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BURGUNDY REPORT

CANADIAN SECURITIES REGULATION: ISSUES AND CHALLENGES

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The Burgundy Reports

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Introduction[1]

The idea of setting up a national securities commission in Canada has recently returned to the forefront. In October 2002, the Deputy Prime Minister and Minister of Finance of Canada asked Harold MacKay to define a process for determining the best securities regulatory system for Canada's needs. After an investigation which indicated "a range of problems with the present system"[2], Mr. MacKay's recommendation was accepted: a committee was set up "to conduct the necessary review and to make recommendations to policy makers". The report is severe: "The current system, as presently operated, must be improved significantly, and in a prompt fashion". Similarly, the five-year report of the Ontario Securities Commission begins by recommending the creation of a single securities commission in Canada. The first chapter of that report is entitled "The Need for a Single Regulator" and begins as follows: "We add our voice to countless others raised in support of the urgent need for a single Canadian securities regulator. This is the most pressing securities regulation issue in Ontario and across Canada. We urge the Minister to assume a leadership role in working with her colleagues across the country to resolve any remaining barriers to the establishment of a single regulator responsible for Canada's capital markets activity."[3]

"The idea of setting up a national securities commission in Canada has recently returned to the forefront."

The matter seems to have been settled. Nevertheless, Harris (2002)[4] points out that the debate is not based on a rigorous empirical study and he criticizes the very limited knowledge we have of the real problems in the Canadian securities market. We are summarizing the situation in these pages in order to understand this apparent paradox—one in which the absence of rig-

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[1] This text describes the main elements of the working document titled "Securities Regulation in Canada" available at :
http://www.cvmq.com/upload/autresdocuments/reglementation valeurs mobilieres 3.pdf

[2] Mackay, H., Nov. 15, 2002. *Letter to The Honourable John Manley, P.C., M.P. Deputy Prime Minister and Minister of Finance*. http://www.fin.gc.ca/news02/data/02-094_1e.html.

[3] *Five Year Review Committee Final Report: Reviewing the Securities Act (Ontario)*, March 2003.

[4] Harris, D.A. 2002. "*A Symposium on Canadian Securities Regulation: Harmonization or Nationalization*?" White Paper. University of Toronto Capital Markets Institute.

orous knowledge does not exclude finding that serious problems exist and recommending that steps be taken quickly. Arguments made to justify centralization of securities regulation are not new. They have been put forward several times over the last twenty years:

"We are summarizing the situation in these pages in order to understand this apparent paradox—one in which the absence of rigorous knowledge does not exclude finding that serious problems exist and recommending that steps be taken quickly."

- Regulation of the Canadian financial sector is too complex and the existence of thirteen securities authorities (ten provinces and three territories) is harmful to proper market operations.

- Such a situation increases issuance and compliance costs, and thereby generally hurts the competitiveness of the Canadian market. Total costs of regulation, higher than in other countries, is particularly harmful in Canada because of the smaller market size.

- Regulation is confusing and sometimes not applied, and this situation hurts both the brokerage industry as well as financing for growth companies. The lines between jurisdictions are not clearly drawn and participants may have to deal with thirteen different jurisdictions for penal proceedings. The compartmentalization of Canadian securities authorities would make complex situations involving investors, intermediaries and issuers in various jurisdictions unmanageable.

- Costs related to the existence of differences in provincial laws and multiple jurisdictions penalize businesses, intermediaries and the entire market in Canada. Canada's ability to compete in a global market, namely its ability to attract foreign businesses seeking equity capital and to hold on to Canadian businesses, is compromised due to the increased cost of capital for Canadian businesses resulting from the cost and complexity of transactions involving several jurisdictions. This situation has changed little and is even un-

changed since the 1964 Porter Report because of the relative ineffectiveness of harmonization efforts in Canada.

- Market globalization is an argument in favour of a single Canadian securities authority and Canada must speak with one voice.

- The Canada regulatory system responds slowly to rapid changes in the environment because of the need for agreement from the different authorities involved. Only a single commission can handle financial and accounting problems such as Enron and the number of such problems is an argument in favour of a centralized regulatory authority. Finally, uniform regulation would avoid a race to the bottom, which occurs when several regulatory jurisdictions compete with each other.

"Most arguments put forward to support the idea of the inefficiency of securities regulation (...) are generally based only on unsupported statements."

Most arguments put forward to support the idea of the inefficiency of securities regulation are not supported by regulatory and finance theory, and are generally based only on unsupported statements. The current debate in the field is a new illustration of the phenomenon which Lacasse (1995)[5] describes: Canadian economic and regulatory policy decisions have more often than not been guided by myths put forward by pressure groups rather than by actual knowledge resulting from rigorous, independent research. It is disturbing to realize that some are considering reforming a system which has not been analyzed carefully, on the basis of assertions made primarily by pressure groups. As a result, it was necessary to provide the basic components for a structured analysis in order to respond to the proposals and assertions made with respect to securities regulation in Canada.

"It is disturbing to realize that some are considering reforming a system which has not been analyzed carefully, on the basis of assertions made primarily by pressure groups."

This report, based on the CIRANO discussion paper entitled "Securities Regulation in Canada"[6], attempts to summarize the key issues of

[5] Lacasse, F. 1995. "Mythes, savoirs et décisions politiques, " Paris: Presses Universitaires de France.
[6] Document available on the Quebec Securities Commission and CIRANO web sites.

this debate. Given the arguments put forward by proponents of the centralization of securities regulation described above, we felt it was important to review six aspects, which are discussed in the six parts of the paper.

We will begin by discussing one of the main arguments of the proponents of centralization, which relates to the existence and lack of agreement of the 13 securities commissions. This is the opportunity to show how securities operations in Canada are divided and to set out the significant progress made towards harmonization of Canadian regulation in this field.

Secondly, we will analyze the arguments and evidence respecting inefficiency of the Canadian securities market in terms of trading costs in the primary and secondary markets. We will also present our own estimates of comparative costs for initial offerings in Canada and the United States.

An analysis of various other arguments generally raised to justify an in-depth overhaul of the securities regulatory system form the subject of the third part. They are: Canadian weakness on the international level, jurisdictional conflicts, response times, accounting manipulation and the ineffectiveness of harmonization efforts.

In Part four we contrast regulatory centralization with regulatory competition, which prevails in company law in the United States. We also present the intermediate solution of reciprocal delegation on which the European passport system is based.

We will then highlight some very significant differences between the Canadian and American markets which make it difficult to transfer the American regulatory system—sometimes cited as a reference—to the Canadian system.

Finally, we will examine the growth of the Canadian securities market during the last decade and the main challenges it will have to face. Debate concerning the dynamism of the Canadian market is presently limited to only one of its components, namely the regulatory factor. Without denying the importance of this factor, it is well established that dynamism of a stock market depends on many other factors such as trading mechanisms and costs and, more generally, market quality. No study of the regulatory system would be complete without considering the growth and very nature of the industry being regulated.

"Debate concerning the dynamism of the Canadian market is presently limited to only one of its components, namely the regulatory factor. Without denying the importance of this factor, it is well established that dynamism of a stock market depends on many other factors such as trading mechanisms and costs and, more generally, market quality."

1. The debate and its key issues

The first argument put forward by the proponents of securities centralization in Canada is that participants have to deal with thirteen securities commissions, thereby increasing costs and reducing the competitiveness of the Canadian securities market. An analysis of the 4,131 companies for which a recent stock exchange symbol is available (Table 1) shows, firstly, that 20% of them should be considered inactive. Also, four provinces monopolize almost all of the share issues (97%), the companies listed on an exchange (90%), the population (85%) and economic activity in Canada. Thus, the vast majority of issuers deal with only one or two securities commissions and it is therefore difficult to argue that a Canadian issuer faces 13 commissions. To address almost all investors, it only has to satisfy four jurisdictions, which are related through mutual review procedures for prospectuses and exemptive relief, under regulation which has gradually been harmonized. In 2003, the disparities which remain only relate to relatively limited aspects of securities law.

"...four provinces monopolize almost all of the share issues (97%), the companies listed on an exchange (90%), the population (85%) and economic activity in Canada."

Table 1: Distribution of Canadian and foreign companies listed on a Canadian stock exchange in November 2002, based on their place of incorporation

	Active Companies		Inactive Companies	Total	
	Number	%	Number	Number	%
British Columbia	1,175	36.13	222	1,397	33.82
Alberta	802	24.66	270	1,072	25.95
Ontario	691	21.25	177	868	21.01
Québec	304	9.35	54	358	8.67
Yukon	94	2.89	30	124	3.00
Foreign companies	80	2.46	92	172	4.16
Manitoba	33	1.01	12	45	1.09
Nova Scotia	24	0.74	14	38	0.92
New Brunswick	20	0.62	5	25	0.61
Saskatchewan	16	0.49	3	19	0.46
Newfoundland	8	0.25		8	0.19
Northwest Territories	3	0.09		3	0.07
Prince Edward Island	2	0.06		2	0.05
Total	3,252	100.00	879	4,131	100.00

Source: *Cancorp Financials*, November 2002, a company is inactive if it has no assets or if it has not filed financial statements after 2000. The place of incorporation of Canadian federally incorporated corporations was determined based on the location of their head office.

"The Canadian Securities Administrators (CSA) are a forum for the exchange of information and mutual reliance whose mission is to coordinate and harmonize regulation of the Canadian financial markets."

The Canadian Securities Administrators (CSA) are a forum for the exchange of information and mutual reliance whose mission is to coordinate and harmonize regulation of the Canadian financial markets. To determine the scope of the remaining differences between securities regulation in the various jurisdictions, we describe the initiatives taken by the CSA to limit the problems caused by the existence of multiple jurisdictions. They are:

- a memorandum of understanding relating to the mutual reliance review system for applications for exemptive relief, the granting of receipts for prospectuses and the acceptance of AIFs, set up through the adoption of the Memorandum of Understanding between all Canadian securities commissions. The decision-maker in a particular securities authority may rely primarily on the analysis and review of the staff of

another securities authority. This system is known under the acronym MRRS (Mutual Reliance Review System).

- a memorandum of understanding between the different Canadian securities authorities for the purpose of regulating and simplifying the oversight of stock exchanges, the "SuperMOU". Each recognized exchange and recognized quotation and trade reporting system has a principal regulator responsible for its oversight and may have one or more exempting regulators. The principal regulator informs the exempting authority of its oversight activities and provides it with all useful information requested by it.

- a registration streamlining system for securities representatives, allowing the efficient registration of representatives of securities firms with several securities authorities.

- national instruments and other texts of national scope, the results of cooperative efforts undertaken through the CSA. The percentage of national instruments which are not currently harmonized is quite low. Most securities transactions are now governed by national instruments, listed on the web sites of the provincial commissions.

- the Uniform Securities Legislation Project, intended to eliminate the remaining differences between provincial and territorial laws. The project was tabled at the beginning of 2003.

The procedures which have been implemented do not yet embrace the principle of mutual recognition which has been accepted in Europe, and the efforts to harmonize securities legislation are not entirely complete. The few differences which still remain relate to sections which could not be harmonized yet due to the highly diversified nature of the Canadian market, a market in which hundreds of mining securities from the West trade with large-cap securities based primarily in Ontario. They also result from the presence

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in Canada of two different legal systems. However, the passport system based on harmonized regulation is at the center of the proposal made by the ministers of the provinces and the territories responsible for securities which is found in the June 2003 consultation document.[7]

2. Regulatory costs and inefficiency

According to the proponents of centralization of securities regulation, there are serious problems of efficiency in terms of excessive costs and delays resulting from compliance with statutes and regulations.

Firstly, it is useful to point out the absence of any rigorous analysis of the costs of securities regulation in Canada or, for that matter, the United States, probably because of the difficulty of evaluating them. Regulation implies three types of costs: direct costs of organizations, indirect or supplementary costs incurred by intermediaries to comply with such regulation, and distortion costs.[8] A comparative estimate of direct costs is difficult because of differences between the regulatory structures for the financial sector in different countries. Whereas the United Kingdom now has only a single authority, a number of other countries regulate the banking, insurance and securities sectors separately.[9] Very little empirical study has been done on showing the additional costs related to regulation, and they almost all deal with

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[7] *Securities Regulation in Canada: An Inter-provincial Securities Framework*, Discussion Paper, Steering Committee of Ministers, June 2003.

[8] One of the directors of the *Financial Services Authority* (FSA) in the United Kingdom defines these costs as follows: *the 'distortion' cost arising from the way in which regulation may change the nature of markets, may prevent or discourage firms from entering or using markets, may constitute new markets that would not exist in the absence of regulation, and may therefore have a significant effect on the nature and availability of the products provided by the financial services industry*. See Clive Briault : *The Costs of Financial Regulation*, 2003,
http://www.fsa.gov.uk/pubs/speeches/sp140.html

[9] The FSA annually produces a schedule containing the direct costs of regulatory organizations in the main countries. The 2003 edition shows that Australia, which has just combined its securities commissions, has a direct cost significantly higher than that of Canada in this respect, for a capitalization which represents two-thirds that of Canada.
http://www.fsa.gov.uk/pubs/annual/ar02_03/ar02_03app8.pdf

specific aspects of American regulation. We are unaware of any rigorous study on the additional costs caused by Canadian regulation. It is, however, important to mention three major factors. They are the putting in perspective of regulatory costs, the taking into consideration regulatory benefits and the effects of regulation on initial offerings.

"We are unaware of any rigorous study on the additional costs caused by Canadian regulation."

Putting in perspective: Although the costs of regulating securities are significant, they should be put in perspective. Issuers and investors incur various forms of costs on the primary and secondary markets, of which regulation is only one component. These costs include four components: the spread which separates the bid and ask prices, the price effect of the announcement of large orders which replaces the spread when blocks are exchanged on the upstairs market, brokerage fees and the cost of settling trades.

On the secondary market, regulatory costs are only a small fraction of costs incurred by issuers and investors in both Canada and the United States. In Canada, only trading costs can be estimated, for the year 2001, at $5.7 billion if we use as a basis the rates in effect in the United States, which would certainly lead to under estimating Canadian costs. Regulation plays a small role at this level and the costs are essentially related to intermediary remuneration. The expenses of the four main Canadian securities commissions are $104.09 million for the same year. To impute solely to regulatory costs the relative inefficiency of the Canadian market overlooks the fact that trading costs are essentially related to market operations and brokerage commissions, which are mainly the responsibility of the brokerage industry itself. The direct costs of regulation per $million of capitalization are $145.8 in Canada, $293.1 in Australia and $141.9 in the United States, if we do not include State securities regulatory organizations. In 2002, Texas alone collected fees of CDN$163 million, which is greater than the costs of all Canadian commissions combined. Each reporting issuer costs $33,600 in Canada in direct regulatory costs. It costs $123,000 in Australia, where the commissions have been combined, and $324,700 in the United States, according to

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data of the UK Financial Services Authority.

Costs and benefits: The costs of regulation must be put in perspective in relation to their benefit. With optimal regulation, the marginal cost is equal to the marginal benefit. Several authors believe that this balance can only be achieved by jurisdictional competition and criticize the regulatory monopoly approach. There do not seem to be any cost/benefit studies of securities regulation in Canada.

Initial offerings: Initial offerings are probably the aspect of the securities business over which regulation may have the most significant effect. The change from the status of closed corporation to that of issuer is subject to greater requirements, whereas the size of the companies is relatively small. The relative burden of the requirements is therefore potentially high. Four studies show that the cost of initial offerings is significantly lower in Canada than in the United States, which does not have multiple securities commissions. The process for an initial offering is not only less costly in Canada, it is also more rapid. It is thus difficult to argue that the existence of several securities authorities in Canada heavily penalizes the competitiveness of the primary securities market, especially since in both countries brokerage commissions constitute the greater share of total direct costs. In addition, our own estimates show that costs imputable to undervaluation, unrelated to regulation but related to broker conduct, are on average much higher than total direct costs, especially in the United States (Table 2). The advantage of Canada in terms of direct costs is around 2% of gross proceeds for an issue under 1 million. It is around 1% for an issue of which the gross proceeds are between 1 and 100 million. It therefore seems unlikely that regulatory costs are a significant factor for cost increases and a barrier to issuances.

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There is very little evidence that the present regulatory structure greatly penalizes Canada: issuers incur lower costs than in the United States,

direct costs appear to be lower than those in Australia, which combined the securities commissions, and direct costs of regulation are only a small fraction of costs incurred by issuers and investors. It is possible that the total level of regulation is not optimal. However, we do not have any studies confirming this.

Table 2: Elements of IPO costs in Canada and the United States according to size of issue, excluding capital pool issues for the period 1997-1999. The average percentages are statistically different from zero to the 1% level.

Size of Issue (US$ million)	Number of IPOs	Brokerage Fees (%)	Other Expenses (%)	Total Direct Costs (%)	Undervaluation (%)
Canada					
1.0 – 9.9	53	8.12%	7.86%	15.98%	30.61%
10– 49.9	49	6.14%	3.31%	9.45%	11.30%
50 – 99.9	10	6%	2%	8%	10.76%
100 and over	16	5.53%	1.75%	7.28%	8.88%
Average		6.88%	4.9%	11.78%	18.95%
Weighted average (by size)	5.35%	1.84%	7.19%	5.11%	
United States					
1.0 – 9.9	119	9.29 %	8.7 %	17.99 %	9.05 %
10.0 – 49.9	532	6.93 %	3.70 %	10.63 %	26.15 %
50.0 – 99.9	300	6.88 %	2.12 %	9 %	55.57 %
100 and over	237	6.09 %	1.2 %	7.29 %	67.19 %
Average		7 %	3.3 %	10.30 %	37.5 %
Weighed average (by size)		5.79 %	1.43 %	7.22 %	38.38 %

3. Various arguments

A certain number of arguments are regularly put forward to justify revision of the Canadian model of securities regulation. We will discuss them in turn below.

Canada is weak on the international level and must speak with one

voice because of market globalization. This argument can hardly be considered significant. The existence and initiatives of the CSA show that the degree of cooperation between securities commissions is high and common viewpoints strong. The argument may therefore be reversed. Is Canada's influence not greater because it has four representatives at the international level (International Organization of Securities Commissions), when these representatives work together closely on most matters?

"Is Canada's influence not greater because it has four representatives at the international level (International Organization of Securities Commissions), when these representatives work together closely on most matters?"

There are jurisdictional conflicts to the extent that participants may face thirteen different jurisdictions for penal proceedings. Jurisdictional problem exists world-wide, not only in Canada, and has lead to the European investment service directive (ISD 93). One of the responses to the problem of multiple jurisdictions is the principle of cooperation and the project to set up uniform securities legislation in Canada.

Response times to rapid changes in the environment are long because of the need for cooperation from the different organizations involved. Although the implementation of solutions may be more rapid in a centralized system, it is not clear that the detection of problems and the proposal of solutions is accelerated by the creation of a single commission. Here again, proponents of regulatory competition insist that only organizations in a competitive situation react quickly to changes in market conditions.

The accounting manipulations which lead to the American financial scandals would be avoided in a centralized securities system. It seems paradoxical to invoke financial scandals which mainly affected American businesses to support centralization of securities in Canada. These abuses took place mainly in a country where securities regulation respecting large companies is essentially under the jurisdiction of the federal government and a single commission, the SEC. In addition, the wish of the American federal government to impose a uniform securities law seems to have had indirect negative effects including the recent financial scandals. These interventions

are seen by some scholars as the direct, although partial, cause of the recent financial scandals. The exclusion of the States from securities litigation of a national scope has eliminated several lawsuits and does not seem to have allowed the harmonization of decisions. However, this effect was reinforced by the inaction and lack of means of the central securities organization, the SEC. This is especially true as observers generally believe that a lack of enforcement, not regulation, in particular by the SEC, is the origin of the recent scandals[10]. Based on the American example, it does not seem that the Enron affair can be a very solid argument for the harmonization of securities legislation in Canada.

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For proponents of centralization, the efforts at uniformity are ineffective. Despite national instruments and current initiatives, securities legislation is not completely harmonized. The cooperation process set up through the CSA is relatively recent and certain major initiatives were put in place after 1997 (MRRS, SEDAR). The harmonization process is continuing. However, it is not clear that complete uniformity is desirable. The very diverse nature of the Canadian market and local peculiarities mean that it can be considered a group of markets rather than a single market. Most studies, however, seem to minimize the level of uniformity set up by the CSA. A study of the national instruments shows, however, that they now govern a large part of the securities business.

The regulatory burden prevents growth companies from having access to financing. Provisions for private placements are still different depending on the Canadian jurisdiction, in particular for sophisticated investors, although efforts at uniformity have been made and are ongoing. The

[10] See, on this issue, Coffee, J.C. 2002. "*Understanding Enron : It's About the Gatekeepers, Stupid*", Columbia Law School, Center for Law and Economics Studies. SSRN Working Paper, and "*Financial Oversight of Enron : The SEC and Private-Sector Watchdogs"*, Report of the Staff to the Senate Comity on Governmental Affairs, 2002, http://www.senate.gov/~gov_affairs/enron100702.htm.

increased number of initial offerings, in particular for venture capital, the high mortality and the weak accounting and market performance of new listed companies leads us to believe that Canadian regulation gives start-up companies access to the stock market too easily.

"The various arguments put forward to justify the creation of a single commission are therefore not very convincing."

The various arguments put forward to justify the creation of a single commission are therefore not very convincing. The benefits of the present system are systematically omitted from the debate and centralization is often presented as the only solution to the various problems raised. This solution leads to a regulatory monopoly, a model criticized by many scholars.

4. Regulatory competition

Arguments put forward by proponents of regulatory centralization assume that a single authority would be able to regulate the securities industry in an optimal manner and at a lower cost. Perfectly homogeneous regulation would be preferable to the current situation. This idea is opposed to the market approach, which exists particularly in the field of company law in the United States. According to this approach, internal and external competition between regulatory bodies should lead to less complete and stable uniformity than that of centralization, but more in keeping with the real needs of participants. Between the two extremes there is a middle position such as reciprocal delegation, on which the European passport system is based.

"... regulatory competition is therefore a necessary condition to counterbalance the excessive power of central authorities who do not necessarily act to maximize social well-being ..."

For several authors, regulatory competition is therefore a necessary condition to counterbalance the excessive power of central authorities who do not necessarily act to maximize social well-being and to allow mechanisms which can lead to maximum social utility to be set up. The counter-argument to this proposal is based on the race to the bottom concept: placed in a competitive situation, organizations are encouraged to reduce their requirements to attract trading and issuers. Aside from the fact that such behaviour adversely affects the local market by increasing risk and the cost of capi-

tal for issuers, there are various mechanisms allowing limits to be placed on the race to the bottom, in particular the establishment of minimum common standards. Some evidence suggests, however, that a race to the top and not to the bottom exists in the securities field where, traditionally, the most exacting jurisdictions have attracted a greater number of issuers and investors.

Competition in company law in the United States seems to have led to the emergence of relatively uniform laws in the various States, although certain authors have criticized this model. Competition has been lead by the State of Delaware, where more than half of American corporations are incorporated and which, between 1996 and 2000, incorporated 90.22% of new companies which chose a State other than their State of origin. This movement does not seem to be to the detriment of investors, as changes from the place of incorporation to Delaware seem to be perceived positively by the stock market. American specialists, such as Roberta Romano of Yale University, suggest that the competition prevailing in company law be applied to securities law.

In the securities field, subject to constant changes, rapidity of adaptation to laws and regulations and quick detection of problems and tendencies is essential. The European system of mutual recognition allows a certain degree of competition. That system does not lead to the disappearance of local authorities, which several countries are currently strengthening. It also allows the existence of differences which can take into consideration the distinctiveness of various countries. As with the European market, the Canadian securities market is diverse in terms of types of companies and provincial initiatives. Because of its regulatory structure, Canada has found itself over the years in a system of imperfect regulatory competition. The various jurisdictions can set up different rules, but issuers and intermediaries remain subject to the jurisdiction of the province where they operate or offer securities. Such a system encourages innovation. The creation of programs such as stock savings plans in Quebec, capital pools in Alberta and negotiated bro-

"As with the European market, the Canadian securities market is diverse in terms of types of companies and provincial initiatives."

kerage fees are examples of innovation begun in one province and copied in others.

"The European situation combines regulatory competition for securities and minimal standards."

The European situation combines regulatory competition for securities and minimal standards. The current steps following the Lamfalussy report, revision of ISD 93, new directives on prospectuses and the FSAP constitute various means used by the European Community to ease dysfunctions in the mutual recognition system initiated in 1993. The absence of minimum standards and mechanisms allowing their development and implementation explains the lack of success of the process of mutual recognition set up in 1993. The objective of recent steps, and in particular those following the Lamfalussy report, is to implement the minimum standards required for the system of mutual recognition to function properly, and not to provide for the creation of a single securities commission in Europe. There is already a forum allowing the setting up of common standards in Canada, and minimum common standards exist in almost all areas. Nothing therefore prevents setting up a passport system.

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A system of regulatory monopoly is not necessarily preferable to that of regulatory competition. Each of the two systems has advantages but the present debate only mentions the disadvantages, either real or perceived, of the existing system. It is true that in the absence of a uniformity effort allowing mutual recognition, a partitioned system has clear disadvantages. However, the Canadian market has greatly evolved over two decades and the option chosen by the European Community should be seriously considered, especially since the American model, often cited as an example, certainly cannot be transferred into Canada.

5. Canadian and American financial systems: competition and regulation

The American situation is often put forward as an example of regulatory centralization and its implementation within a federal state. There are, however, significant differences between the two markets.

The American financial market is very fragmented, both in banking and securities. Regulatory centralization may be best in such a case, although a number of researchers dispute this. Regulatory monopoly is, however, only apparent: it does not exist for banking or company law, and is only partial for securities. The United States General Accounting Office states that in March 2002, the SEC oversaw nine exchanges, the over-the-counter market and seventy alternate trading systems, as well as twelve clearing houses. The American banking and securities markets include a very large number of participants, which strongly compete with each other. The United States has regulatory competition for company law. In the banking sector, a dual system was set up, allowing a certain degree of competition. Securities regulation is segmented, with small local issues being governed locally. The SEC may be considered a regulatory monopoly with respect to important securities, in the face of a competitive and fragmented industry. In securities in particular, the United States is considered to have onerous, costly and strict regulation. This regulation applies to companies very different from those in Canada, where small issues predominate. The SEC is considered to be inefficient, slow and lacking resources. The Unites States is therefore not a model of regulatory centralization in the various areas related to the financial sector. In terms of lawsuits involving securities, centralization is highly criticized and sometimes linked to the series of recent stock market scandals.

"The SEC may be considered a regulatory monopoly with respect to important securities, in the face of a competitive and fragmented industry."

On the contrary, the Canadian financial system is highly concentrated, as shown in Table 3, which presents various concentration data. For the Task Force on the Future of Canadian Financial Services (MacKay letter), Canada was the developed country with the most concentrated banking

"On the contrary, the Canadian financial system is highly concentrated..."

sector in 1997. The method used by the Royal Bank gives a ratio of Canadian concentration of 46% as opposed to 81% for the MacKay letter, which means that Canada comes after Switzerland and the Netherlands. However, the study by the Bank for International Settlements confirms the MacKay letter data and also shows strong growth in the concentration, which increased from 60.2 to 77.1% from 1990 to 1997. Such an increase is not seen in any other country. Only the United States is experiencing similar growth, but the concentration index was only 11.3% in 1990. Canada, along with the Netherlands, seems to be the OECD country where the banking sector is the most concentrated. Despite this already high concentration, the largest banks have tried several times to merge. In 2001 the six main integrated firms belonging to the six largest Canadian banks had more than 70% of the business in the industry. All the large integrated brokerage firms in Canada therefore belong to six banks representing more than 90% of the total banking assets in 2002. These institutions are heavily involved in the holding of exchanges and in the boards of directors of various self-regulatory organizations, where they hold the majority of seats (54%) as opposed to 8% for issuers and none for investors.

"Canada has only one exchange group, two clearing agencies, one regulatory service and a few alternative trading systems, which are mostly under the direct or indirect control of the large banks and their broker subsidiaries."

Canada has only one exchange group, two clearing agencies, one regulatory service and a few alternative trading systems, which are mostly under the direct or indirect control of the large banks and their broker subsidiaries. To our knowledge, no developed country presents such a high level of banking, financial and self-regulatory concentration. The financial aspect is governed by provincial securities commissions. Centralization proposals for regulation of securities-related responsibilities will, faced with such a group, lead to a single securities commission. The establishment of a national commission would lead to regulatory monopoly. Authorization of the mergers of banks, which own the main brokerage firms, and the growing concentration in this sector, seems to be leading Canada to oligopoly. According to the forecasts of regulatory theoreticians, a situation where a regulatory monopoly governs an oligopoly is potentially dangerous. This cannot be ignored in the present discussion surrounding the restructuring of securi-

"According to the forecasts of regulatory theoreticians, a situation where a regulatory monopoly governs an oligopoly is potentially dangerous."

ties regulation in Canada.

Table 3: Ratio of concentration in the Canadian banking sector according to various studies

Task Force on the Future of Canadian Financial Services (MacKay letter)[1]		Royal Bank Study[2]	Bank for International Settlements (BIS)[3]	
1997[4]		1997[5]	1990[6]	1997[7]
Switzerland	71 %	80 %	53.2 %	57.8 %
Australia	69 %	--	72.1 %	73.9 %
Netherlands	75 %	57 %	73.7 %	82.2 %
Canada	81 %	46 %	60.2 %	77.1 %
France	--	36 %	67.8 %	69.3 %
United Kingdom	40 %	19 %	43.54 %	35.2 %
Japan	--	12 %	31.8 %	29.1 %
United States	19 %	7 %	11.3 %	25.56 %
Germany	15 %	20 %	17.1 %	18.8 %

1: Task Force on the Future of Canadian Financial Services: *Competition, Competitiveness and the Public Interest* Background Paper No. 1, September 1998.
2: Royal Bank of Canada, *Canada's Banks: A Strategic Asset*, Spring 1998.
3: Group of Ten, *Report on Consolidation in the Financial Sector*, available at www.bis.org, January 2001.
4: The ratio equals the total banking assets of the five largest banks over total banking assets.
5: The ratio equals the total banking assets of the five largest banks over total assets of all financial institutions.
6: Indeterminate method of calculation.
7: Data from the United Kingdom and Germany are dated 1998 and that of Switzerland 1997.

Source: MacKay letter, Royal Bank of Canada study and Group of Ten Report.

The American regulatory framework is complex. The regulation of local issues has remained the responsibility of the States, and these issues constitute the vast majority of Canadian issues. The American system has not proven its effectiveness and nothing therefore leads us to believe that the American securities regulatory model can be transferred to Canada. Moreover, the very high concentration of the Canadian financial sector makes a regulatory solution based on a single body dangerous.

The preceding sections should not make anyone believe that the Canadian securities market is not threatened. It faces considerable challenges, but they do not appear to have been created by the provincial regulatory structure.

6. Growth of the Canadian securities market: findings and challenges

According to the proponents of centralization for securities, regulatory decentralization and multiple securities commissions would impair the development of the Canadian stock market. As there is little information on this market, we will look at its growth over the past decade and point out the special features of the Canadian securities market.

"... it (the Canadian securities market) is distinguished from other developed markets by:

- *the presence of many small-cap companies*
- *the presence of many new companies*
- *the high mortality of listed corporations."*

It is distinguished from other developed markets by the presence of many small-cap companies: in 2002, 67% of operating corporations had shareholder equity of less than $10 million and less than 600 could be listed on the NASDAQ. In addition, the Canadian market in characterized by the presence of many new companies. On average, 189 new public offerings are conducted each year. The Canadian market is also distinguished by the high mortality of listed corporations.

Table 4 shows the growth of capitalization of the main OECD countries, according to S&P data. We have corrected the Canadian capitalization to make it consistent between 1990 and 2000 and to neutralize the effect of the stock exchange restructuring. Canadian stock market capitalization has more than tripled during the last decade, increasing from US$242 billion at the end of 1990 to US$771 billion in 2002. In 2000, Canada ranked behind France, Germany and Switzerland. The market capitalization of Germany tripled in 10 years, whereas that of Japan stagnated. If these variations are corrected to neutralize variations in the market index (Table 4, Panel B), the real Canadian capitalization increase is, however, much lower than that of other countries (with the exception of Japan). The net Canadian capital cre-

ated was only 16% in ten years, as opposed to 62% in France, 52% in the United Kingdom and Germany and 24% in the United States. Real Canadian capitalization growth and trading volume is slow, not very different from that of the economy, and the relative position of Canada in relation to the main countries of the OECD is worsening. Canada is unattractive for foreign corporations and the presence of foreign corporations is symbolic: more than 99.9% of the trading value in such securities is outside the Canadian market. It appears that the Canadian stock market is no longer attracting trading in foreign stocks. On the other hand, the American market captures a significant share of trading in large Canadian inter-listed companies. More than one-third of heavily traded Canadian stocks are now traded in the United States rather than in Canada. This is a very worrisome situation, given the importance of a stock market for a country.

"Real Camadian capitalization growth and trading volume is slow, not very different from that of the economy, and the relative position of Canada in relation to the main countries of the OECD is worsening."

Table 4: Ranking of the first 6 countries at the end of 1990 and 2000 by market capitalization, distribution of market capitalization in billions of US$, according to S&P data. Panel A shows gross data, panel B shows data net of index fluctuations.

Panel A	Variation %	2000		1990	
		Rank	Capitalization	Rank	Capitalization
United States	393.76	1	15,104	1	3,059
Japan	8.19	2	3,157	2	2,918
United Kingdom	203.53	3	2,577	3	849
France	360.83	4	1,447	5	314
Germany	257.75	5	1,270	4	355
Canada corrected	218.60	7	771	6	242

Panel B	Variation %	2000 Net Capitalization	1990 Net Capitalization
United States	23.50	3,778	3,059
Japan	-29.34	2,062	2,918
United Kingdom	51.83	1,289	849
France	62.10	509	314
Germany	52.39	541	355
Canada corrected	16.12	281	242

Sources: Standard & Poors, Emerging Stock Market Fact Book, New York, 2000 and 2001. TSE Review 1993 and 2001, Five-Year Statistical Summary, Bank of Canada exchange rate at the end of the year, and market index per country from Datastream.

"The Canadian market (...) is progressively losing its role as the dominant market for high-volume Canadian securities."

The Canadian market is not the dominant market (where the majority of trades take place) for foreign securities, and it is progressively losing its role as the dominant market for high-volume Canadian securities. This phenomenon might grow, as models predict that the transfer of trading will continue to gravitate to the country offering the most favourable trading conditions. In addition, the upstairs market is developing rapidly, and only 30% of the total trading value for Canadian securities is now done on the regular Toronto market. This situation is generally seen as a problem and the NYSE, for example, greatly limits this practice.

A study of factors leading investors to prefer one market over another shows that the Canadian securities market is facing important challenges. The factors which attract investors and issuers are mainly market quality, the registration effect, and the corporate visibility effect.

Market quality: Investors and issuers are attracted by highly liquid markets, where large block trades of securities have minimal effect and where trading costs are the lowest possible. Issuers are also attracted by markets where they can raise large amounts, which is related to market size. They also attach great importance to the following of stocks by securities analysts.

The registration effect: Companies choose markets where disclosure standards are more strict than the country of origin to benefit from the registration effect and a lower cost of capital. The Canadian market is facing a dilemma. Should disclosure and governance standards be realigned with the new American standards for disclosure and governance set out in the Sarbanes-Oxley Act or, on the contrary, should they be softened to meet a more local dimension in keeping with the requirements of small-cap companies?

The corporate visibility effect: Having its securities traded on an American market is seen as prestigious. Some companies whose products are sold in the United States also seek to make their customers their shareholders.

There are obstacles to the transfer of companies to the US market. The main one seems to be related to the costs incurred by the application of American accounting principles[11]. The harmonization of national instruments should progressively eliminate this cost, as the multijurisdictional disclosure system seems to have eliminated the additional costs related to compliance with SEC requirements. The progression of trades to the United States should therefore continue. It represents a major challenge to the Canadian securities market. The TSX is meeting the criteria of world markets less and less. It corresponds more to a regional market, defined according to Galper (1999)[12] as follows: *the Regional Exchange dominates its local economy. It has the greatest concentration of regional listings available and is the chief expert in these listings. By virtue of its intense national concentration, its index becomes a barometer of the health of the publicly quoted part of the regional economy. It may trade securities and derivative products. It draws its clientele primarily from regional investors, with a smaller share of international investors interested in benefiting from the available expertise and opportunities*. The TSX Venture Exchange is apparently a small and medium business market (SMB, Schulman, 1999), a category in which the NASDAQ also falls. To the extent that Canada has less than 600 corporations which can be listed and traded on the NASDAQ, the TSX should also be in that category. This appears to be all the more true as trading in large-cap securities progressively gravitates to the American market. The implications are significant, in terms of development and regulatory strategy. The main aspect to be considered for SMB exchanges is proximity: *an exchange provides a real estate function for companies in the sense that it is where companies locate their stock listings and it is where customers (investors) come to buy and sell that stock. Therefore, to enhance the profile of an SMB market, exchanges should create attractive SMB market communities with*

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[11] Houston, C.O. and R.A. Jones, "*Canadian Manager Perceptions of the US Exchange Listings : Recent Evidence*", Journal of International Financial Management and Accounting 13: 3, 2002, 235-253.

[12] Galper, J. 1999. "*Three Business Models for the Stock Exchange Industry*," World Federation of Stock Exchanges.
http://www.world-exchanges.org/index.asp?resolutionX=1280&resolutionY=1024

financial influence, recognized value, and uniquely beneficial services (Schulman, 1999, p.14).[13] As the few large-cap securities are gravitating to American markets, it seems inescapable that the Canadian market will progressively become a market of medium and small companies by international standards.

"As the few large-cap securities are gravitating to American markets, it seems inescapable that the Canadian market will progressively become a market of medium and small companies by international standards."

The Canadian securities market is therefore facing major challenges in terms of public policy. A revision of the current regulatory structure is probably not an essential aspect of the situation. The progression of trades to the United States, the smaller and smaller portion of trades carried out on the downstairs market, and the total lack of attraction to Canada by foreign securities are more problematic. The stakes are high and cannot be ignored in the debate taking place in Canada. The factors of location, adaptation to different regional and sector factors, the framework of small-cap securities, the switch from risk capital to public financing and the survival of new issues will become major factors. Moreover, the reduction of real or perceived advantages from the transfer of trading to the United States should become a subject of study and careful thought.

"A revision of the current regulatory structure is probably not an essential aspect of the situation. The progression of trades to the United States, the smaller and smaller portion of trades carried out on the downstairs market, and the total lack of attraction to Canada by foreign securities are more problematic."

7. Conclusion

The Canadian securities market is confronted with major challenges. It faces direct competition from a much larger market, where various market systems compete fiercely with each other. A serious review of the factors which encourage the migration of cross-border trading, and which seriously limit trading of foreign securities in Canada, is warranted. It appears difficult to impute to the provincial regulatory structure these difficulties which essentially affect the secondary market and the costs of which are mostly related to stock exchange operations and brokers.

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[13] Schulman, A. 1999. "*Small and Medium Size Business Markets*," World Federation of Stock Exchanges. http://www.world-exchanges.org/index.asp?resolutionX=1280&resolutionY=1024.

Regulation is often presented as a cost factor and an impediment to new issues, which are relatively numerous and comparatively inexpensive as compared to similar operations conducted in the United States. No study has shown that the current regulatory structure disadvantages Canadian issues. The analysis of prospectuses and applications for exemptive relief is also more rapid in Canada. While we are not saying that there is no room for improvement, it must be admitted that the argument of the negative effects of the regulatory system on Canadian issues has not been proven.

The proposed centralized model would change with respect to harmonization of securities legislation which, to a great extent, is now governed by national standards. It would create a regulatory monopoly, a dangerous situation given the very high concentration of the regulated industry, and would cause the loss in Canada of the benefits of regulatory competition which currently prevails. There are few arguments to the effect that such a structure would reduce direct costs and the Australian example seems to indicate the opposite. On the contrary, a system based on harmonization and mutual recognition (the passport) presents advantages which have lead the European Community to opt for this system of securities regulation.