

# Making Securities Regulation Work for BC's New Economy

An initiative of the British Columbia Securities Commission

Our mission as a regulator is twofold: to protect the investing public, and to foster a dynamic and competitive securities industry that provides investment opportunities and access to capital. Consequently, we have a responsibility to understand and respond to major sectors of the BC economy to ensure they are not hampered by ineffective securities regulation. The NEAT initiative is an important step in this direction.





**MAKING SECURITIES REGULATION WORK  
FOR BC'S NEW ECONOMY**

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## Overview

The British Columbia Securities Commission is committed to being a responsive and effective regulator. In part, this entails listening to the industries we regulate. The New Economy and Adoption of Technologies (NEAT) initiative reflects this commitment. ■ While it is focused on the technology sector, NEAT addresses regulatory issues that affect business in general, and will therefore have benefits well beyond the scope of this initiative's mandate.

### Why We Need to Respond to BC's New Economy

The Commission's establishment of the NEAT initiative recognizes the growing importance of the technology sector in BC as an employer and contributor to provincial GDP. This sector has grown more than twice as fast as the economy as a whole over the past decade.

However, statistics show that BC has had a limited ability to attract sufficient venture capital to early-stage technology companies. This is a large stumbling block and the province is now falling competitively behind other jurisdictions that are mobilizing more venture capital to build their new economy sectors. In response, the Commission, through NEAT, has worked to identify ways it can help start-up companies in

high technology and other emerging sectors find financing for their businesses by ensuring they are not hampered in their capital raising efforts by unnecessary regulations.

### The NEAT Public Consultation Process

Since it was formed in late 2001, NEAT has conducted an extensive industry consultation process. This has included one-on-one interviews and focus groups with over a hundred industry executives, advisers and investors, executive forums held through leading provincial technology and biotechnology organizations, and an online survey gathering comprehensive feedback from a wide range of industry participants. The NEAT committee analyzed all of the information received, with input from its industry advisers.

## PARTICIPANT INPUT AND COMMISSION RESPONSES

The objectives of the NEAT initiative are to identify regulatory barriers facing technology-based companies in the province and improve the Commission's understanding of how these firms operate so it can be more responsive and effective. Therefore, the information in the report is organized into two categories directly relating to these objectives:

1. barriers to doing business resulting from excessive or irrelevant securities regulation and requirements, and disparity among regulators
2. barriers to doing business resulting from a lack of new economy business knowledge and experience among regulators, investors and industry

Under each general “barrier” category (noted above), we have described the specific problems participants identified along with their suggestions. The concerns presented in this report reflect purely the views and experiences of industry participants.

## PARTICIPANT FEEDBACK

Barrier #1

**Excessive or irrelevant securities regulation and requirements, and disparity among regulators**

Overall, regulatory burden is seen by industry as a deterrent for businesses that wish to access the public markets and a frustration for those that do. Participants indicated that ineffective securities regulation poses a major barrier to their ability to do business and raise capital in BC. Too many regulations, and regulations that vary among Canadian regulators and the US Securities and Exchange Commission, were seen as large obstacles. This is especially the case for early-stage new economy businesses with limited resources. In the participants' view, the greatest hurdles to doing business and raising capital are:

- Burden of regulations in general
- Escrow policy as a business deterrent
- Disparity in continuous disclosure requirements
- Irrelevant disclosure documents and review process
- Prohibitive TSX Venture listing requirements
- High cost and inequity of underwriter requirement
- Ineffectiveness of capital pool company program

## COMMISSION RESPONSES TO BARRIER #1

In the preceding information provided to NEAT by industry participants, the comments and suggestions entail looking at two distinct areas of regulatory change: revising specific regulatory requirements, and harmonizing and streamlining requirements among regulators. The Commission has addressed these separately in the following responses.

### COMMISSION RESPONSES: REGULATORY CHANGE

The Commission will consider:

- ▶ revisiting the mandatory escrow policy and giving further consideration to removing or limiting its application
- ▶ permitting electronic delivery of financial statements by posting them on a website as an added alternative to current methods of delivery
- ▶ continuing to work with the TSX Venture to review feedback from participants

### COMMISSION RESPONSES: HARMONIZATION AND STREAMLINING

The Commission will consider:

- ▶ working with other regulatory bodies to implement harmonized and streamlined regulations that are applied consistently and take into consideration the nature of new economy businesses

Since the start of the NEAT initiative, other regulatory bodies and organizations have identified and undertaken initiatives to address a number of the same industry concerns that were expressed by NEAT participants relating to regulatory burden and lack of harmonization. These include major projects that aim to simplify, streamline and harmonize regulations, such as the Commission's two-year Deregulation Project and the CSA's Uniform Securities Legislation Project, as well as proposed national instruments to simplify reporting obligations for small businesses, entitle SEC-registered companies to rely on their US financial statements, and allow the use of the Internet for disclosure and delivery of documents.

## PARTICIPANT FEEDBACK

Barrier #2

Lack of new economy business knowledge and experience among regulators, investors and industry

Participants expressed that an across-the-board lack of understanding of their industry sector and its unique business and financial characteristics has a very detrimental effect on their ability to raise capital and grow new

economy businesses in BC. In particular, the following problems were identified:

- Lack of new economy business and finance experience among regulators and exchange staff
- Lack of new economy business and finance experience among analysts
- Foreign investors' lack of familiarity with BC regulatory requirements
- Local investors' lack of understanding of the new economy sector
- Lack of business and capital market experience in BC's new economy

**COMMISSION RESPONSES TO BARRIER #2**

**COMMISSION RESPONSES: EDUCATION**

The Commission will consider:

- ▶ developing an education program to increase awareness of regulatory requirements and the characteristics of new economy businesses targeting analysts, issuers, investors, entrepreneurs, and regulators, including Commission staff
- ▶ reviewing the Commission's current methods of communicating information to the new economy sector and develop new ways to ensure industry is aware of regulatory developments that directly affect it

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The NEAT initiative reflects the Commission's commitment to industry and the investing public to be proactive in understanding the unique challenges facing BC's technology industry. NEAT's efforts will enable us to work toward ensuring that irrelevant or excessive securities regulations do not impede the continued growth of this important sector of our provincial economy, while maintaining investor confidence.

## *Overview*

The British Columbia Securities Commission is committed to being a responsive and effective regulator. In part, this entails listening to the industries we regulate. For example, our relationship with the mining industry has a long history. We have developed expertise in this sector over the years and have put in place regulatory requirements tailored to its special circumstances. Similarly, our counterparts in other regions have developed expertise to meet the needs of the major industries in their jurisdictions.

■ The New Economy and Adoption of Technologies (NEAT) initiative reflects our intent to continue to be responsive to industry. BC's economy has evolved and so must we. Today, the technology sector, while still relatively young, has become a significant contributor to the province's development and prosperity. The BC government has set an objective to have BC globally recognized as one of the world's top ten technology centres by 2006. ■ Our mission as a regulator is twofold: to protect the investing public, and to foster a dynamic and competitive securities industry that provides investment opportunities and access to capital. Consequently, we have a responsibility to understand and respond to major sectors of the BC economy to ensure they are not hampered by ineffective securities regulation. The NEAT initiative is an important step in this direction. It is among four key projects outlined in our 2002-2005 strategic plan that address the problem of excessive regulatory burden on the securities market. It is also consistent with the province's larger initiative to promote cooperation between government and private enterprise to assure the continued growth of the new economy sector. ■ While this initiative is focused on the technology sector, it addresses regulatory issues that affect business in general, and will therefore have benefits well beyond the scope of NEAT's mandate.

## *Why We Need to Respond to BC's New Economy*

### The "New Economy"

According to 'Canadian Economy Online,' the Government of Canada's online resource for information about the national economy: "The term 'New Economy' describes aspects or sectors of an economy that are producing or intensely using innovative or new technologies. This relatively new concept applies particularly to industries where people depend more and more on computers, telecommunications and the Internet to produce, sell and distribute goods and services."

### Increasing Importance of the New Economy Sector in BC

The Commission's establishment of the NEAT initiative recognizes the growing importance of the technology sector in BC as an employer and contributor to provincial GDP. The BC Premier's Technology Council projects the technology industry will be the most significant industrial sector of the province in the next 5-10 years. In 2001 high technology industries contributed \$3.3 billion to provincial GDP.

According to BC Stats, the BC high technology sector has grown more than twice as fast as the economy as a whole over the past decade. Although the industry, particularly high tech manufacturing, has been adversely affected by the overall downturn in global technology markets in the last few years, the number of high tech businesses in the province continued to grow in 2001 to a total of 11,699 businesses. Excluding establishments with no employees (53.4% of all businesses in the high tech sector), employment in the high tech sector rose by 5.2% in 2001 to 45,550 workers, accounting for one in nine net new jobs in the province, compared with employment growth in all industries in BC of only 1.4%.

Information recently released by T-Net, a leading web portal for the BC high tech industry, cited revenues for BC's top 100 technology companies of \$4.8 billion in 2001, up 1.04% over 2000. Nationally, the Deloitte & Touche 2002 Fast 50, an annual ranking of Canada's fastest growing technology companies, showed British Columbia's prominence as a Canadian high tech hub increased in 2001.

### Significant Challenge to Capital Raising for Emerging Companies

One of the BC new economy sector's major challenges is that it is falling behind competitive jurisdictions in its ability to mobilize investment:

DOLLARS OF PRIVATE EQUITY INVESTED IN EARLY-STAGE TECHNOLOGY COMPANIES

Region	Population	\$ Invested in 2000/2001	\$ per capita
BC	4.1 million	589.0 million	143
Alberta	2.9 million	207.0 million	71
Ontario	11.8 million	5.0 billion	421
Canada	31.0 million	10.3 billion	332
Washington	5.9 million	3.8 billion	645
California	34.0 million	56.4 billion	1,658

*Business in Vancouver, May 14-20, 2002 Issue 655. "BC needs to feed growing appetite for venture capital," Brent Holliday*

The province's limited ability to attract sufficient venture capital to early-stage technology companies is a significant stumbling block to the growth of its new economy sector. In response, the Commission, through NEAT, has worked to identify ways it can help start-up companies in high technology, and other emerging sectors, operate and find financing for their businesses by ensuring they are not hampered in their capital raising efforts by unnecessary regulations.

## *The NEAT Industry Consultation Process*

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**Formed in late 2001, NEAT's mandate as outlined in the Commission's 2002 three-year strategic plan was as follows:**

“... to open the channels of communication with firms operating in this (the technology) sector, and identify candidates to act as external advisers to the BCSC on regulatory issues affecting these firms. The NEAT group's focus this year will be to:

- ▶ Identify regulatory barriers facing these firms, such as impediments to capital raising. We will identify potential areas of concern through industry surveys, focus groups, one-on-one interviews, and consulting with industry associations.
- ▶ Improve our understanding of how these firms operate, e.g., the business cycles of these firms, unique challenges facing them such as the need for large amounts of capital to fund R&D commitments. We will assess what the BCSC can do to assist these firms to operate their businesses, either by eliminating unnecessary regulatory requirements or revising existing requirements.”

Accordingly, this report is the result of an extensive industry consultation process, in which NEAT took the following steps to achieve its mandate:

- ▶ From December 2001 through March 2002 NEAT held one-on-one interviews and focus groups with more than one hundred individuals either holding senior positions in the technology sector or serving as advisers to, or investors in, the industry.
- ▶ Executive forums were also held through both the BC Technology Industries Association (BCTIA) and the BC Biotech Alliance.
- ▶ An online survey announced through the media and posted on the Commission's public website from mid-January to the end of February 2002 resulted in NEAT receiving further comprehensive feedback from a wide range of industry participants.

Combined, this industry input assisted the Commission in developing an overall picture of the relationship of BC's new economy with public investors, capital markets, the Commission and other regulators, government bodies, and investment industry participants such as the brokerage community and analysts.

As a result, this is a report about new economy business as described by new economy participants. It identifies their major challenges and suggestions for addressing those challenges. The report then outlines the Commission's responses in the areas of regulatory change, harmonization and streamlining, and education, based on the analysis of the NEAT committee with input from its industry advisers (the members are listed below).

## *New Economy and Adoption of Technologies Committee*

### Commission Members

Stephen Wilson	<i>Executive Director</i>
Derek Patterson	<i>Project Chair</i>
Anthony Wong	<i>Lead Counsel</i>
Pamela Egger	<i>Senior Legal Counsel, Corporate Finance</i>
Rosann Youck	<i>Senior Legal Counsel, Legal and Market Initiatives</i>
Brenda Lea Brown	<i>Communications Liaison</i>
Nimmi Khangura	<i>Research Analyst</i>

### Industry and Exchange Advisers

Harry Jaako	<i>Co-founder, Chair and co-CEO of Discovery Capital Inc.; board member, TSX Group, Inc.</i>
David Raffa	<i>Partner, Catalyst Corporate Finance Lawyers; specialist in corporate finance issues for emerging technology companies</i>
Bruce Schmidt	<i>Founding Director of Genome BC; Past Chair of the BC Biotech Alliance</i>
Derek Spratt	<i>Founder, Past CEO and Chair, and Chief Strategist of Intrinsic Software Inc.</i>
Mike Volker	<i>Chair, Vancouver Angels Network and BC Advanced Systems Institute; Director, University-Industry Liaison Office, Simon Fraser University</i>
Darryl Yea	<i>Chair and Chief Executive Officer, Datawest Solutions Inc., former member, VSE (now TSX Venture Exchange) board of governors</i>
Susan Copland	<i>Manager, National Policy, TSX Venture Exchange</i>

## PARTICIPANT INPUT AND COMMISSION RESPONSES

**HOW THE INFORMATION IS ORGANIZED** The following information synthesizes all of the input gathered from industry participants by NEAT over almost a year-long period. The objectives of the NEAT initiative are to identify regulatory barriers facing technology-based companies in the province and improve the Commission's understanding of how these firms operate so it can be more responsive and effective. Therefore, the information in the report is organized into two categories directly relating to these objectives:

1. barriers to doing business resulting from excessive or irrelevant securities regulation and requirements, and disparity among regulators
2. barriers to doing business resulting from a lack of new economy business knowledge and experience among regulators, investors and industry

The information in the report is at times complex and overlapping. We have organized it using the most reader-friendly format possible. Under each general "barrier" category (noted above), we have described the specific problems participants identified along with their suggestions. As individual Commission responses often address several problems raised by participants, these responses are grouped at the end of each major section.

**PARTICIPANT FEEDBACK** It is important to keep in mind that the concerns presented reflect purely the views and experiences of industry participants. While potential solutions to these lie with a number of different entities — regulators, the provincial and federal governments, and other organizations — participants often do not distinguish between solution providers. To them, which policy maker is responsible does not matter as much as the fact that problems exist and need to be fixed. We have intentionally not reorganized participants' feedback according to which authority has ultimate responsibility, in order to present this information accurately from industry's perspective.

**COMMISSION RESPONSES** In the Commission's responses we have noted which entity has responsibility for addressing particular concerns. Some issues participants brought forward are already being addressed by the Commission and other bodies, and those initiatives are described. The fact that industry participants may not be aware of such measures is itself a concern and has been addressed in the Commission's education and communications responses.

## PARTICIPANT FEEDBACK

Barrier #1

Excessive or irrelevant securities regulation and requirements, and disparity among regulators

### Burden of regulations in general

Overall, regulatory burden is seen by industry as a deterrent for businesses that wish to access the public markets and a frustration for those that do. Participants indicated that ineffective securities regulation poses a major barrier to their ability to do business and raise capital in BC. Too many regulations, and regulations that vary among Canadian regulators and the United States Securities and Exchange Commission (SEC), were seen as large obstacles. Participants stated that the number, complexity and lack of harmonization of regulations increases not only the time they must spend to ensure compliance but their legal and accounting expenses. Such expenses, in turn, deplete precious capital that could otherwise be invested in business operations. This is especially the case for early-stage new economy businesses with limited resources.

Participants' suggestions for addressing this problem:

- **Harmonize regulations across Canadian jurisdictions first, then with the SEC.** Larger new economy businesses would benefit from one set of regulations that is applied consistently with other Canadian jurisdictions, Canadian exchanges and the SEC.
- **Deregulate in BC.** Smaller new economy companies doing business only in BC favoured reducing regulations in BC over harmonizing across jurisdictions. However, if all jurisdictions could deregulate on a harmonized basis, it was felt all new economy businesses would benefit.
- **Increase enforcement rather than the number of regulations.** An approach of legislating to the lowest common denominator is seen as a hindrance to business; instead, industry suggests more emphasis be placed on enforcement to eliminate the lowest common denominator.

### Escrow policy as a business deterrent

Securities regulators usually require a company making an initial public offering (IPO) to enter into an escrow agreement between its principals and an escrow agent that restricts the principals from selling those securities until they are released from escrow.

Participants felt the current escrow policy hinders new economy businesses in several ways. One problem they experience is that mandatory escrow deters top candidates from becoming company directors because their securities will be restricted. This is seen to have a detrimental effect on small new economy businesses which need quality management. Participants also saw the current escrow regime as being unfair by restricting the securities of those who have done all the hard work to build the company, while allowing immediate liquidity for others who have not participated in the company's development.

Another problem expressed was that current escrow policy prevents new economy businesses from obtaining much-needed financing from venture capital companies. Participants felt that many venture capital companies, especially in the US, are not interested in nurturing Canadian new economy businesses because the venture capitalists' securities would be subject to mandatory escrow on completion of the investee company's IPO. (In the US, escrow is not mandated by regulation so venture capital investors can reap the benefits of their investment immediately on completion of a successful IPO.) Participants related that by deterring venture capital, current escrow policy can become a driver of business decisions in that lack of funding can result in a company's inability to go public, in turn, forcing management to sell the business or its technology asset.

Participants' suggestions for addressing this problem:

- **Limit escrow to securities not obtained for fair value.** Since management is often the greatest asset of a new economy business, the structure of escrow should be changed so it does not deter potential top candidates from becoming company directors. Currently, all directors are required to escrow their securities regardless of the value paid for the securities. If a director acquires securities for fair value, those securities should not be subject to escrow.
- **Remove the escrow requirement for longtime investors.** Venture capital companies and other angel investors who nurture a new economy business for a significant period of time prior to its IPO should not be required to escrow their securities. This would help attract capital to businesses in the very early stages when a new economy business needs it most. As well, it would provide greater access to capital by removing a key deterrent facing US venture capital companies — the escrow regime — who could otherwise build relationships with Canadian start-ups. This approach would also recognize those shareholders who contribute significant value to a business in the form of early investment when the risk is highest.
- **Remove the regulated escrow requirements completely.** Rather than having regulators mandate the lock-up of securities at the time of an IPO, the system used in the US should be adopted whereby the company negotiates with the market and arm's length parties (underwriter and significant shareholders) to determine appropriate agreements.

### Disparity in continuous disclosure requirements

Continuous disclosure refers to all legally required ongoing public disclosure by reporting companies. Participants said the major obstacle in their continuous disclosure obligations is the disparity between Canadian and US accounting standards: Canadian generally accepted accounting principles (GAAP) are based more on an approach of spirit and intent, and US GAAP on highly detailed specific requirements. The difference between these two reporting philosophies results in a major expense for businesses that operate and report in both jurisdictions, requiring Canadian and US auditors. Participants said for businesses that cannot afford the expense of complying with both standards, cross-border business opportunities become limited.

Although it was noted that the dual reporting process becomes less of a burden once it is set up, the cost of initially setting up and subsequently maintaining the process remains onerous, particularly for small and emerging businesses.

Participants' suggestions for addressing this problem:

- **Create simpler financial reporting requirements.** To ease the high expense of reporting requirements for smaller new economy businesses, simplified financial reporting requirements should be established, for example, in the Management Discussion and Analysis (MD&A).
- **Accept US accounting standards.** If these were accepted in Canada without a reconciliation to Canadian standards, new economy businesses required to file in Canada and the US could significantly reduce their compliance expenses and more easily market themselves cross-border.

### Irrelevant disclosure documents and review process

Participants told NEAT that much of the information a new economy business must put in disclosure documents such as prospectuses and offering memorandums is not relevant in a business' early stages. In particular, historical information such as financial statements are not necessarily accurate indicators of a business' current status.

Participants said investors, who are the intended audience for disclosure documents, do not read them because the documents are too long and complex, and instead rely on their brokers or the Internet for information. It was suggested that excessive disclosure information has the effect of "burying" important information.

Participants also felt the current review process for disclosure documents is too long because regulators base their evaluations on criteria not relevant to new economy businesses. They complained that being caught up in lengthy regulatory reviews causes companies to miss out on important opportunities to raise capital.

In addition, many participants stated that the financial burden of preparing disclosure documents would be eased if they could deliver their documents over the Internet and eliminate printing and mailing costs.

Participants' suggestions for addressing this problem:

- **Permit new economy businesses to use a simplified offering document.** The simplified document would be tailored to new economy businesses as follows: no longer than ten pages, financial statement requirement limited to a one-year audit, and requiring only disclosure of information that is relevant for a new economy business, including resumes of management, management's track record of public company successes and failures, outstanding share capitalization, company business plan, cash flow projections, and criminal checks.
- **Permit delivery over the Internet.** Businesses should be permitted to deliver prospectuses, financial statements and other continuous disclosure documents to investors over the Internet to eliminate the cost of printing and mailing.

### Prohibitive TSX Venture listing requirements

A concern of participants was that the listing requirements of the TSX Venture Exchange (TSX Venture) are too stringent to allow early-stage new economy businesses to participate in the public market. It was felt that unless a company with a potentially viable business can meet the minimum listing requirements, or is able to enter into an arrangement with a venture capital company, it would likely dissolve due to lack of funding before having an opportunity to prove itself.

While participants recognized that good corporate governance is important to the success of a company even at the junior stage, some were concerned Toronto Stock Exchange (TSX) standards that may not be pertinent or achievable for smaller new economy businesses are applied on a blanket basis by the TSX Venture.

Those participants who had completed a transaction classified as a reverse takeover or a change of business through the TSX Venture expressed frustration about the requirement for shareholder approval when there was no real change in control of the company.

Participants also thought it redundant for the TSX Venture and the Commission to require two separate personal information forms for insiders containing identical information.

Participants' suggestions for addressing this problem:

- **Establish more flexible listing requirements.** This would allow early-stage new economy businesses to gain greater access to public capital instead of being dependent on venture capital companies. Also, it could bring the TSX Venture more business and enhance its reputation.
- **Remove the shareholder approval requirement for certain transactions.** This would reduce the time and cost to complete transactions classified as reverse takeovers or changes of business, where there is no real change of control or change of business.
- **Review corporate governance requirements.** The TSX Venture should review TSX corporate governance guidelines to assess their appropriateness for smaller new economy businesses pursuing listing.
- **Harmonize with other regulators.** By removing requirements that overlap with or duplicate the Commission's requirements, the time and cost of doing business on the TSX Venture would be reduced.

### High cost and inequity of underwriter requirement

The Commission and exchange regulations mandate that companies going public have an underwriter — someone registered to trade in securities, i.e., a brokerage firm — perform all necessary due diligence, sign the prospectus, and act as the gatekeeper for public investors and adviser to the issuers.

Many participants thought that while, in theory, the primary role of the underwriter in IPOs is that of gatekeeper and adviser, this is not the case in reality. They felt that underwriters' need to make a profit conflicts with their legislated role of gatekeeper.

Smaller businesses felt the regulated requirement for an underwriter creates a monopoly that results in businesses being taken advantage of because there are no alternatives. Participants said they had paid for the due diligence review but often completed most of it themselves, and that underwriters they used required a commission for each IPO subscription, even though the company's management brought in the majority of subscribers.

Participants described how preferred lists used by underwriters to divide a popular IPO's distribution among a handful of their select clients, combined with the underwriters' ability to influence the IPO share price, were detrimental to the secondary market (trades over the exchange) and to the business itself. They explained that underwriters and their select clients are able to realize trading profits immediately on the listing due to the price set by the underwriter. However, the general investing public and the listing company are left with losses after analysts stop touting the stock and a true post-IPO market value develops.

Participants' suggestions for addressing this problem:

- **Revise the role of underwriters.** Businesses should be permitted to negotiate a fair price for due diligence and corporate finance services for their IPO. The requirements to have an underwriter sign the prospectus certificate and sponsor the listing should be reassessed. Other professionals, such as accounting firms, law firms or business analysts, should be permitted to undertake the due diligence. This could result in more competitive pricing while maintaining a high level of review. In addition, businesses should be provided with a registration exemption to trade but not advise. Businesses could then choose to carry out their own offering if they already have their subscribers. They could also use electronic document delivery to undertake a full or partial public offering over the Internet. In this way, costly corporate finance fees, commissions, printing charges, and delivery charges could be avoided, leaving more proceeds for growing the business.
  
- **Provide alternate public offering procedures.** To address the challenges presented by the use of preferred client lists and arbitrary IPO pricing, alternate public offering procedures such as the Dutch auction system should be permitted. Under that system, companies can set a range of prices at which they are willing to sell their securities, and purchasers can set the price within that range at which they are willing to buy. This helps avoid losses to the general public due to selective IPO distributions and artificial IPO and secondary market pricing.

### Ineffectiveness of capital pool company program

The biggest challenge identified by participants was a lack of venture capital in the province, or an inability to access available venture capital because of regulatory restrictions. The TSX Venture's capital pool company (CPC) program was cited as a prime example. The program allows companies without a specific business to raise capital, become listed, and then identify and acquire a business. CPCs are listed on the TSX Venture under a specific category and do not have all the rights that go along with a full listing. They can raise a

maximum of \$700,000, which can only be used for limited purposes. Their primary function is to identify and acquire target businesses. When the acquisition is completed, the CPC becomes a fully listed, operating company with all of the rights that entails.

As of August 2002, there were approximately 209 CPCs listed on the TSX Venture, holding in aggregate approximately \$104 million of uninvested funds, or an average of about \$498,000 per CPC (compiled monthly by David Ing, Pacific International Securities). In participants' view, this large amount of venture capital is not being invested in early-stage new economy businesses mainly because of difficulties with the current CPC structure. The key problems cited involve limits on CPC funds and on how those funds can be distributed to a target business.

New economy businesses look to go public because they need an infusion of cash to grow. CPCs, as a vehicle to help them achieve this, usually have significantly less funds available than these businesses require, which are further depleted by the expenses associated with acquisition of a business by a CPC.

When CPC policies were originally put in place, it was intended that on acquiring a business, the CPC would do a concurrent private placement to raise money to fund the target business' plan. However, current market realities are making this difficult. Therefore, CPCs find themselves in the position of being unable to finance and unable to complete a deal without financing.

Participants also thought restrictions on the treasuries of CPCs to be problematic. The amount of funding a CPC can advance to a target business prior to completing the qualifying transaction is limited to \$25,000 on a non-refundable basis, and up to \$100,000 as a refundable deposit or secured loan. This means the target business cannot access substantial funding until the acquisition closes, which can take six months or longer before all approvals are obtained.

Participants felt both the shareholder approval requirement and the requirement to first obtain TSX Venture approval of the information circular substantially increase the time it takes to complete a qualifying transaction.

Generally, participants thought that with changes to the CPC program, the TSX Venture could become a true alternative source of venture capital for new economy businesses.

Participants' suggestions for addressing this problem:

- **Require CPCs to raise more money.** The maximum amount should be increased to \$1.5 million, and a minimum amount of \$750,000 should be introduced. Existing CPCs could be offered the right to do a private placement to bring them up to this total. After expenses, this would enable CPCs to provide funding to new economy businesses similar to that of an initial venture capital round without undertaking a new financing. A requirement to raise this amount of capital would compel CPCs to develop a strong management team and reduce the number of CPCs with too little funds on hand, thereby increasing the overall quality of CPCs.

- **Allow CPCs to advance capital.** CPCs should be allowed to advance capital prior to the completion of the qualifying transaction on the recommendation of management, provided the terms are approved by the board of directors. Those entrusted with the direction of the CPC should make the decisions relating to the qualifying transaction, as long as they provide full and timely disclosure to the CPC's shareholders.
- **Remove the shareholder approval requirement for qualifying transactions.** The management team, whom the investors have invested in, should be allowed to make the qualifying transaction decision without seeking shareholder approval. In lieu of filing an information circular, the CPC could file a detailed filing statement before closing the qualifying transaction. The elimination of the shareholder approval requirement would permit qualifying transactions to be completed in 90 to 120 days, a much more realistic timeframe for new economy businesses.

### COMMISSION RESPONSES TO BARRIER #1

In the preceding information provided to NEAT by industry participants, the comments and suggestions entail looking at two distinct areas of regulatory change: revising specific regulatory requirements, and harmonizing and streamlining requirements among regulators. The Commission has addressed these separately in the following responses.

### COMMISSION RESPONSES: REGULATORY CHANGE

The Commission will consider:

- ▶ revisiting the mandatory escrow policy and giving further consideration to removing or limiting its application

Participants provided a range of suggestions to solve the problems they perceived with the current escrow regime. The suggestions ranged from eliminating escrow where “fair value” was paid for the securities, to eliminating mandatory escrow completely. In its paper entitled “New Concepts for Securities Regulation” released on February 18, 2002, the Commission indicated it would consider the best approach to escrow after a consultation process. Participants’ views and suggestions will be considered during that consultation process.

- ▶ permitting electronic delivery of financial statements by posting them on a website as an added alternative to current methods of delivery

According to the BC Securities Act, there are two separate requirements for financial statements: the requirement to prepare and file them with the Commission, and the requirement to deliver them to shareholders. At present, the term “delivery” refers to delivery by mail, however, the Canadian Security

Administrators' (CSA) National Policy 11-201 Delivery of Documents by Electronic Means expands this to permit delivery by e-mail in certain circumstances. The Commission will give further consideration to permitting companies to post financial statements on their websites, as an alternative to delivering them by e-mail or mail. The statements would still have to be prepared and filed with the Commission and posted on the SEDAR website for public viewing as currently required.

- ▶ continuing to work with the TSX Venture to review feedback from participants

Since Canadian exchanges can only operate within the authority granted to them by the provincial securities commissions, they are restricted as to how innovative they can be in meeting the needs of their listed companies, or those that hope to become listed. It is therefore necessary for the Commission and the exchange to work together to identify opportunities to assist new economy businesses or any other industries represented on the exchange. The Commission may consult with the TSX Venture and other commissions to review concerns raised by participants. A joint effort could address listing requirements, building relationships with new economy businesses and the investment community, sponsorship, capital pool companies, changes of business and reverse takeovers, significant acquisitions and alternate public offering procedures.

## COMMISSION RESPONSES: HARMONIZATION AND STREAMLINING

The Commission will consider:

- ▶ working with other regulatory bodies to implement harmonized and streamlined regulations that are applied consistently and take into consideration the nature of new economy businesses

In October 2001, the Commission launched a two-year Deregulation Project. Its objective is to significantly reduce the burden of regulation that hampers the securities market's ability to raise capital and provide investment opportunities in the province and across Canada. The Commission is also working closely with the CSA, an association of the securities administrators of each Canadian province and territory, to produce a proposal for harmonization under the CSA's Uniform Securities Legislation Project. The project is part of a broader proposed strategy of regulatory reform that aims to reduce the burden of regulation on market participants and make regulation more effective. Canadian regulators recognize that much of the regulatory burden is due to each of Canada's provinces and territories having different securities legislation. The objective of the project is to eliminate these differences by developing a uniform act and rules within two years for adoption across Canada.

Where opportunities for harmonization and streamlining have been identified that are not within the direct mandate of the Commission, the responsible parties will be advised of NEAT's findings. Where appropriate, NEAT committee members can work with the responsible parties to develop harmonized policies.

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Since the start of the NEAT initiative, other regulatory bodies and organizations have identified, and undertaken initiatives to address, a number of the same industry concerns that were expressed by NEAT participants relating to regulatory burden and lack of harmonization. In cases where solutions are already actively being pursued by these groups, the Commission has not responded specifically. Where these initiatives are still in the formative stage, the Commission will ensure the information and suggestions provided by NEAT participants are brought forward for consideration.

The following is a summary of important parallel initiatives that address a number of participants' concerns involving regulation:

- ▶ The Commission's Deregulation Project has proposed, among other things, replacing the current prospectus-based system to permit certain companies to issue securities, on the basis of up-to-date continuous disclosure, without a prospectus. The Deregulation Project continues to consider whether to allow non-registrants to act as due diligence providers.
- ▶ The Commission recently adopted Multilateral Instrument 45-103 Capital Raising Exemptions that uses a more simplified form of offering memorandum.
- ▶ The CSA is developing proposed National Instrument 51-102 Continuous Disclosure Obligations, proposed National Instrument 71-102 Continuous Disclosure and Other Exemptions Relating to Foreign Issuers, as well as a proposed National Instrument for Acceptable Accounting Principles and Auditing Standards. Under these instruments, it is proposed that small businesses will have simplified financial reporting obligations, including the MD&A, and SEC-registered companies will be entitled to rely on their US financial statements without reconciliation to Canadian GAAP. NI 51-102 may also permit companies to deliver their financial statements only to those shareholders who have requested them. As well, the CSA is revising the long form prospectus rule. It is expected that the revised rule will have the same simplified financial reporting obligations for small businesses as the proposed NI 51-102 continuous disclosure instrument described above.
- ▶ The CSA has implemented National Policy 47-201 Trading Securities Using the Internet and Other Electronic Means, National Policy 11-201 Delivery of Documents by Electronic Means, and National

Instrument 54-101 Communication with Beneficial Owners of Securities of a Reporting Issuer, all of which relate to the use of the Internet for disclosure and delivery of documents.

- ▶ The TSX Venture is in the process of revising its sponsorship policy to exempt certain transactions from the requirement to have a sponsor.
- ▶ The Canadian Institute of Chartered Accountants is reviewing Canadian GAAP and GAAS to determine if and how they can be harmonized with US GAAP and GAAS or international accounting standards.

## PARTICIPANT FEEDBACK

Barrier #2

Lack of new economy business knowledge and experience among regulators, investors and industry

### Lack of new economy business and finance experience among regulators and exchange staff

Participants attributed most of their frustration and costly delays, such as the current lengthy process for review of disclosure documents, to the fact that regulators probe issues that are irrelevant to their businesses. From industry's perspective, regulators' lack of understanding of how new economy businesses operate results in an insistence on using standards and methods of evaluation that simply do not apply. It was felt these methods are often more relevant and specific to, for example, mining companies, reflecting standards that were implemented at a time when resource-based industries were dominant. But in many ways these are not applicable gauges of new economy businesses that have since become a significant market force. Participants complained that this continuous apples-to-oranges information conflict bogs their businesses down in regulatory review, often causing them to miss out on key opportunities to raise capital.

Similarly, participants viewed staff of the TSX Venture as having insufficient knowledge of new economy businesses and therefore being unable to properly analyze such businesses. As a result, they found the review and approval processes too long or irrelevant. This was seen as having a severe impact on new economy businesses as most have only a two to three month window of opportunity to complete a transaction; if TSX Venture review takes six months or longer, the opportunity is lost.

- Participants' suggestions for addressing this problem:
  - **Educate regulators who can specialize in the review of new economy businesses.** Certain Commission staff should have specific knowledge of the business operations and financial aspects of new economy businesses to make the review process more relevant and efficient.
  - **Educate TSX Venture staff about new economy businesses.** With better knowledge about this sector, exchange staff who assess new listings and review transactions will avoid irrelevant issues that impede a listing or business opportunity.

### Lack of new economy business and finance experience among analysts

Participants noted that, traditionally, the analyst community in BC has had an excellent understanding of the junior resource market that characterized the predecessor exchanges to the TSX Venture. However, they feel this knowledge and understanding has not been applied to new economy businesses. As a result, they have experienced a lack of willingness on the part of analysts to become involved with new economy businesses at the listing stage, and a lack of subsequent analyst coverage once a new economy business is listed.

Participants' suggestions for addressing this problem:

- **Educate the investment community.** Investment analysts should be made aware of the applicability of certain resource-based business concepts to new economy businesses. The concepts of developing milestones and valuation models, as well as seeking larger development partners, are as applicable to new economy businesses as they are to resource issuers.

### Foreign investors' lack of familiarity with BC regulatory requirements

Among the impediments to raising capital and doing business in the province, participants predominantly cited foreign investors' lack of familiarity with both BC regulatory requirements and certain government policies and initiatives. Many stated that US venture capitalists are interested in BC companies but reluctant to invest because they are not familiar with our securities regulatory regime and tax laws, and have concerns about our multi-jurisdictional regulatory environment. This lack of understanding limits new economy business' access to foreign venture capital sources.

Although the federal and provincial governments provide funding at the research and development stage, participants stated there is a lack of sufficient private capital and government funding for commercialization of intellectual property developed in BC. Therefore, when they reach this stage businesses are often forced to relocate outside BC. Participants felt strongly it would be beneficial for these businesses — and for the province, by virtue of a stronger economy, job creation and a return on governments' investment in research and development — to take measures to attract foreign investors' capital to the province rather than have innovative BC businesses relocate to where capital is available.

Participants' suggestions for addressing this problem:

- **Educate foreign investors.** Currently there is no way for a foreign investor to get comprehensive information on our securities regulatory regime and tax laws without actively seeking the information and incurring the expense of an adviser. The goal should be to provide an overview of our regulatory regime, particularly explaining the workings of the exempt market, while also providing some information on the impact of our tax laws on cross-border activities. This should help to remove uncertainty and dispel misinformation about doing business in BC and Canada's multi-jurisdictional environment, enabling foreign investors to focus on evaluating the merits of the new economy business venture.

- **Create partnership opportunities.** Many foreign investors rely on local Canadian venture partners to perform due diligence and lead them through BC regulatory requirements. Channels need to be developed to inform foreign investors of opportunities to partner and form strategic alliances with BC venture capitalists.

### Local investors' lack of understanding of the new economy sector

Generally, participants felt that misunderstanding of new economy businesses on the part of the investing public has two negative consequences: BC investors miss out on the opportunity to invest at the start-up stage in innovative technologies developed locally, and new economy businesses lose an opportunity to access the capital needed to further develop their concepts and products and take them to commercialization.

Specifically, participants stated that a barrier to capital raising is investors' lack of understanding of the unique business cycles, operations and attributes of new economy businesses. Unlike more traditional companies and products, few new technology applications have been tried and tested in the marketplace to determine their economic viability and potential value. This is seen as a particular problem for biotechnology companies and those developing technologies that may not have a marketable product for 10 years or longer. For example, biotechnology firms must go through many levels of clinical trials and government approvals, requiring capital for a long period of time before there is any return on investment. Investors' lack familiarity with these types of businesses makes them reluctant to invest in concepts that are less tangible than traditional businesses.

Participants also noted it is often mistakenly assumed that the risk and value of investments in new economy businesses can be evaluated using the same criteria and indicators that are used with traditional companies. They stated that evaluating new economy businesses involves different valuations, rates of return, timeframes and technical due diligence.

Participants' suggestions for addressing this problem:

- **Educate local investors.** Information on the unique business cycles and operations of high tech, biotechnology, and other new economy businesses should be shared with local investors, who need to have a general understanding of the operations of early-stage new economy businesses. This could be done through different channels such as information forums and the Commission's website.
- **Brand BC as the place for new economy business and investment.** Currently, though BC is able to create new technologies and innovations at the research and development stage, the province is losing them at the commercialization stage to eastern Canada and the US. This is because these companies are able to receive better funding and support by relocating. Creating an awareness of the technological innovation that occurs in the province is one means of expanding available capital for new economy businesses.

Lack of business and capital market experience in BC's new economy

Participants identified that a lack of availability of new economy business and finance experience at the management level is a challenge to growing a new economy business from conception to commercialization in BC. Strong management expertise and a thorough understanding of BC's capital markets is critical to creating viable business and financing strategies, attracting key investors, and making a successful transition to marketability. Without this direction, participants noted, many good ideas never make it past the conception stage or fail in the attempt to get to commercialization.

Participants' suggestions for addressing this problem:

- **Educate management.** Effectively communicate the business and finance issues management needs to consider when raising capital in BC for a new economy business. This will help provide management with real world expectations of what it takes to successfully participate in BC's capital markets. Initiatives such as NEAT should form strategic alliances with existing provincial and federal government business education initiatives.

COMMISSION RESPONSES TO BARRIER #2

COMMISSION RESPONSES: EDUCATION

The Commission will consider:

- ▶ developing an education program to increase awareness of regulatory requirements and the characteristics of new economy businesses targeting analysts, issuers, investors, entrepreneurs, and regulators, including Commission staff

The concept behind this response is to address industry's concerns and input that suggest the need for more effective communication, rather than revisions, of regulations. The information could range from a general overview of the BC securities regulatory system, its participants and their roles, to specific regulatory requirements. Educational efforts could also provide information on the differing natures of new economy and traditional businesses from an investment and regulatory perspective.

New material may be developed and produced in modules that can be easily integrated into the Commission's existing education programs as required. As well, it may be distributed in a variety of ways, from live seminars to the Internet, to ensure accessibility.

The Commission will consider partnering with other organizations to provide securities-related content in exchange for using those organizations' distribution channels and industry presence. The NEAT committee has already submitted proposals for two education modules to the Commission's Industry and Investor Education Committee focusing on de-mystifying the capital raising process for investors, entrepreneurs and issuers.

Of particular importance will be efforts to educate Commission staff about new economy businesses, and to work with the TSX Venture on educational proposals to assist the exchange in connection with new economy issuers.

- ▶ reviewing the Commission's current methods of communicating information to the new economy sector and look at new ways to ensure industry is aware of regulatory developments that directly affect it

This response addresses the NEAT committee's observation that many industry participants in its surveys and consultations did not seem to be aware of significant measures already being taken by regulators to deal with problems participants red-flagged as major obstacles to doing business. Since information on these activities is being regularly disseminated in various communications vehicles, from the Commission's Weekly Reports to press releases to partner organizations' communications, why are participants still unaware of actions being taken to remedy issues so vital to their businesses? Whether the reason is information overload, a common complaint, or ineffective communications methods, the Commission will investigate this problem and look at developing more tailored or innovative methods of keeping the new economy sector informed.

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The NEAT initiative reflects the Commission's commitment to industry and the investing public to be proactive in understanding the unique challenges facing BC's technology industry. NEAT's efforts will enable us to work toward ensuring that irrelevant or excessive securities regulations do not impede the continued growth of this important sector of our provincial economy, while maintaining investor confidence.





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