffilings%2F00491376%2F00000011%2Fh%3A%5CPrivate%5CFILINGS%5CMetallic%5CIPO%5CPros02%5CAmend%5 CAmFinPro.pdf.)

[34] For example, the underwriters in the scuttled $5 billion Hydro One IPO in Ontario were only expected to charge a commission of approximately 2.25 per cent . A. Willis, "Eves, First Boston pass ethical test on Hydro One IPO," Globe and Mail, 4 April 2002, at B14. The underwriting fees for the recent initial public offering by the TSX Group, which intends to raise approximately $341.6 million, amount to approximately 4.9 per cent of the offering price. (Online on SEDAR at http://www.sedar.com/csfsprod%2Fdata34%2Ffilings%2F00480106%2F00000027%2FSEDAR%3A%5Cengclean.pdf.)

[35] R.A. Booth, "Discounts and Other Mysteries of Corporate Finance" (1991) 79 Cal. L. Rev. 1055 at 1092.

[36] See, for example, S.M. Tinic, "Anatomy of Initial Public Offerings of Common Stock" (1988) 43 Journal of Finance 789; K. Rock, "Why New Issues are Underpriced" (1986) 15 Journal of Financial Economics 187; A.P. Ljungqvist, V. Nanda & R. Singh, "Hot Markets, Investor Sentiment, and IPO Pricing" NYU Stern School of Business Working Paper (October 29, 2001), online: http://www.stern.nyu.edu/~aljungqv/papers/sentiment.pdf; L.A. Stout, "The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation" (1988) 87 Mich. L. Rev. 613.

[37] L. Lowenstein, "Shareholder Voting Rights: A Response to SEC Rule 19c-4 and to Professor Gilson" (1989) 89 Colum. L. Rev. 979 at 998. Professor Lowenstein has decried the incentives created during "late stages of bull markets when investors' wits are dulled and their appetites whetted, by the prospect of easy money". He describes the sales techniques that inhere in this type of market and the consequent impacts on market volatility as follows (*Ibid.* at 999):

> If new issues seem to be "bargains", it is because they have been consciously priced as such. The salesperson … can pull out his spreadsheet and show that this or that new issue is "cheap". And he is right — in some very myopic sense. Almost by magic, many a new issue moves to a premium price the very day of the offering. This "found money" whets appetites, of course, and refuels the process. But eventually the bull market in stocks as a whole dies, bringing even greater losses in these "bargain" new issues.

[38] A "firm commitment" underwriting is commonly referred to as a "bought deal" or "offer to sell", reflecting the fact that the underwriter agrees to purchase all of the securities subject to distribution prior to the offering. The underwriter then assumes the responsibility for reselling the securities to investors. The effect is to relieve the issuer of some of the underlying risk involved in both the market price and the saleability of the securities. Nevertheless, the underwriter typically retains some risk-sharing protections in the form of carefully drafted "market out" clauses. See M.R. Gillen, *Securities Regulation in Canada* (Scarborough: Carswell, 1998) at 21-22. This can be contrasted with a "best efforts" or "agency" deal in which the underwriter does not purchase the issuer's securities in advance, but instead agrees to act as an agent for the issuer in selling the shares.

[39] R. de R. Barondes, "Dynamic Economic Analyses of Selected Provisions of Corporate Law: The Absolute Delegation Rule, Disclosure of Intermediate Estimates and IPO Pricing" (1994) 7 DePaul Bus. L.J. 97 at 137.

[40] R.P. Beatty & I. Welch, "Issuer Expenses and Legal Liability in Initial Public Offerings" (1996) 39 J.L. & Econ. 545 at 552. The authors cite a number of studies that attempt to explain how riskier offerings require more underpricing. These studies have suggested that the tendency is based on one or more of the following: the signaling of quality, reducing the risk of subsequent legal action, to facilitate pre-selling, and/or to compensate uninformed investors for the winner's curse. A recent Canadian article on the subject of Internet-based securities offerings has accepted the winner's curse model of underpricing, summarizing it succinctly as follows:

> The model is based on the existence of information asymmetries about firm value between two groups of investors: (i) informed investors who have perfect or superior knowledge about firm value, and (ii) uninformed investors who lack special knowledge about firm value. The competition between informed and uninformed investors for good offerings induces an adverse selection mechanism where uninformed investors get securities in poor quality issues with greater probability. While uninformed investors will bid for new issues indiscriminately, informed investors will generally only subscribe to an issue where its expected after-market price exceeds the offering price. Thus, informed investors will subscribe to more shares of the good quality issuers, leaving the uninformed investors with a disproportionate number of the less successful issues that will be overpriced … Rational investors who realize that they receive a disproportionate amount of overpriced securities will refuse to participate in the IPO market unless they are compensated for their informational disadvantage. Therefore, according to the winner's curse model, IPOs are underpriced to keep uninformed investors in the market and to ensure that new issues are fully subscribed. The excess returns on underpriced issues compensate uninformed investors for the losses they incur when they bid for overpriced issues.

Rousseau, *supra* note 29 at 235. See also C.B. Barry & R.H. Jennings, "The Opening Price Performance of Initial Public Offerings of Common Stock" (1993) 22 Financial Management 54.

[41] See N. Ursel, "Priced to Sell: The Evolution of Underpricing in Canadian Initial Public Offerings" (2000) 8 Canandian Business Economics 15 [Ursel, "Priced to Sell"]. While Ursel's literature review finds what might be classified as "optimistic" levels of underpricing in Canadian equity markets, her study is more valuable for revealing that most of the Canadian literature has focused on offerings listed on the TSE. She notes that such findings are likely not indicative of the economic environment faced by SMEs listing on the CDNX (now the TSX-V), where smaller-capitalization Canadian companies are likely to be listed, and cites recent studies that reinforce this hypothesis. See Robinson, *supra* note 32 and N.D. Ursel, "Hot Issue Markets in Canada" unpublished working paper, University of Windsor (2000).

[42] See, for example: R.G. Ibbotson, "Price Performance of Common Stock New Issues" (1975) 3 Journal of Financial Economics 235; and T. Loughran, J.R. Ritter & K. Rydqvist, "Initial Public Offerings: International Insights" (1994) 2 Pacific-Basin Finance Journal 165.

[43] J.A. Shayne & L.D. Soderquist, "Inefficiency in the Market for Initial Public Offerings" (1995) 48 Vand. L. Rev. 965 at 966. See also T. Loughran & J.R. Ritter, "The New Issues Puzzle" (1995) 50 Journal of Finance 23.

[44] S. Espenlaub, A. Gregory & I. Tonks, "Re-assessing the Long-Term Underperformance of UK Initial Public Offerings" (2000) 6 European Financial Management 319.

[45] Ursel, "Priced to Sell", *supra* note 41 at 15.

[46] Put another way, "the entrepreneurs who founded the company are selling it too cheaply", and are thus "giving much of the value of the company to those who first buy its shares on the stock exchange". Ursel, *ibid.* at 15.

[47] L.M. Benveniste, S.M. Erdal & W.J. Wilhelm, "Who Benefits from Secondary Market Price Stabilization of IPOs?" (1998) 22 Journal of Banking & Finance 741. The authors argue that underwriters and their brokerage house affiliates employ stabilization techniques that pressure retail investors to retain ownership of their shares for an extended period of time after the offering while simultaneously permitting "large quantity, presumably institutional" selling pressure on the same securities. This effect is mitigated, however, in the case of "poorly-received offerings", in which secondary market trading is less voluminous. *Ibid.* at 765.

[48] Shayne & Soderquist, *supra* note 43 at 977.

[49] *Ibid.* at 966.

[50] M. Andrews, *Initial Public Offerings: The Experience of Eight Canadian Growth Companies* (Ottawa: Conference Board of Canada, 1995) at 10.

[51] The energy devoted to the process is equivalent to human capital that has been diverted away from current management operations. This tends to occur at what is typically a crucial moment in the life cycle of the business, as working capital is low (or may even be in a deficit position) and little attention is paid to maintaining relationships with customers, suppliers, employees, and lower-level management. If the capital raising efforts are ultimately unsuccessful, the spiraling effects of diverted human capital "can cripple a struggling young business". See J.A. Timmons &

D.A. Sander, "Everything You (Don't) Want to Know About Raising Capital" (Nov-Dec 1989) Harv. Bus. Rev. 70 at 70–71.

[52] OSC Task Force Report, *supra note 1 at 33–34.*

[53] *Ibid. at 34.*

[54] See A.N. Berger & G.F. Udell, "The Economics of Small Business Finance: The Roles of Private Equity and Debt Markets in the Financial Growth Cycle" (1998) 22 Journal of Banking & Finance 613. The authors note that small businesses can be considered to have a financial growth cycle in which the financial needs and options of the business change "as the business grows, gains further experience, and becomes less informationally opaque". Smaller businesses at the beginning of their life cycle must rely upon insider finance, trade credit, and/or "angel" finance for their initial financing needs. As the business matures, the firm may gain access to intermediated sources of capital, including venture capital or bank loans. Ultimately, if the business is successful and continues to mature, they may gain access to the public markets. *Ibid. at 622.*

[55] Angel financing refers to capital contributions from individual sources who typically do not assume any of the day-to-day management functions of the enterprise. Such investments are often undertaken by friends and family of the business owner, clients of the business, or other individuals who have been solicited for support. See G.W. Fenn *et al., The Economics of the Private Equity Market (Staff Study of the Board of Governors of the Federal Reserve System, November 1995). See also J. Lerner, "'Angel' Financing and Public Policy: an Overview" (1998) 22 Journal of Banking & Finance 773* and S. Prowse, "Angel Investors and the Market for Angel Investments" (1998) 22 Journal of Banking & Finance 785.

[56] J.G. MacIntosh, "Venture Capital Exits in Canada and the United States" in P.J.N. Halpern, ed., *supra note 32 at 279. MacIntosh argues that there are two prices that "dominate" the decision for venture capital firms in choosing whether to invest in a company: "the entry (purchase price) and* the exit price", both of which are "inextricably linked". *Ibid at 279. See also D.J. Cumming & J.G. MacIntosh, "Venture Capital Investment Duration in Canada and the United States" University of Toronto Capital Markets Institute Working Paper (May 18, 2000), online: http:// www.rotman.utoronto.ca/cmi/papers/paper5-1.htm.*

[57] Milhaupt, *supra note 2 at 178. See also A. Godley & D.M. Ross, "Introduction: Banks, Networks, and Small Firm Finance" in A. Godley and D.M. Ross, eds., Banks, Networks and Small Firm Finance (London: Frank Cass, 1996) at 1.*

[58] For example, in the Province of Ontario, statistics indicate that small businesses (defined as businesses with fewer than 100 employees) account for 53 per cent of private sector employment and constitute 98 per cent of all firms operating in the province. Ontario, Committee on Access to Capital, *Financing Jobs and Growth, Report to the Minister of Finance, February 1997 at 2, online: http://www.gov.on.ca/FIN/english/ ss-engli.pdf. A recent federal report has produced similar results, finding that of the approximately 928,000 business enterprises in Canada, 75.4 per cent had fewer than 5 employees, 17.8 per cent had 5 to 19 paid employees, 4.3 per cent employed between 20 and 49 people, and the remaining 2.4 per cent of firms had more than 50 employees. See Riding, supra note 29 at 9.*

[59] Benveniste *et al., supra note 47 at 742. See also M. Pagano, "The Floatation of Companies on the Stock Market: A Coordination Failure Model" (1993) 37 European Economic Review 1101 at 1125.*

[60] Section 58 of the *Securities Act (Ontario), supra note 3, requires that a prospectus shall contain a certificate signed by the chief executive officer, the chief financial officer and any two directors of the issuer duly authorized to sign and any person or company who is a promoter of the issuer stating that the information contained in the prospectus "constitutes full, true and plain disclosure of all material facts relating to the securities offered by this prospectus as required by Part XV of the Securities Act and the regulations thereunder".*

[61] Recall the discussion on the pricing implications of informational asymmetry and the consequences of adverse selection, *supra notes 7–16 and accompanying text. As Leland and Pyle have suggested, the effects of intermediation on such factors are twofold: either sellers of securities with favourable risk characteristics (or at a minimum, quality information) will prefer to deal through an informationally-efficient intermediary rather than subjecting their securities to an uninformed marketplace of investors; and second, with the segmentation of quality issuers through the services of an intermediary, the "average" price of the remaining securities in the market will be less valuable, creating inducements to the use of an intermediary by "the next best risks". Ultimately, it is predicted that eventually sellers of all risk categories of securities will sell through* an intermediary with the exception of those at the "bottom of the barrel". Leland and Pyle, *supra note 11 at 384.*

[62] See G.L. Priest, "A Theory of the Consumer Product Warranty" (1981) 90 Yale L.J. 1297 at 1303.

[63] See S.J. Grossman, "The Informational Role of Warranties and Private Disclosure About Product Quality" (1981) 24 J.L. & Econ. 461, for an excellent discussion of the role of consumer product warranties in resolving information problems in a market for goods or services.

[64] S.J. Choi, "Gatekeepers and the Internet: Rethinking the Regulation of Small Business Capital Formation" (1998) 2 J. Small & Emerging Bus. L. 27 at 45.

[65] S.J. Choi, "Market Lessons for Gatekeepers" (1998) 92 Nw. U. L. Rev. 916 at 927-928 [Choi, "Market Lessons"]. George Stigler has presented a similar formula for sellers "searching" for the most favourable price through a market canvass. He argued that for sellers, the "optimum amount of *search will be such that the marginal cost of search equals the expected* increase in receipts". See G.J. Stigler, "The Economics of Information" (1961) 69 Journal of Political Economy 213 at 216. While Stigler looked at the value of advertising in eliminating uncertainty, in our situation, the "search" costs of gathering and evaluating information by third parties by *issuers are ultimately impounded into the market price of the security.*

[66] See *infra note 98 to 102 and accompanying text, which examines the reluctance of investment banks to underwrite smaller issues of securities.*

[67] R. Kraakman, "Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy" (1986) 2 J.L. Econ. & Org. 53 at 57 [Kraakman, "Gatekeepers"].

[68] According to Charles Darwin, the "fight or flight" mechanism is a natural bodily response to external stress, which triggers coping or exit strategies *to avert danger. C. Darwin, The Expression of the Emotions in Man and Animals (1872).*

[69] Professor Kraakman presents an interesting set of descriptive analogies for *the different options open to gatekeepers, labeling gatekeepers that disrupt conduct by excluding services as "bouncers" and gatekeepers that work to change present or expected conduct as "chaperones". See Kraakman, "Gatekeepers", supra note 67 at 63.*

[70] A more benign signal from the underwriter might be evident in the *underwriter's choice of underwriting agreement. For example, the underwriter might choose to pursue an agency deal as opposed to a firm commitment underwriting.*

[71] T.S. Campbell & W.A. Kracaw, "Information Production, Market Signalling, and the Theory of Financial Intermediation" (1980) 35 Journal of Finance 863 at 864. The authors, in attempting to refine the proposition of Leland and Pyle that information production is a sufficient condition for the emergence of intermediaries in otherwise imperfect capital mar*kets, offered that intermediation occurs as a result of a confluence of complementary explanations. They argued that intermediaries emerge as "because the production of information, the protection of confidentiality, the provision of transaction services, as well as other intermediary services, are naturally complimentary activities". While this author cannot dispute the logic of their contention, ultimately it will be argued that the complementary functionality does not present a persuasive argument against disintermediation, given the impact of the current market for intermediary services on specific constituencies (notably SMEs) by such conglomeration. Moreover, their general argument raises issues of conflicts of interest in large investment banking institutions, a topic that extends far beyond the scope of this paper.*

[72] For a fuller discussion on this point, see Kraakman, "Gatekeepers", *supra note 67 at 66–74.*

[73] Section 127 of the *Securities Act (Ontario), supra note 3, permits the Commission to make one or more of the following orders: the suspension, restriction or termination of a person or company's registration, cease trading orders, the revocation of previously-granted exemption orders, a reprimand, orders forcing a person from resigning their position* as director or officer of an issuer and/or prohibiting that person from *becoming a director or officer of an issuer.*

[74] Statutory civil liability for misrepresentation in the Ontario *Securities Act can be found in sections pertaining to prospectus disclosure (s. 130), offering memorandums (s. 130.1) and circulars (s. 131). Section 130(1) provides for a common law right of action for damages or rescission against (a) the issuer or selling security holder, (b) the underwriter, (c) every director of the issuer, (d) "every person or company whose consent has been filed", and (e) "every person or company who signed the prospectus or the amendment to the prospectus". Subsection 130(2) provides an exemption from liability where the investor purchased with knowl-*

edge of the misrepresentation. Liability under section 130 is further limited by the "due diligence" defences provided in subsections 130(3) where the issuer/intermediary "had no reasonable grounds to believe and did not believe there had been a misrepresentation" or 130(4) and (5) where it must be established that the intermediary (a) "failed to conduct such reasonable investigation as to provide reasonable grounds for a belief that there had been no misrepresentation"; or (b) believed there had been a misrepresentation. Pursuant to subsection 130(8), all of the parties listed in subsection (1) are subject to joint and several liability.

[75] The common law liability of an intermediary can be founded in negligence and requires the plaintiff to establish that the intermediary breached a duty of care owed to the investor. *Hedley Byrne & Co. v. Heller & Partners Ltd.*, [1964] A.C. 465 (H.L.) was the seminal case which first permitted a third party to assert a claim against an intermediary (in this case, a solicitor) for negligent loss owing to a misstatement . Ultimately, the issue falls to that of the existence of a duty of care to the plaintiff. The test for breach of duty of care in this context was set out in *Anns v. Merton London Borough Council*, [1978] A.C. 728 (H.L.) by Lord Wilberforce. It involves a two-step analysis which inquires as to whether, first, there is a sufficient relationship of proximity between the parties, and second, whether there are any considerations which ought to negative, or to reduce or limit the scope of the duty or the class of person to whom it is owed. The case was adopted and applied by the Supreme Court of Canada in *Kamloops (City) vv. Nielsen*, [1984] 2 S.C.R. 2, 10 D.L.R. (4th) 641, and *Hercules Managements Ltd. v. Ernst & Young*, [1997] 2 S.C.R. 165, 146 D.L.R. (4th) 577. In the latter case, the Supreme Court of Canada elaborated upon the second branch of the test in *Anns* by recognizing the existence of broad policy considerations that militate against the imposition of liability on third-party intermediaries (in that case, auditors). After reviewing the arguments for imposing a broad duty of care on auditors, the court held (at para. 36) that "the possible repercussions of exposing auditors to indeterminate liability are significant" and thus allowed policy considerations to negate the *prima facie* duty of care. The case was not without its detractors, and there are persuasive arguments that intermediaries such as auditors (and lawyers) should anticipate the fact that their financial statements (and legal opinions) will be examined by investors in the process of determining the investment quality of the issuer: See, for example, M.E. Deturbide, "Liability of Auditors — *Hercules Managements Ltd. et. Al. v. Ernst & Young et al.*" (1998) 77 Can. Bar Rev. 260 at 263.

[76] Kraakman, "Gatekeepers", *supra* note 67 at 56.

[77] *Ibid.* at 57.

[78] *Ibid.* See also J.C. Coffee, "No Soul to Damn, No Body to Kick: An Unscandalized Inquiry into the Problem of Corporate Punishment" (1981) 79 Mich. L. Rev. 386. Kraakman also alludes to the "administrative" costs of such an approach. See G.S. Becker, "Crime and Punishment: An Economic Approach" (1968) 76 Journal of Political Economy 169.

[79] R.H. Kraakman, "Corporate Liability Strategies and the Costs of Legal Controls" (1984) 93 Yale L.J. 857 at 889–890 [Kraakman, "Corporate Liability"].

[80] Z. Goshen & G. Parchomovsky, "On Insider Trading, Markets, and 'Negative' Property Rights in Information" (2001) 87 Va. L. Rev. 1229 at 1263.

[81] R.J. Gilson & R.H. Kraakman, "The Mechanisms of Market Efficiency" (1984) 70 Va. L. Rev. 549 at 604.

[82] Mann argues that the reputation of the intermediary (which he calls "third-order information") verifies the assertions of the intermediary (second-order information), which in turn verifies the informational assertions of the principal ("first-order information"). R.J. Mann, "Verification Institutions in Financing Transactions" (1999) 87 Geo. L.J. 2225 at 2270.

[83] See O.E. Williamson, "Credible Commitments: Using Hostages to Support Exchange" (1983) 73 Amercian Economic Review 519.

[84] "Underwriter" is defined in section 1(1) of the *Securities Act (Ontario)*, *supra* note 3, as

> (a) a person or company whose interest in the transaction is limited to receiving the usual and customary distributor's or seller's commission payable by an underwriter or issuer,
>
> (b) a mutual fund that, under the laws of the jurisdiction to which it is subject, accepts its shares or units for surrender and resells them,
>
> (c) a company that, under the laws of the jurisdiction to which it is subject, purchases its shares and resells them, or
>
> (d) a bank listed in Schedule I or II to the Bank Act (Canada) with respect to the securities described in paragraph 1 of subsection 35(2) and to such banking transactions as are designated by the regulations.

For comparative purposes, the term "underwriter" is defined in the U.S. *Securities Exchange Act of 1933* as "any person who has purchased from [a company] with a view to, or offers to sell for [a company] in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking." 15 U.S.C. § 11b(a)(11) (2001).

[85] See S.N. Allen, "A Lawyer's Guide to the Operation of Underwriting Syndicates" (1991) 26 New Eng. L. Rev. 319. Allen provides a detailed overview of the underwriter's role in the public offering process, including a detailed examination of the division of labour amongst the various firms operating within a typical underwriting syndicate.

[86] *U.S. v. Morgan*, 118 F. Supp. 621 (SD NY, 1953) at 650. The case involved an anti-trust suit initiated by the U.S. federal government against seventeen investment banking firms accused of various violations of the Sherman Anti-Trust law. It provides an excellent historical and functional overview of the role of investment banks in the American economy.

[87] See, for example, section 25(1) of the Ontario *Securities Act*.

[88] The extensive IDA Rulebook is available online at http://www.ida.ca/Files/Regulation/RuleBook/RuleBook_en.pdf.

[89] S.P. Ferris, J.S. Heller, G.A. Wolfe & E.S. Cooperman, "An Analysis and Recommendation for Prestigious Underwriter Participation in IPOs" (1992) J. Corp. L. 581 at 583.

[90] J.J. Hass, "Small Issue Public Offerings Conducted Over the Internet: Are They 'Suitable' for the Retail Investor?" (1998) 72 S. Cal. L. Rev. 67 at 96.

[91] See D.C. Langevoort, "Angels on the Internet: The Elusive Promise of 'Technological Disintermediation' for Unregistered Offerings of Securities" (1998) 2 J. Small & Emerging Bus. L. 1 at 13 [Langevoort, "Angels"].

[92] See Allen, *supra* note 85 at 340–1, who explains that roadshow presentations:

> … consist mostly of short speeches and presentations by the issuer's CEO, CFO and other senior management members, along with one-on-one meetings with particular investors expected to make large purchases of securities in the offering. The presentations give details about the offering and the issuer, and may include oral material that is not contained in the prospectus. Slide shows and video tapes are often used but the preliminary prospectus contained in the registration statement is the only written material that is distributed to potential investors. Counsel for the issuer and underwriters often render general advice concerning the contents of the materials used in the roadshow, but rarely actually attend the presentations.

[93] Rousseau, *supra* note 29 at 245–6.

[94] Ferris *et al.*, *supra* note 89 at 584.

[95] Rousseau, *supra* note 29 at 246.

[96] Gilson & Kraakman, *supra* note 81 at 620.

[97] See the discussion pertaining to the direct and indirect costs of an initial public offering, *supra* at notes 29–56 and accompanying text.

[98] In the words of the OSC Task Force on Small Business Financing, *supra* note 1 at 96–97:

> … with few exceptions, Canadian dealers have little inclination to assist SMEs in raising equity capital, whether this be in an underwriting capacity, as market-makers in actively promoting the purchase by their clients of securities in SMEs or even in analyzing these types of investment opportunities on their clients' behalf.

[99] In their informative article on the topic, Ferris *et al.* explain that economists typically organize investment banking institutions into a "simple binary classification … prestigious and non-prestigious". This binary classification system is used to examine the performance characteristics of IPOs underwritten by the two groups. Although the authors imply that the binary classification system is flawed (arguing instead for "an expanded classification design that would place underwriter prestige along a continuum"), they nevertheless recognize that there are perceived differences in quality between various investment banking institutions. They consequently attempt to set out a series of factors that represent the attributes of prestigious investment banks. Such factors include the ability to certify the quality of information released by the issuer (measured in terms of the investment bank's own reputational capital), their ability to

handle the due diligence investigation, the level of aftermarket support an investment dealer can offer the issuer following the offering, and finally, the "clientele factor" which divides and ranks investment banks in terms of their client base (with more prestigious dealers selling primarily to institutional investors, and lesser dealers selling to individual retail investors). See Ferris *et al., supra note 89 at 586–588.*

100 For such institutions, the relatively small commissions relative to the amount of labour involved in the due diligence process for a small and as yet unproven corporate entity combined with their reluctance to stake their reputations on such an undertaking militates against their participation. See Hass, *supra note 90 at 95.*

101 See Ferris *et al., supra note 89 at 585.*

102 OSC Task Force Report, *supra note 1 at 33. The Report recognizes that although there are some Canadian dealers active in the market for smaller-scale public offerings, they do not have distribution networks comparable to their American or Canadian large-scale counterparts. See also J. MacIntosh, "Legal and Institutional Barriers to Financing Innovative Enterprise in Canada" School of Policy Studies, Queen's University, October 1994 at 140–142.*

103 Hass, *supra note 90 at 100–102.*

104 In the present context, value creation by intermediaries relates to the question of whether the participation of the intermediary in a particular business transaction increases the value of the transaction (net of the fees charged by the intermediary) as a result of that intermediary's participation in the transaction. For an extended analysis on the concept of value creation by intermediaries, see R.J. Gilson, "Value Creation by Business Lawyers: Legal Skills and Asset Pricing" (1984) 94 Yale L.J. 239.

105 V.P. Alboini, "Due Diligence and the Role of the Securities Lawyer" (1982) 6 Can. Bus. L.J. 241.

106 S.M. Beck, "The Role and Responsibilities of the Lawyer in the Securities Law Context," in *Recent Securities and Corporate Law Developments, Advice to My Client, Public Seminar of the Canadian Bar Association (May 8, 1980) at I-135.*

107 Kraakman, "Gatekeepers", *supra note 67 at 83. Professor Kraakman introduces the analogy of the nightclub bouncer to describe the ex ante enforcement strategy of the securities lawyer as market gatekeeper.* Purdy Crawford has made similar comments, instead creating an analogy between the role of the securities lawyer and that of a "referee". Crawford argues that "[t]hrough their exposure to and management of novel legal issues, securities lawyers gain an appreciation for the bounds of acceptable legal conduct and a refined sense of the norms and mores that govern the capital markets. As such, securities practitioners participating in current transactions are effectively serving as referees of future transactions". P. Crawford, "A Vision of the Securities Law Practitioner as Legal, Business, and Social Architect" in *Securities Law in the Modern Financial Marketplace, Special Lectures of the Law Society of Upper Canada 1989 (Toronto: DeBoo, 1989) 133 at 140.*

108 Professor Gilson's argument is essentially that business lawyers operate *as "transaction cost engineers", by effectively reducing the costs to their clients associated with business transactions such as the corporate takeover. Gilson suggests that lawyers fulfill this role by creating and sus*taining an environment in which the ability of the various parties to a transaction are discouraged from engaging in opportunistic behaviour by encouraging the production and exchange of truthful information. *See Gilson, supra note 104.*

109 In contrast with the transaction cost economics in Professor Gilson's *approach to value creation by lawyers in the takeover context, Professor* Utset suggests that the securities lawyers in the initial public offering context act as "production cost engineers" based on their role in the creation of intangible bundles of information and property rights in securities where a public market for such had not previously existed. See M.A. Utset, "Producing Information: Initial Public Offerings, Production Costs and the Producing Lawyer" (1995) 74 Or. L. Rev. 275.

110 Beatty & Welch, *supra note 40.*

111 J. Fisch, "Can Internet Offerings Bridge the Small Business Capital Barrier?" (1998) 2 J. Small & Emerging Bus. L. 57. The VC "realizes" its investment by cashing out during the IPO process or becoming a significant shareholder in the newly-public company.

112 Indeed, it has been suggested that their ability to reduce "the asymmetry *of information between the issuing firm and investors and financial specialists such as underwriters and auditors, venture capitalists are able to lower the costs of going public". W.L. Megginson & K.A. Weiss,* "Venture Capitalist Certification in Initial Public Offerings" (1991) 46 Journal of Finance 879 at 901. The authors found empirical "evidence of significantly lower underpricing and underwriter compensation" in VC-backed IPOs versus non-VC-backed IPOs.

113 A.L. Shapiro, "Digital Middlemen and the Architecture of Electronic Commerce" (1998) 24 Ohio N.U. L. Rev. 795.

114 It has been suggested that because distribution expenses can account for *50 to 80 per cent of the final cost of consumer products, the creation of* distribution channels for consumer goods devoid of the friction caused by traditional middlemen can create tremendous cost savings for consumers. See M.N. Cooper, "Inequality in the Digital Society: Why the Digital Divide Deserves All the Attention It Gets" (2002) 20 Cardozo *Arts & Ent. L.J. 73 at 94.*

115 The process of financial disintermediation has been occurring in the *banking sector for almost 30 years, as ordinary depositors who once kept their savings in deposit accounts at financial institutions shifted these assets into other investment vehicles such as money market funds which were not subject to the interest rate ceilings of the highly-regulated banking sector. See J. Fisher, E. Harshman, W. Gillespie, H. Ordower, L. Ware & F. Yeager, "Privatizing Regulation: Whistleblowing and Bounty Hunting in the Financial Services Industries" (2000) 19 Dick. J. Int'l L. 117 at 124.*

116 Peer-to-peer software and the proliferation of online music swapping services such as Napster, Gnutella, and Morpheus have presented a direct threat to the monopoly previously held by record companies and recording artists' associations. See D. Skolnik, "Private Use Out of Control: Disintermediation in the Music Business, While the Bands Play On" (2000) 5 I.P.L. Bull. 13.

117 Distance education has been presented as an alternative for individuals who do not have the proximity, time or finances to justify enrollment in traditional post-secondary educational institutions.

118 An important issue in the United States is the system of managed care organizations (MCOs) and the possibility that disintermediated, patient-*directed plans could emerge to reduce the reliance (and concurrent inefficiencies and quality control problems) engendered by the use of MCOs. See J.V. Jacobi & N. Huberfeld, "Quality Control, Enterprise Liability, and Disintermediation in Managed Care" (2001) 29 J. L. Med. & Ethics 305.*

119 Because increasing levels of economic activity are taking place over the Internet and through other disintermediated forums, the traditional objects of taxation have become highly decentralized and transient. See A.J. Cockfield, "Transforming the Internet into a Taxable Forum: A Case Study in E-Commerce Taxation" (2001) 85 Minn. L. Rev. 1171. See also U.S. Department of the Treasury, Office of Tax Policy, "Selected Tax Policy Implications of Global Electronic Commerce" (1996), online: http://www.fedworld.gov/pub/tel/internet.txt.

120 Akerlof, *supra note 8 at 488.*

121 Kraakman, "Gatekeepers", *supra note 67 at 93.*

122 See Choi, "Market Lessons", *supra note 65 at 927.*

123 Rousseau, *supra note 29 at 244.*

124 Allebach, *supra note 19.*

125 J.K. Winn, "Catalytic Impact of Information Technology on the New International Financial Architecture" (2000) 34 Int'l Law. 137 at 141.

126 Langevoort, "Angels," *supra note 91 at 15.*

127 Langevoort, "Information Technology", *supra note 4 at 753.*

128 Rousseau, *supra note 29 at 238.*

129 H.C Fontana, "Securities on the Internet: World Wide Opportunity or Web of Deceit?" (1998) 29 U. Miami Inter-Am. L. Rev. 297 at 306–7.

130 D.E. Giddings, "An Innovative Link Between the Internet, the Capital Markets and the SEC: How the Internet Direct Public Offering Helps Small Companies Looking to Raise Capital" (1998) 25 Pepp. L. Rev. 785.

131 It has been suggested that the maintenance costs of a Web-based system *of disclosure is approximately $200: G. Sinclair, "Internet Direct Public Offerings: New Opportunities for Small Business Capital Finance"* (2001) 27 Man. L.J. 297 at 309, citing S.K. Gregg, "Regulation 'A' Initial Public Offerings on the Internet: A New Opportunity for Small Business?" (1997) 1 J. Small & Emerging Bus. L. 417 at 433. This can be contrasted with the cost of the paper-based model, for which printing costs alone have estimated to be in the area of $75,000 and up. See *supra note 31.*

132 "SEDAR" stands for the System for Electronic Data Analysis and Retrieval, the electronic filing database created in 1996 by National Instrument 13-101.

133 United States Securities and Exchange Commission, *Use of Electronic Media for Delivery Purposes, 60 Fed. Reg. at 53, 468.*

134 See National Policy 11-201, "Delivery of Documents by Electronic Means" (1999), 22 O.S.C.B. 8156, online: http://www.osc.gov.on.ca/en/Regulation/Rulemaking/Policies/11-201_19991215.html, and National Policy 47-201, "Trading in Securities Using the Internet and Other Electronic Means" (1999) 22 O.S.C.B. 8170, online: http://www.osc.gov.on.ca/en/Regulation/Rulemaking/Policies/47-201_19991217.html.

135 On the use of this term, see L. Lessig, "The Path of Cyberlaw" (1995) 104 *Yale L.J. 1743 and T. Frankel, "The Internet, Securities Regulation, and* Theory of Law" (1999) 73 Chicago-Kent L. Rev. 1319 at 1336.

136 A recent article by Professor Anand has argued that the current "regulation by analogy" approach is "in the long term, incompatible with a world in which corporations communicate electronically with investors and other interested parties". She contends that "the CSA's concern that investors have access to a paper version of a document which is identical to the electronic version is an unnecessary and potentially misguided *requirement". A.I. Anand, "Securities Law in the Internet Age: Is 'Regulating By Analogy' the Right Approach?" (2001) 27 Queen's L.J. 129 at 132.*

137 In the United States, the first Internet roadshow was undertaken by Net Roadshow Inc., See Net Roadshow Inc., SEC No-Action Letter, 1997 SEC No-Act. LEXIS 864 (Sept. 8, 1997).

138 The first Canadian roadshow was undertaken on behalf of Celestica Inc. in its initial public offering in the Spring of 1998. See M. Deslauriers, *"Taking Your IPO Roadshow Online" Osler Technology Business Briefing (Fall 1998), online: http://www.osler.com/publications/Tech*nology/tb_brief.htm.

139 H. de Azevedo Ferreira Franca, "Legal Aspects of Internet Securities Transactions" (1999) 5 B.U.J. Sci. & Tech. L. 4 at para. 19.

140 B.C. Eddy, "Internet Road Shows: It's Time to Open the Door for the Retail Investor" (2000) 25 J. Corp. L. 867 at 877.

141 S.S. Svahn, "Greater Investor Outreach at the Click of a Mouse: Internet and Closed-Circuit Roadshows Should Reach Retail Investors" (1999) 65 Brook. L. Rev. 249 at 279.

142 National Policy 47-201, *supra note 134. The text of subsection 2.7(2) pertaining to roadshows reads as follows:*

(2) The securities regulatory authorities do not object in principle to an issuer or underwriter holding a roadshow over the Internet during the "waiting period" in connection with a distribution of securities. However, care should be taken to ensure that the transmission of a roadshow over the Internet complies with the "waiting period" requirements and securities legislation generally. In this connection, the following guidelines are recommended:

1. Pursuant to securities legislation, a copy of the filed preliminary prospectus is required to be made available to each viewer before each roadshow transmission, and each transmission should contain visual statements emphasizing that the information conveyed through the roadshow does not contain all of the information in the preliminary prospectus, which should be reviewed for complete *information. A copy of the preliminary prospectus could be sent electronically to viewers in accordance with the guidelines contained in National Policy 11-201.*

2. Electronic access to the transmission of a roadshow over the Internet should be controlled by the issuer or underwriter conducting the roadshow, using such means as password protection, in order to ensure that all viewers are identified and have been offered a preliminary prospectus. Any persons or companies that are "prospective purchasers" as referred to in the provisions of securities legislation relating to roadshows may be invited to view the road*show.*

3. An issuer or underwriter should not transmit a roadshow to a person or company unless that person or company has agreed not to *copy or further distribute the transmissions. An issuer or under*writer should take reasonable steps to prevent copying or further distribution of transmissions.

143 W.K. Sjostrom, "Going Public through an Internet Direct Public Offering: A Sensible Alternative for Small Companies" (2001) 53 Fla. L. Rev. 529 at 560.

144 Note, "Auctioning New Issues of Corporate Securities" (1985) 71 Va. L. Rev. 1381 at 1385.

145 Michael Evelyn of W.R. Hambrecht & Co., quoted in G. Wirth, "After *Taking Heat for Its Dutch Auction Model, W.R. Hambrecht May Have the Last Laugh: Freddie Mac buys in, and Wall Street firms may be* next," Investment Dealers Digest, 11 December 2000.

146 See B. Biais & A.M. Faugeron-Crouzet, "IPO Auctions: English, Dutch, . . . French, and Internet" (2002) 11 Journal of Financial Intermediation 9.

147 Examples include the Santa Monica California-based Direct Stock Market (http://www.dsm.com) and Financial Web (http://www.financialweb.com).

148 Fisch, *supra note 111 at 76–77.*

149 See Z.J. Acs & F.A. Tarpley, "The Angel Capital Network (ACE-Net)" (1998) 22 Journal of Banking & Finance 793.

150 See Web site of Grant Street Group, online: http://www.grantstreet.com/perl/bond.pl.

151 As at December 20, 2002, the site states that is has conducted 5,790 auctions for 517 issuers, raising over $3.48 trillion.

152 Sjostrom, *supra note 143 at 591.*

153 Mann, *supra note 82.*

154 N. Tait & N. Denton, "ASX to Offer Fund Raising on the Internet" Financial Times, 12 June 1997, available online (WL) at 11034279.

155 Examples include Wit Capital (http://www.witcapital.com), E*Offering, which is 28 per cent owned by E*Trade, (http://www.eoffering.com) and W.R. Hambrecht & Co.'s OpenIPO.

156 See Wilhelm, *supra note 5.*

157 L.A. Mondschein, "The Solicitation and Marketing of Securities Offerings through the Internet" (1999) 65 Brook. L. Rev. 185 at 241–2.

158 See Fontana, *supra note 129 at 312.*

159 Sjostrom, *supra note 143 at 533.*

160 The first Canadian Internet DPO was conducted by e-minerals Exploration Corporation in 1999. The second was the FLOWTHRU.COM Limited Partnership, which conducted an initial public offering later that year.

161 D.C. Langevoort, "Behavioural Theories of Judgment and Decision Making in Legal Scholarship: A Literature Review" (1998) 51 Vand. L. *Rev. 1499. Langevoort argues that where judges, policymakers, and academics make predictions concerning Mental models of individual and social behavior that are "naï ve and intuitive [and] without any strong empirical grounding, they are susceptible to error and ideological bias". He further states that "something more rigorous is thus expected when normative claims are advanced, and the place of the social sciences has expanded in legal discourse to satisfy this expectation". (Ibid. at 1499–1500).*

162 See *ibid., for a useful introduction to the subject matter as it impacts upon the various branches of the law.*

163 Akerlof, *supra note 8 at 500.*

164 Indeed, the law of express and implied warranties, typically restricted to the realm of sales of tangible goods, has been introduced into the law of financial intermediation. See, for example, *CBS Inc. v. Ziff-Davis Publ. Co. (1990) 554 N.Y.S. 2d 449 at 450, which discussed the applicability of express warranty claims by an investor who questioned the accuracy of financial information.*

165 L.E. Mitchell, "The Importance of Being Trusted" (2001) 81 B.U. L. Rev. 591 at 599. Regarding the work of Luhmann, the author cites N. Luhman, "Trust and Power" (1979).

166 L.E. Mitchell, "Fairness and Trust in Corporate Law" (1993) 43 Duke L.J. 425 at 432.

167 *Ibid.*

168 F. Fukyama, "Differing Disciplinary Perspectives on the Origins of Trust" (2001) 81 B.U. L. Rev. 479 at 479-480.

169 *Ibid. at 480.*

170 T. Frankel, "Trusting and Non-Trusting on the Internet" (2001) 81 B.U. L. Rev. 457 at 459 [Frankel, "Trusting"]. As the author explains: "if the risks and costs of reducing the risks to the trusted party are higher than the benefits, the party will not interact. If the costs to the trusted party of establishing its trustworthiness are higher than the benefits, it will not interact. The parties will enter into a relationship, however, if third parties, including the government through the law, reduces their costs, bridging the gap." (*Ibid. at 460)*

171 D.C. Langevoort, "Selling Hope, Selling Risk: Some Lessons for Law from Behavioural Economics about Stockbrokers and Sophisticated Customers" (1996) 84 Cal. L. Rev. 627 at 636. Langevoort introduces rationales for such behaviour that extend beyond the desire to make money, such as the play value of gambling.

172 See H. Nissenbaum, "Securing Trust Online: Wisdom or Oxymoron?" (2001) 81 B.U. L. Rev. 635 at 646-648.

173 G.R. Shell, "Opportunism and Trust in the Negotiation of Commercial Contracts: Toward a New Cause of Action" (1991) 44 Vand. L. Rev. 221 at 258.

174 Talley has suggested that a society that benefits from "extralegal norms of honest disclosure might ironically favour more expensive legal regulation than would a similarly situated society in which weak or nonexistent". E. Talley, "Disclosure Norms" (2001) 149 U. Pa. L. Rev. 1955 at 1958-9. While the author is correct in his suggestion that the extralegal contribution to the gatekeeper liability regime acts as a useful complement to formal legal sanctions, the argument can be turned on its head to suggest that the formal legal regime should instead operate to complement the more powerful informal (or "extralegal") sanctioning instruments at the disposal of private sector actors.

175 There are credible reasons for suggesting that investor protection through informational efficiency is not the only laudible objective of securities market regulation. It is suggested that the overall health of the national economy requires the ability of innovative and untested (and thereby potentially risky) young companies to be permitted access to the capital markets. See the discussion regarding the effects of small businesses on the economy, *supra* note 58 and accompanying text. Of course, a marked deterioration in informational efficiency would make it difficult (if not impossible) to achieve the goal of capital raising by small businesses. Hence, the need to achieve a workable balance between the competing objectives.

176 Choi, "Market Lessons", *supra* note 65 at 934.

177 See *supra*, note 75.

178 The changes were proposed in Bill 198, *Keeping the Promise for a Strong Economy Act (Budget Measures), 2002*, 3d Sess., 37th Leg., Ontario, 2002 (assented to 9 December, 2002), S.O. 2002, c. 22. "Expert" is defined in section 138.1 of the Act as:

> a person or company whose profession gives authority to a statement made in a professional capacity by the person or company, including, without limitation, an accountant, actuary, appraiser, auditor, engineer, financial analyst, geologist or lawyer.

179 Frankel, "Trusting", *supra* note 170 at 470.

180 Estey suggests that much of the material information contained in a prospectus "depends upon a business analysis of the issuer and of the industry of which the issuer is a part, together with an analysis of what will affect the price of the offered securities in the public securities markets", and that such matters "are beyond the competence of a lawyer as such". Instead, he suggests that responsibility for all such matters should be that of the underwriter, and lawyers should therefore refrain from giving opinions on such matters, instead restricting their comments to the legal aspects of the securities offering and of the due diligence review. W.M. Estey, *Legal Opinions in Commercial Transactions*, 2nd ed. (Toronto: Butterworths, 1997). Similarly, the Legal Opinion accord of the Business Law Section of the American Bar Association has also suggested that "negative assurance statements" are generally inappropriate. See Committee on Legal opinions Third Party Legal Opinion Report, including the Legal Opinion accord, of the Section of Business Law, American Bar Association, (1991) 47 Bus. Law. 167 at 28. The contrary argument must be made in the context of the present discussion that it is precisely such functions that the securities lawyer can and should attempt to fulfill, to the extent possible and in conjunction with other experts such as the company's management and auditors. It is hereby suggested that the competence of the experienced securities lawyer extends beyond attending to merely the legal minutiae of an offering; indeed, counsel is typically highly attuned to such matters and is capable of rendering an opinion or outsourcing to the appropriate entity (another lawyer at the firm or an external party) where the matter extends beyond their competence.

181 K.S. Okamoto, "Reputation and the Value of Lawyers" (1995) 74 Or. L. Rev. 15 at 27.

182 *Ibid.* at 28.

183 *Ibid.* at 28–29.

184 *Ibid.* at 29.

185 See the discussion, *supra* note 28 on the relaxation of financial statement requirements for some smaller issuers who lack the financial history for comprehensive audits.

186 The recent involvement of the global accounting firm Arthur Andersen in the bankruptcy of the multinational energy trading firm Enron has revealed the possibility that individual members of an auditing firm might have deliberately destroyed documents and attempted to otherwise shelter financial information concerning such matters as off-balance sheet partnerships from the investing public. The U.S Justice Department recently thereafter took the unprecedented step of issuing an indictment against the auditing firm for, among other things, destruction of incriminating evidence.