

The impact of multiple regulators on the cost of raising capital for small and medium-sized businesses

Overview and key findings

Using publicly available data, research by the Canadian Bankers Association (CBA) demonstrates that the existing decentralized structure of securities regulation has a substantial negative impact on all Canadian firms' attempts to raise capital. This burden, however, falls disproportionately on small and medium-sized businesses (SMEs). This decentralized regulatory structure limits SMEs' ability to tap into all of Canada's capital market and it imposes high costs on smaller firms.

In particular, the CBA's research has demonstrated that:

- There are clear scale economies in developing and filing securities offerings. Offering expenses decrease relative to the size of the offering as the offering size increases. A \$1 million offering incurs four times the costs, relative to the amount of capital raised, as does a \$10 million offering.
- If these firms seek to raise capital in all 13 jurisdictions rather than just one, we estimate that regulation-related costs would double, to 16% of capital in the case of a firm seeking to raise \$1 million and to 4% of capital in the case of a firm seeking to raise \$10 million.
- In practice, these regulatory costs limit the number of jurisdictions in which firms seek to raise capital.

Regulatory costs for SMEs are the crux of the matter

In the debate about the best structure for securities regulation in Canada, opponents of a single or common regulator have often cited concerns that such a body would be dominated by Ontario, given the volume of capital market activity in that province relative to the rest of Canada and that the Ontario Securities Commission is the largest existing securities regulator in the country. With the development of the Crawford Panel model for a common regulator, with its governance structure giving an equal voice to each participating jurisdiction, those concerns have been addressed.

Proponents of a decentralized system of securities regulation have also claimed, however, that while a single regulator might be advantageous for large firms, small issuers would be hurt because a single regulator would focus on larger firms and ignore the particular needs of smaller issuers. In that vein, it is also claimed that allowing every jurisdiction to tailor rules to their own circumstances leads to greater innovation and lower cost of capital for SMEs. Moreover, given that the Canadian economy has a greater proportion of SMEs than does the United States, it is crucial to employ a regulatory structure that is appropriate for the kinds of firms that typify the Canadian marketplace.

To test these assertions empirically, and in particular, to determine the impact of multiple jurisdictions on the cost of raising capital and on SMEs' decisions about where to raise capital, the CBA set out to three answer three questions:

- Does the requirement to file in multiple jurisdictions increase the cost of raising capital?
- Is the cost borne disproportionately by smaller firms?
- How much does it end up costing issuers?

Source of data

SEDAR (System for Electronic Document Analysis and Retrieval) is a public electronic database of issuers of securities which proved to be a useful resource in trying to answer these questions. In order to analyse the relationship between the expenses of a securities offering and the number of jurisdictions in which it is filed, CBA staff collected the following public data from offering prospectuses published on the SEDAR website over the period January 2002 – May 2006:

- Size of the offering (i.e. how much money the firm set out to raise);
- The expenses associated with the offering (i.e. administrative, legal, and other costs associated with the offering, excluding the underwriter's commission); and
- The number of jurisdictions in which it has filed the prospectus.

To make the data as homogenous as possible, data were only collected from prospectuses that met the following criteria:

- Long-form prospectus offerings (as opposed to short-form);
- Offerings from corporations (as opposed to income trusts);
- Corporations headquartered in Canada; and
- Issuers listing (or proposing to list) on either the TSX or the TSX Venture Exchange

Also excluded were those offerings where the offering expenses were not clearly stipulated in the prospectus and/or cases where the prospectus only indicated the “remaining” offering expenses to be paid from the proceeds of the offering (thus inferring that the total cost of the offering was something greater than the stated amount). In addition, efforts were made to exclude those issues that had notably different regulatory and reporting requirements such as:

- junior capital pool entities;
- follow-on offerings from large, publicly-trade enterprises (to the extent that such offerings were made using long-form prospectuses); and
- offerings of special purpose entities established by large, publicly-traded enterprises (e.g. securitization vehicles) to the extent that such entities are formed as corporations.

In addition, after an initial review of the data, a few exceptionally large IPOs (e.g. ING Canada) were removed as they were clear outliers in terms of the size of the offering. After making these adjustments, this left 299 records for analysis.

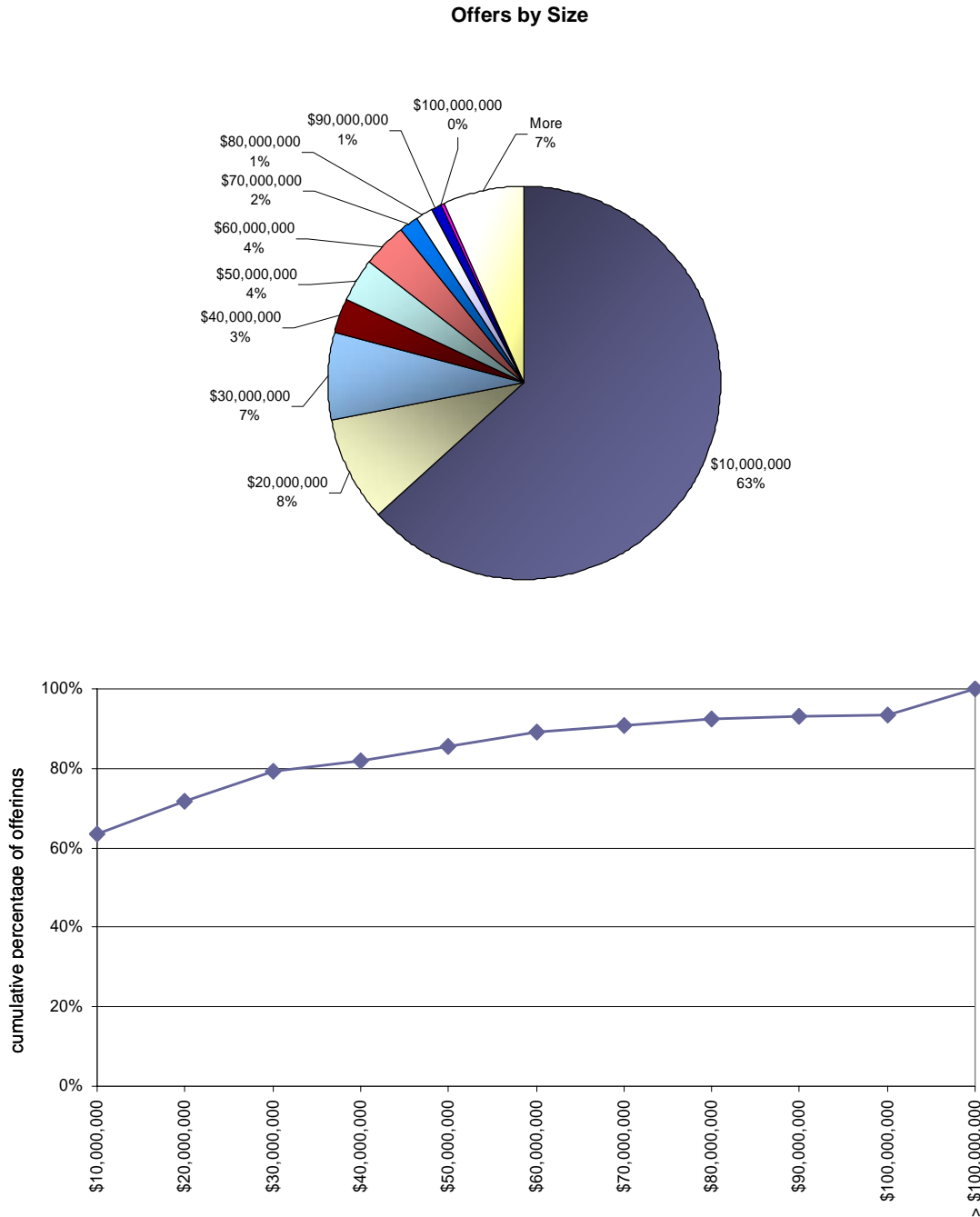
As shown in the Figure 1, the resulting constituent firms were primarily small to mid-sized public issuers. The median offering size was \$6 million and nearly 2/3 of offerings were for less than \$10 million. This represented a good database upon which to analyze the impact on the cost of raising capital by SMEs.

The geographical distribution of these issuers by home jurisdiction is as follows:

British Columbia	91 issuers	Manitoba	3 issuers
Alberta	85 issuers	Nova Scotia	2 issuers
Ontario	83 issuers	Saskatchewan	1 issuer
Quebec	32 issuers	Yukon	1 issuer

As noted above, the sample of issuers was designed to be as homogeneous as possible so that we could better isolate the effects of multiple jurisdictions on issuer expenses. Interestingly, even a more comprehensive analysis of the SEDAR database for the four largest jurisdictions (Ontario, Quebec, Alberta and British Columbia) showed that the profile of issuers varied only modestly amongst those provinces. Broadly speaking, the profile of issuers was the same, that is, small firms primarily involved in the resource, industrial and FIRE (finance, insurance and real estate) sectors.¹

Figure 1



¹ Canadian Bankers Association, "Proposals for and Efficient an Effective Regulatory System in Canada," Submission to the Wise Persons' Committee, June 2003, p. 14-15.

Isolating regulation-related expenses

In conducting this research, the CBA had to clarify a number of issues with respect to the data. As the issue under consideration is costs associated with the regulatory environment and structure, it is important to understand the extent to which expenses associated with marketing the offering (i.e. “roadshow” expenses) are included in this figure and/or influence its value. The elements that are included in “offering expenses” are often not elaborated upon in the prospectus, and where some elaboration is made, the elements listed are typically legal expenses, audit fees, and regulatory filing fees. The fact that they are never mentioned suggested they were either elsewhere captured or immaterial. Research conducted by public offering research firm IPO Vital Signs on U.S. IPOs suggests that roadshow expenses are immaterial. IPO Vital Signs conducted research on the elements that went into offering expenses in U.S. public offerings as well as the information that was disclosed on those expenses. It found that only 2% of all IPOs in the U.S. in 2005 explicitly listed roadshow/marketing expenses as an offering expense item. More commonly, it was rolled into miscellaneous expenses with lists of other ancillary expenses, which collectively constituted 10% of the average IPO offering expenses and 5.5% of the median IPO offering expenses. Moreover, since the average offering size exceeds the median, this suggests that roadshow expenses actually increase in significance as the offering size increases. This suggests that the latter figure (5.5%) is more likely to be representative of Canadian offerings which tend to be smaller than those in the U.S.²

In light of the above, the CBA is confident that the expenses data are related primarily to the regulatory environment and structure and not marketing expenses.

Isolating the independent roles of issue size and number of jurisdictions on expenses

The second data issue which needed to be addressed was the relationship between issue size and the number of jurisdictions in which an offering is filed. One would expect that larger issues would be filed in more jurisdictions to tap a larger investor base and, to some extent, the higher expenses are due to the issue size rather than the number of jurisdictions. While there is little available research on what motivates large issuers to file in most or all jurisdictions, a likely explanation is that for large issuers, the compliance and reputation risks associated with not filing nationally and inadvertently running afoul of a small jurisdiction’s securities laws outweigh the incremental expense of extending the offering to those smaller jurisdictions, especially when coupled with the scale economies that offerings seem to display.

In order to address this issue, the database was sorted to identify sets of offerings of identical sizes but made available in different numbers of jurisdictions. Those sets were then analyzed individually by comparing the average offering expenses for offerings filed in the fewest number of jurisdictions against the average expenses for all other offerings of that size. Figure 2, below, shows the calculation for a group of offerings at the \$2.5 million level. In this particular example, the average offering expenses for firms filing in more than 2 jurisdictions is 37% higher than the average for firms filing in only 2 jurisdictions, which in this size band is the fewest number of jurisdictions. For three firms, however, the added cost exceeded 70%.

² For more information see, IPO Vital Signs “Tallying the Costs of Going Public: IPO Legal and Audit Fees” (www.ipovital signs.com/PressReleases/9_26_05_Article.htm) and “Part II Expenses: The Lesser Fees” (www.ipovital signs.com/PressReleases/11_07_05_Article.htm).

Figure 2

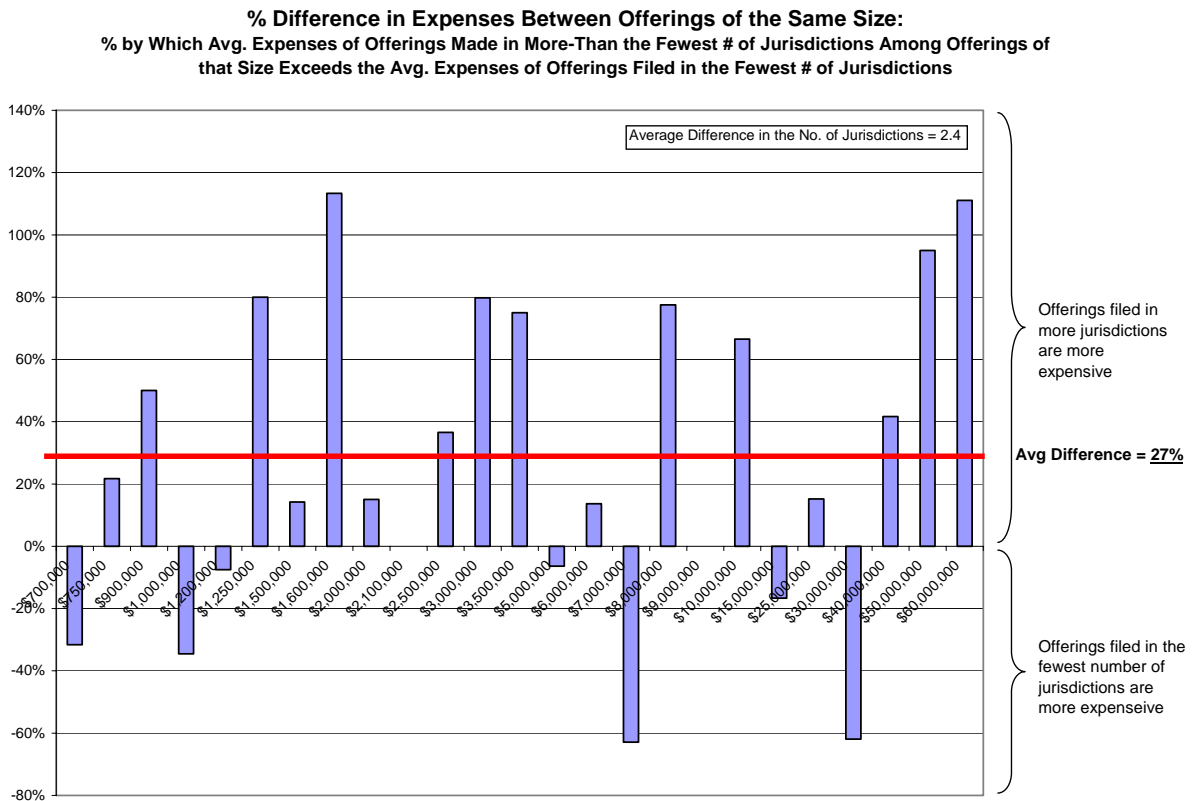
No. of Jurisdictions in which the Offering is Filed	Offering Expenses
2	\$ 80,000
2	\$ 95,000
3	\$102,500
4	\$ 50,000
4	\$145,000
4	\$150,000
5	\$150,000

Average = \$87,500 ("Group 1")
 Average = \$119,500 ("Group 2")

Figure 3 below performs a similar exercise for every size class. While there is significant variation, it is clear that there is an upward bias – offering expenses for Group 2 firms will typically exceed those for Group 1. On average, offering expenses for Group 2 firms are 27% higher.

The conclusion is clear – for any particular size of offering, firms attempting to raise capital in more jurisdictions typically must pay more in offering expenses.

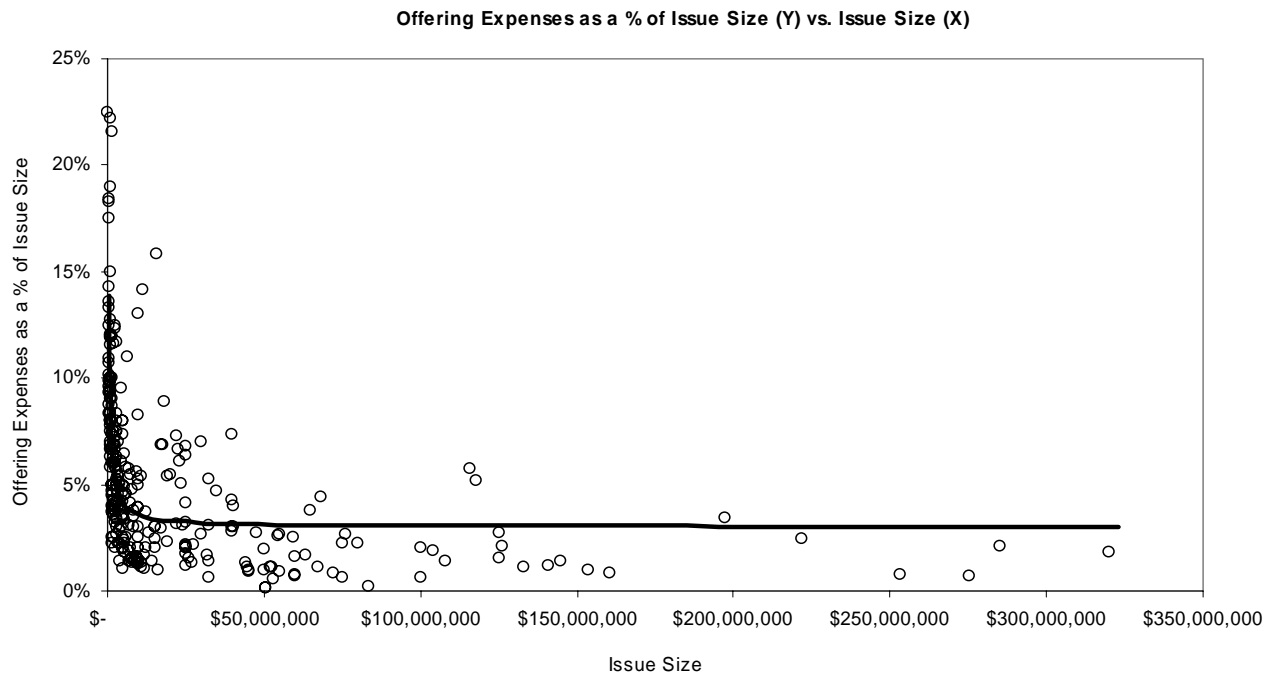
Figure 3



Economies of scale

The above discussion has dealt with two of the potential concerns about the quality of the data. As noted, the CBA is confident that the data represent primarily costs associated with the regulatory environment and structure and that the number of jurisdictions has an impact on regulatory costs. The next matter to determine is whether regulatory compliance expenses exhibit economies of scale. Simply put, there is a view that small issuers tend to pay more than large issuers when adjusted for size. That trend is clearly present in this dataset, with offering expenses as a percentage of offering size falling rapidly for offerings under \$10 million and then continuing to fall but at a much slower rate (Figure 4).

Figure 4



Note: One observation above \$350 million was removed for scaling purposes.

Based on the above data, a strong case can be made that:

- For any particular size of offering, filing in more jurisdictions increases the expenses associated with completing an offering.
- There exist very pronounced economies of scale in offering expenses – these expenses decrease relative to the size of the offering as the offering size increases.

Estimating the incremental cost of filing in 13 jurisdictions

The next question to tackle is the incremental effect on regulatory costs of adding each additional jurisdiction. This calculation could help to determine the total incremental filing costs of dealing with 10 or 13 jurisdictions as opposed to only one.

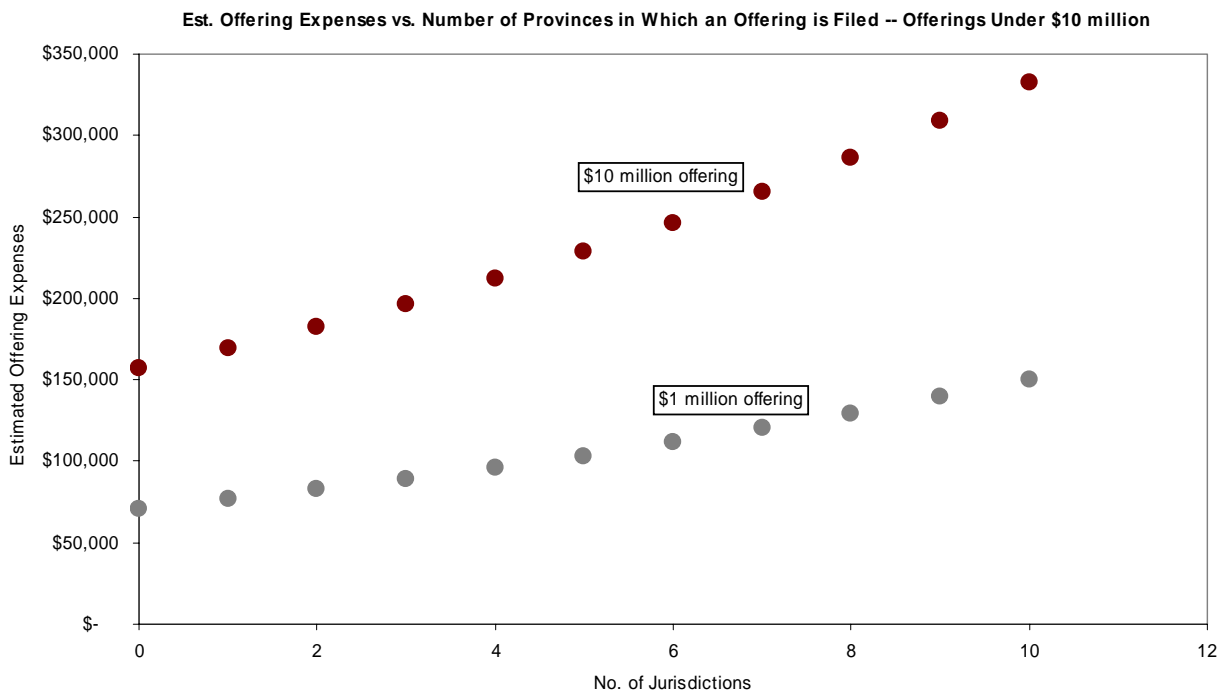
As is shown in Figure 3, the cost of filing in more than the minimum number of jurisdictions is about 27% higher than filing in the minimum number. For each size band, however, there is only a small difference in the actual number of jurisdictions. What is needed, therefore, is some other way of determining how costs increase when an issuer chooses to file in all jurisdictions as opposed to only one.

To do this, a regression equation has been fitted in which total costs are determined by issue size and the number of jurisdictions. Recognizing that the size of offering and the number of jurisdictions are related to some extent, the CBA looked at some sub-samples of the full data set to ensure that any estimates of the coefficient on the number of jurisdictions would be as robust as possible. Two sub-samples of data were analysed to focus in specifically on smaller public offerings:

- offerings of under \$10 million;
- offerings filed in fewer than 10 jurisdictions.

The results of the analysis for offerings of under \$10 million are shown in Figure 5 below. In both cases, all variables remain statistically significant at a 95% confidence level. The model continues to display the same two properties – economies of scale in offering expenses and increasing expenses associated with increasing numbers of jurisdictions. The additional costs associated with the offering increase by approximately 7%³ for every additional jurisdiction in which a firm files its prospectus so it can solicit investment.

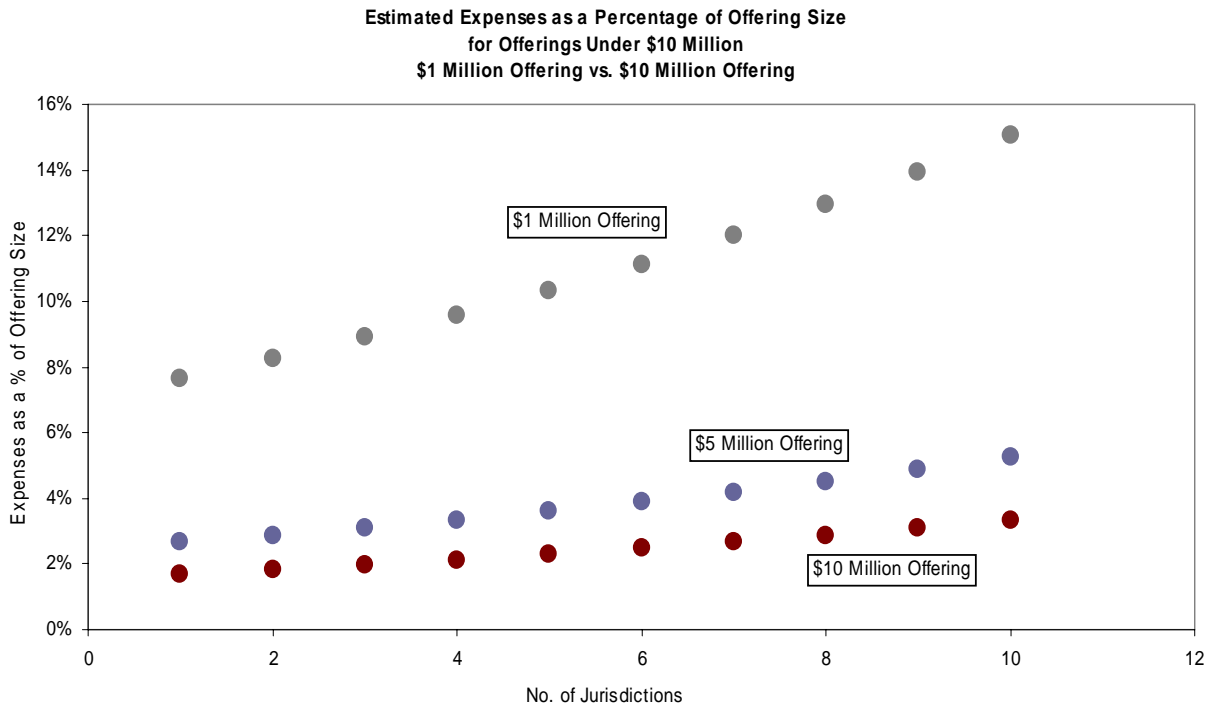
Figure 5



³ 6.4% for offerings filed in under 10 jurisdictions, and 7.5% for offerings of under \$10 million.

The model also displays the economies of scale noted earlier. As offering size increases, the estimated offering expenses decrease. This is evident in Figure 6 below.

Figure 6



Conclusion

Based on the information and analysis of prospectus data on offering expenses, there is a compelling case that the existing decentralized system of securities regulation is far from being small business friendly:

- For any particular size of offering, filing in more jurisdictions increases the regulation-related expenses associated with completing an offering. Indeed, going from one jurisdiction to all 13 will double the regulation-related expenses associated with the offering.
- There are clear scale economies in developing and filing securities offerings. Offering expenses decrease relative to the size of the offering as the offering size increases. A \$1million offering incurs four times the costs, relative to the amount of capital raised, as does a \$10million offering.
- In practice, these regulatory costs limit the number of jurisdictions in which firms seek to raise capital.

Regression analysis suggests that for offerings of any given size, each additional jurisdiction increases offering expenses by approximately 7%. Consequently, filing in 13 jurisdictions rather than one approximately doubles the regulatory costs of raising capital.

From a policy perspective, this would clearly indicate that jurisdictional fragmentation of the securities market in Canada is creating friction in Canadian capital markets, forcing entrepreneurs seeking capital to weigh the advantages of making their offer available more broadly against the costs that are incurred with each additional provincial border that is crossed.