THE CANADIAN SECURITIES INDUSTRY AND OWNERSHIP REGULATION

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INTRODUCTION

The 1987 changes in Canada's securities industry regulations have been called the "little bang". This term refers to the view that deregulation of the financial markets would set off a flurry of activity. With relaxed regulations regarding entry and ownership of securities firms, observers believed that the Canadian capital markets would develop into a more active global player. In fact, the increased activity occurred to some extent in the early stages and subsequently accelerated to result in a significant industry restructuring.

Chartered banks quickly seized the opportunity for a presence in the securities industry. Examples of domestic chartered bank arrangements include the Bank of Nova Scotia's one hundred percent ownership of McLeod Young Weir and CIBC's sixty-seven percent ownership share of Wood Gundy. Indeed, domestic banks partially or wholly own all of Canada's top five securities firms.

In addition to the increased chartered bank presence in the Canadian securities industry, this same sector has undergone a series of mergers and purchase agreements with domestic financial institutions. The creation of securities subsidiaries by both Trilon Financial Corporation and Royal Trustco Ltd. is another example of the domestic trend towards increased consolidation of financial services.

Foreign financial institutions also wanted to gain a foothold in the Canadian securities industry. In the first instance, foreign banks purchased complete or partial stakes in five existing Canadian securities firms. Other foreign financial institutions such as J.P. Morgan Securities Canada, Credit Suisse Inc. and Citibank Canada Securities Ltd. have chosen to establish a

presence through their own investment houses. Furthermore, there are more than two dozen foreign securities firms set up in Canada including giant Nomura Securites of Japan and other foreign interests such as Commerzbank of Germany, Britain's S.G. Warburg and California-based Security Pacific Corporation. The result of both the domestic and foreign led activity has been the integration of securities firms into much larger financial institutions with their concomitant capital bases.

Meanwhile, the future for medium-size independent brokerage houses looks bleak. Only the small "boutique" operators with an established and specialized niche are likely to stand a chance of survival in this increasingly competitive market of large players.

Further entry and consolidation in the securities industry will obviously create increased competition and a larger capital base. However, the overall economic impact of these changes was not entirely clear at the time of deregulation. This paper will examine i) the role of the securities industry in the Canadian economy, ii) the debate of the 1970s and 1980s which inspired deregulation and iii) the impact of the reduced restrictions.

The securities industry which emerged from deregulation in the late 1980s and continues to develop into the 1990s demonstrates significant progress. It should be pointed out, however, that Canada's securities market does not function in isolation. Trends in the international financial services industry during the past several years prove that deregulation is a critical ingredient in ensuring that Canada's securities industry remains a viable and active player in the global market.

SECURITIES MARKET

SIZE AND IMPORTANCE

This section of the study examines the role of the securities sector and provides background data on the magnitude and adequacy of the Canadian securities market.

The capital market exists as a means to transfer funds from savings surplus units to savings deficit units. Thus, the capital market stimulates economic growth by ensuring that resources are allocated towards productive use. One of the methods of completing this transfer is through the issue of securities. Securities, in effect, are claims offered by deficit units in exchange for cash from surplus units. This can be done by one of two methods i) directly between surplus and deficit units or ii) financial institutions which acquire the claims of deficit units and issue new claims on themselves.

Securities markets offer liquidity to holders of securities. Liquidity means that holders are able to exchange securities for cash at a low transaction cost without appreciably affecting the price of the security. Through intermediation, financial institutions are then able to turn these short term liquid funds into longer term securities. The conversion to longer term securities is critical since it means that savings funds are more effectively allocated to longer term investment needs.

Given the importance of the securities market, it is interesting to examine a number of measures which provide a background to its role and importance. Domestic and international savings trends provide the basis to determine the adequacy of Canada's capital market to finance

capital formation. Capital formation measures the capital expenditures which are invested in real assets in the economy. This investment can take the form of direct investment in real assets or investment in financial assets. The direct investment in real assets does not require any capital market involvement since savers convert surplus funds directly into capital expenditures. These capital expenditures can also be financed by capital market transactions.

CAPITAL FORMATION

In an early Canadian capital market study published by Shaw and Archibald (1972), the authors arrived at the conclusion that Canada's "historical international position as an importer of funds has changed and this country can generate sufficient savings to finance the current level of capital investment".[1] However, this conclusion would not seem to be borne out by statistics from the period 1970 to 1988. Although the years 1970 and 1988 did exhibit the trend suggested by Shaw and Archibald, this was in fact the exception.

Information regarding gross domestic saving and investment (domestic capital formation) in Canada for the period of 1970 to 1988 is presented in Table 1. Data for five year intervals between 1960 and 1985 were used as well as data for 1986 through 1988. The comparisons of these figures may be affected by the cyclical effects present in any given year selected but overall trends may still be analyzed. Table 1 demonstrates the difference between the amount of domestic savings and capital formation and reflects to what extent international capital markets play a role in Canada's capital formation. In the period 1960 to 1988, gross domestic capital grew from 7.0 billion to 119.8 billion. In terms of the relationship between savings and investment, this varied from a savings surplus in 1988 of 13% to a savings deficit in 1960 of

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[1] David C.Shaw and T.Ross Archibald, Canada's Capital Market (Toronto: University of Western Ontario and the Toronto Stock Exchange, 1972) p.14.

TABLE I

SOURCE AND DISPOSITION OF NATIONAL SAVINGS IN CANADA

(Billions of Dollars)

	1960	1965	1970	1975	1980	1985	1986	1987	1988
SOURCES(savings)									
Persons and unincorporated business	1,675	2,927	3,975	9,366	21,889	43,944	37,845	33,096	39,275
Personal savings									
Adjustment on grain transactions	6	(44)	207	(7)	707	13	(109)	(251)	148
Government	(809)	246	3,327	(552)	(2,446)	(26,836)	(22,539)	(17,028)	(11,564)
Corporate and government business enterprises									
Undistributed profits	824	1,415	2,744	7,641	18,394	17,824	15,796	23,878	46,402
Inventory valuation adjustment	(57)	(325)	(171)	(2,998)	(7,096)	(2,165)	(1,789)	(3,036)	(3,254)
Capital assistance	0	84	121	336	519	3,288	3,278	2,444	2,139
Capital consumption allowances and misc. valuation adjustments	4,291	6,110	9,898	17,469	33,448	53,725	59,438	64,066	67,813
Residual error	(96)	26	(451)	(171)	(127)	1,765	132	1,652	(987)
GROSS DOMESTIC SAVING	5,834	10,439	19,650	31,084	65,288	91,558	92,052	117,245	135,005
USES(investment)									
New residential	1,476	2,124	3,558	7,960	14,046	25,447	30,823	39,192	43,539
New non-residential	2,567	4,024	8,160	15,808	29,477	36,056	35,654	37,720	42,807
New machinery and equipment	2,569	4,503	6,243	13,561	25,382	31,134	34,849	39,265	45,140
Physical change in inventories	316	948	122	(836)	(1,754)	2,681	2,936	2,719	2,483
Residual error	97	(25)	452	171	128	(1,764)	(131)	(1,651)	986
GROSS DOMESTIC CAPITAL FORMATION	7,025	11,574	18,535	36,664	67,279	93,554	104,131	105,072	119,824
Net foreign investment	(1,191)	(1,135)	1,115	(5,580)	(1,991)	(1,996)	(12,079)	12,173	15,181
TOTAL	5,834	10,439	19,650	31,084	65,288	91,588	92,052	117,245	135,005
Gross domestic saving / G.N.P.	15%	19%	23%	19%	22%	20%	19%	24%	23%
Gross domestic capital formation / G.N.P.	18%	21%	22%	22%	23%	20%	21%	20%	21%
Domestic saving as a percent of Gross domestic capital formation	83%	90%	106%	85%	97%	98%	90%	112%	113%

SOURCE: STATISTICS CANADA, "NATIONAL INCOME AND EXPENDITURE ACCOUNTS",CAT. 13-001 (VARIOUS ISSUES)

17%. These figures suggest that although Canada was able to generate adequate savings to finance capital investment in several periods (notably 1970,1980,1985,1988), there is evidence that other periods have required substantial foreign investment (1960,1975).

Moreover, Canada's situation as a net exporter of capital in 1970, 1987 and 1988 may simply be a reflection of a slowing economy which was not able to attract foreign investment. In fact, economic indicators for these years illustrate that Canada's economy as a whole was in a downswing and therefore did not attract foreign funds. One consequence of the reduced economic activity during these three years was that domestic funds were more than sufficient to finance capital investment.

Based on an international comparison (Table 2) 1987 rates place Canada near the average of approximately 20% for both gross fixed capital formation and the gross saving ratio. Japan is by far the highest saver among industrialized countries and as well its rate of capital formation is the highest. Canada ranks second in the rate of capital formation and fifth in the savings ratio for 1987 but the rates of the other industrialized nations are similar.

TABLE 2

1987 INTERNATIONAL COMPARISONS

(% of GDP)

	GROSS FIXED CAPITAL FORMATION[1]	GROSS SAVING RATIO[2]
CANADA	21.0	18.8
UNITED STATES	17.3	14.7
JAPAN	28.9	32.3
FRANCE	19.4	19.6
GERMANY	19.4	23.9
ITALY	19.9	20.9
UNITED KINGDOM	17.3	17.2

SOURCE: OECD ECONOMIC SURVEYS, CANADA 1988-89, "BASIC STATISTICS: INTERNATIONAL COMPARISONS"

1. GROSS FIXED CAPITAL FORMATION = TOTAL PRIVATE AND PUBLIC INVESTMENT

2. GROSS SAVING = GROSS NATIONAL DISPOSABLE INCOME MINUS PRIVATE AND GOVERNMENT CONSUMPTION.

PERSONAL SAVINGS

Savings by households or persons is an important source of funds for the capital market. If these savers acquire real assets directly, there is of course no capital market transaction. If instead the household savers purchase financial assets, there is an inflow to the capital market. The surplus available from households has increased significantly over the past two decades. The savings rate reached highs between 13 and 18% in the early 1980's and even though this rate has declined considerably since 1985 it still remains well above rates prior to 1973. In an international comparison, Canada's savings rate compares favourably to other OECD countries. Among the seven largest Western industrialized nations Canada's savings rate has been similar to that of most of the Western European countries while falling short of Italy and Japan. In fact, Canada's household savings rate has outperformed the total OECD average for all of the 1980's and up until 1985 remained very close to the average savings rate for the four major European countries. On the other hand Canada's savings rates have been much higher than smaller OECD countries and the U.S.[2] The relatively high domestic savings rates are significant as they are an indicator of the availability of funds for investment into financial assets.

FUNDS FLOWS

The structure of personal funds flows into financial assets in Canada is one means of determining the changing patterns of investment by Canadians. Data from Statistics Canada[3] demonstrates that until 1986 currency and deposits were still the largest share of financial assets

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[2] OECD ,OECD Economic Outlook,June 1988 (Paris,1988)Table R12.

[3] Statistics Canada, Financial Flow Accounts, Vol. 13-002, various issues.

flows at 43%, even though there had been a substantial decline in their importance since 1970. In fact, in the eighteen year period from 1970 to 1988 there has been a net decline of more than 55% in the holdings of currency and deposits. Life insurance and pension funds displaced currency and deposits as the most active asset flows in 1987-1988. Meanwhile, a number of securities instruments experienced a small net increase in their percentage of total asset holdings. One of the most notable changes within this category is the level of holdings of stocks. This asset showed considerable growth to a level in 1985-86 of approximately 7-8% of personal funds flows. In 1987-88, however, as the stock market soured, funds flowed to more secure assets such as bonds and treasury bills. One observation becomes evident from the examination of funds flows during the 1970s and 1980s. This is that although the amount of funds placed in the various financial instruments is subject to large fluctuations depending on market conditions, the presence of the securities sector has become much more prominent during the past twenty years.

SECURITY ISSUES

The corporate sector is historically a net borrower in financial markets. Although the sector does have savings, these are generally either reinvested in real assets or distributed as dividends. This sector does provide short-term funds but overall the investment in securities is relatively small. In fact, currency, deposits, receivables and other financial assets form a large proportion of business asset holdings. In periods of growth the business sector has a need for funds to fuel expanding production. Similarly,there is an increased requirement for net borrowing in periods of recession when this sector's financial position deteriorates.

Governments are large demanders of funds from the securities markets. In order to fund the

expenditures of the various levels (federal, provincial, municipal) it is necessary that large issues be placed on the market. Governments agencies also have requirements due to their role as financial intermediaries in providing loans to business and homeowners.

The level of new security issues by Canadian corporations indicates the trend within this market. Even with slumping markets, Canadian corporations raised 22.0 billion in 1987 compared to 1.8 billion 21 years earlier in 1965. The growth in these issues over five year intervals is most impressive from 1970-1985 with increases of between 89 and 125%. If we compare debt and equity financing ratios over this twenty year period, debt financing had dropped from a peak of 82% in 1970 to a low of 33% in 1985. Meanwhile, equity growth experienced the opposite trend. The drastic reduction in new issues and the reversal of the longstanding trend towards equity financing can again be attributed to the stock market slump present since 1987. In fact, the percentage of total issues for bonds and stocks has come full circle since 1970. Bond issue and stock issue levels in 1988 were 83 % and 17% respectively, almost identical to their proportion in 1970.

The level of foreign corporate financing is high considering that earlier data (Table 1) had demonstrated sufficient domestic saving for capital financing. For example, in 1980 there was 29% foreign financing while the gross domestic savings available suggest the possibility of 97% domestic capital financing. The lowest level of foreign corporate financing occurred in 1975 with 16%.[4] This contrasts remarkably with the 85% ratio of domestic saving to domestic capital formation. This anomaly suggests that foreign financing may not simply be filling gaps in domestic savings but may in fact be replacing it as an alternative for financing capital projects.

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[4] **Bank of Canada Review,"Net New Issues of Securities by Financial and Non-Financial Corporations"(Table F11,various issues)**

However, there may be additional factors leading to this seemingly high level of foreign financing. For instance, foreign securities firms' global presence and financial innovations allows penetration of Canadian domestic markets. Domestic and foreign financial institutions also have the added regulatory freedom to underwrite securities issues destined to be placed in international markets. This creates a potential bias for these financial market players to raise capital in foreign markets. Finally, foreign firms are often able to underbid Canadian securities firms. Foreign bond financing seems to have undergone rapid growth after 1975 with foreign financing at 58 and 70% in 1980 and 1985 respectively.[5] Meanwhile total debt financing has been on the decline during this same period. Therefore, even with these high levels of foreign bond financing, Canada has maintained a relatively stable share of overall domestic self-sufficiency in securities markets financing.

FINANCIAL MARKET STRENGTH:MORE EVIDENCE

One additional measure of the size of financial markets is the ratio of total domestic financial assets to Gross Domestic Product. A high ratio signifies a financial market with the ability to match the savings and investment preferences of portfolio holders. Canada's 1985 ratio of financial assets to GDP grew to more than 4.4 times the GDP. This ratio, approximately the same as other industrial countries,(Table 3) marks the presence of several layers in the financial market and is further evidence of a well-developed financial system.

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[5] Ibid

TABLE 3

KEY FINANCIAL RATIOS

1970-1985
(percent)

	1970	1975	1980	1983	1984	1985
CANADA						
TDFA/GDP	404.5	384.7	437.3	438.9	436.3	447.9
FAFI/TDFA	36.7	38.5	40.9	41.3	40.9	41.2
UNITED STATES						
TDFA/GDP	390.3	368.9	391.6	420.7	424.2	462.2
FAFI/TDFA	33.9	37.8	37.1	38.1	38.4	37.9
GERMANY						
TDFA/GDP	242.2	279.0	313.8	350.8	359.5	363.2
FAFI/TDFA	48.5	48.3	47.9	47.7	47.0	46.8
UNITED KINGDOM						
TDFA/GDP	N/A	447.9	432.4	561.6	632.6	N/A
FAFI/TDFA	N/A	32.9	33.6	34.4	34.8	N/A
ITALY						
TDFA/GDP	323.9	392.3	414.8	369.7	391.9	397.6
FAFI/TDFA	35.6	39.3	31.6	35.8	32.7	31.2

TDFA = TOTAL DOMESTIC FINANCIAL ASSETS GDP = GROSS DOMESTIC PRODUCT

FAFI = FINANCIAL ASSETS INTERMEDIATED BY FINANCIAL INSTITUTIONS

Note: The statistics for the above comparison are taken from the respective countries' System of National Accounts.

SOURCE: OECD ECONOMIC SURVEYS, CANADA 1986-87,p. 41

TABLE 4

SHARE OF SECURITIES ISSUES IN TOTAL CREDIT FLOWS[1]

1970 - 1985
(PERCENT)

	1970-71	1975-76	1980-81	1984-85
CANADA	49.5	39.3	40.4	49.4
UNITED STATES	20.5	38.6	35.1	46.7
GERMANY	20.5	28.5	25.5	36.4
ITALY	27.0	23.0	9.9	44.4
FRANCE	26.2	24.8	27.7	42.5

1. TOTAL CREDIT FLOWS = SUMMARIZES FLOWS IN MAIN CREDIT MARKETS, THAT IS, THE ORGANIZED MARKETS FOR SECURITY ISSUES AND NEGOTIATED LOANS THAT ARE THE PRINCIPAL FORMS OF EXTERNAL FINANCING FOR CAPITAL FORMATION, GOVERNMENT REQUIREMENTS AND OTHER NON-FINANCIAL ACTIVITIES.

SOURCE: OECD ECONOMIC SURVEYS 1986-87, (OECD FINANCIAL STATISTICS PART II)

FINANCIAL MARKETS: SHAKING THE PILLARS, p.42

Table 4 demonstrates further that Canada has developed one of the largest capital markets in relation to total credit flows. Credit flows summarize the principal forms of external financing for capital formation, government requirements and other non-financial activities. The size of the Canadian capital market and the demand for fixed income securities by institutional investors meant that changes in the structure of the supply of the capital market assets (i.e.

public sector deficit financing by financial institutions) could be absorbed without leading to reduced intermediation or to changes in the household sector's asset holdings. This is in contrast to the European situation where the public sector deficit was financed by bond issues which were purchased by the household sector. Canada and other OECD countries' experience was in fact a "financial deepening" in the sense that the role of intermediation fulfilled by financial institutions grew within the economy. Table 3 illustrates Canada's financial intermediation ratio (FAFI/TDFA-measured by the ratio of assets of financial institutions to total financial assets held by domestic residents) has increased since 1970 and has levelled off at approximately 41%. Although not displayed in Table 3, data for 1988 confirm a stable level of financial intermediation at approximately 42%.[6] This increased intermediation is further proof of the growing role of financial institutions in the economy's financial activities.

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[6] OECD, OECD Economic Surveys 1989-90: Canada (Paris 1990) p.120

TABLE 5

CORPORATE SELF-FINANCING RATIO[1]

1970-1985
(RETAINED INCOME AS A PERCENTAGE OF INVESTMENT)

	1970	1975	1980	1983	1984	1985
CANADA	78.4	76.5	72.1	97.1	106.4	93.9
UNITED STATES	73.6	89.9	81.6	114.6	N/A	N/A
GERMANY	58.3	56.4	48.6	58.9	58.3	N/A
ITALY	57.1	19.2	48.7	20.9	N/A	N/A
FRANCE	74.3	56.9	59.9	56.6	70.0	74.0
UNITED KINGDOM	70.1	51.2	73.8	113.5	121.4	N/A
JAPAN	81.2	40.9	62.8	68.6	70.0	N/A

1. THE CORPORATE SELF-FINANCING RATIO IS THE RETAINED INCOME BEFORE DEPRECIATION AND PROVISIONS AS A PERCENTAGE OF INVESTMENT IN NON-FINANCIAL ASSETS.

SOURCE: OECD ECONOMIC SURVEYS,1986-87

FINANCIAL MARKETS : SHAKING THE PILLARS

As discussed earlier, the business sector is a net borrower in financial markets. Canadian firms have relied to a greater extent on self-financing of its investment activity than European or Japanese firms but to a lesser extent than the United States. Table 5 shows that in the first half of the 1980's Canada increased its level of corporate self-financing (CSF) although this

ratio does show rather wide fluctuations. The Canadian CSF is consistently higher than other OECD countries except for the United States and the United Kingdom.

Canadian capital markets also demonstrate their strength in the percentage of investment financed by the issue of securities. A study by the OECD confirmed that many member countries rely more heavily on their banking sectors to finance business activity.[7] Once again Canada trails only the United States in its use of the capital market for business financing during the period of 1970-1985.

The preceding evidence leads an observer to conclude that Canada's capital market is healthy and growing. The flow of funds into this segment of the financial sector as well as the volume of securities issues reflects the market's strengthening during the period reviewed.

In summary, the basic characteristics of the Canadian financial market, when compared to measures of similar characteristics in other countries, indicate the relative strength of the Canadian capital market. The Canadian capital market's frequent comparison to the capital markets of such countries as Japan, the United States and the United Kingdom distorts our impression of the domestic market's stature. In fact, Canada's financial markets rank with the largest and most stable financial markets of the world.

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[7] OECD Economic Surveys,Canada:1986-87."Securities Issues as Percentage of Investment".(Paris:OECD ,1987)p.45

SECURITIES MARKET EFFICIENCY

Equally important in the discussion of the securities market is its role in the economy as an efficient resource allocator.

One of the classic studies of the stock market and its efficiency was written by Professor William Baumol, then of Princeton University. His 1965 study outlined his own view that efficient capital markets will lead to efficient resource allocation. This view maintains that the efficient firm will have easier access to capital markets than will the inefficient firm. Thus capital will be channelled towards the most productive uses and the economy's growth will benefit. This control of the economy's capital allocation ensures the composition of the economy's output meets consumers' wishes.

Securities transactions offer several advantages as a capital market mechanism for resource allocation. First, business is able to obtain information on the cost of capital and therefore can decide what level of investments to make. Secondly, a large number of savers with a broad combined level of wealth are accessible through the securities markets. Thirdly,this market also allows for simple transfers of funds between lenders and borrowers without excessive transfer costs. Fourth,the market provides the lender with an indication of the financial condition of the borrowing firm through its securities prices. Finally,the market also permits short-term savings to be pooled together for use in long-term loans.

All of these factors could lead an observer to conclude that the stock market is an efficient allocator of resources. This conclusion is not entirely correct though. Effective resource allocation means that the market value of a firm's securities reflect the capitalized value of the

company's expected future investment opportunity earnings. There is presumption that, by way of this mechanism, funds will be provided to those firms that make best use of them. This relationship between earnings and a security's market value ensures that inefficient or unprofitable firms will either be denied funds or will receive them on unfavourable terms.[8]

Observation of stock prices suggests that this link between potential earnings and market prices does not reflect the actual situation. Statistical studies have shown that market prices are largely random and thus the market mechanism is not currently an important factor in resource allocation.

Several conditions are considered essential for an efficient capital market to develop. First, allocational efficiency means the ability of one opportunity to attract savers' funds before a second opportunity that offers an inferior risk-return combination. This risk-return combination can of course be affected by government taxes and subsidies aimed at altering investment decisions. However, it is not certain that the allocation favoured by the government's program is in fact the best for the economy.

The second condition is operational efficiency. This is defined as a market with low transaction costs where investors must be able to transfer costs among various market alternatives. Operational efficiency also includes capital market services at minimum cost. This includes the costs of obtaining and interpreting securities information, the costs of regulation as well as brokers' commissions. Operational efficiency is necessary in the capital market if price distortions are not to be brought to bear on allocational efficiency.

The third condition is external efficiency. A market is considered externally efficient if

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[8] William Baumol, The Stock Market and Economic Efficiency (New York : Fordham University Press, 1965) pp. 1-8

security prices are determined by expectations of future value. This means that information about a company is reflected in its stock price. In this manner an investor knows that the market places a fair value on a stock based on all available public information. Even though stock prices in an externally efficient market fully reflect available information, these prices are not necessarily correct since the true value of a company cannot be completely known. Even if a company's stock value is known by insiders, it may not be information available to the public. If information is easily attainable and is available at minimum cost, then a market is considered externally efficient. In this type of capital market more investors will be able to analyze the information and prices will adjust according to their judgements.

Allocational efficiency requires that both external efficiency and operational efficiency exist in the capital market. This means that in the case of external efficiency, security prices will reflect all available information on returns and risks. Operational efficiency is necessary to ensure that transaction costs are kept at a minimum and investment is therefore encouraged. Also if the transaction costs of purchasing securities is greater than the same costs associated with investment alternatives, then the stock purchase appears unattractive.

Allocational efficiency is crucial to the capital market since the price of a firm's stocks reflects what an investor expects to get as a return on his investment. This price will be determined by the risk and return investors predict for a stock. The cost of equity capital for a company is a result of this rate of return. For a company to be able to make profitable investments it must be able to purchase real assets whose rate of return is above the cost of capital or its net rate of return to investors. This same cost of capital should determine the the allocation of capital within an economy. A market which is allocationally efficient and in which

prices reflect a company's risk and return should provide a measure of the cost of capital through these same prices. The end result should be efficient investments in real assets.

The efficiency of the Canadian capital market can be measured to determine whether in fact the market is inadequate. On the issue of external efficiency, a number of Canadian and U.S. studies have been done to test the stock market's efficiency.

Three forms of external efficiency have been identified in the literature. Weak form efficiency implies that patterns in stock prices and hence stock returns should not be apparent. If there were serial correlation patterns which could be determined by investors, then these changes could be used for buying and selling to earn above-normal returns.

In fact, empirical work has shown that weak form efficiency does exist. However, future returns do not appear to be predictable based upon current stock returns. The evidence supports the random walk theory which states that the best prediction of tommorrow's price is today's price.[9]

The second test of stock market efficiency is the semi-strong form. This form of efficiency holds that public information will not cause stock price movements. If prices fully reflect the expected impact of announcements, then anticipated events should have no effect upon prices. Prices would only react to the unexpected parts of an announcement. Tests of this form of efficiency have generally supported its conclusion.[10] However, several exceptions whereby investors are able to earn abnormal profits with the use of public information have been

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[9] Douglas K. Pearce,"Challenges to the Concept of Stock Market Efficiency", The Economic Review, Sept./Oct. 1987 p.16-33. This article provides a summary of empirical research on the subject of stock market efficiency.

[10] Ibid

reported. Studies have also found price reactions to public announcements which are delayed. This evidence does not support the semi-strong form of efficiency either since only an immediate reaction to the unexpected portion of an announcement will ensure that no abnormal profits are earned.

The final form of efficiency is the strong form. This version of external efficiency describes a market where prices reflect inside information. In this situation not even insiders would be able to profit from information indicating stock price movements. This form of efficiency does not stand up to observation. Many cases of alleged or confirmed insider trading have come to the attention of securities market authorities in the recent past.[11] These insiders have earned above normal profits which would not have been possible if the market reflected all information.

EXTERNAL EFFICIENCY - CANADIAN EVIDENCE

Several efficiency tests have been conducted based on Canadian evidence. The first of these, a study by N. Close[12] in 1973, examined the impact of sales and purchases of blocks of securities and secondary placements on stock prices. Close's study was a test of the semi-strong form of efficiency. According to the theory of the efficient market, the market's reaction to a transaction only reflects the expected value of this new information. Since the price adjustment occurs rapidly, it should be impossible for an investor to earn abnormal returns based only on

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[11] U.S. securities authorities have successfully prosecuted several individuals including Ivan Boesky. On the Canadian front the investment activites of the Bennett family and Murray Pezim have come to the attention of securities regulators.

[12] N. Close," Price Reaction to Large Transactions in the Canadian Equity Markets ". Financial Analysts Journal Vol. 31 no.6 (November - December 1975) p.50

this information. At the same time, price theory holds that large transaction volumes create excessive bid and ask conditions which drive prices away from their equilibrium value. This produces abnormal returns until a new state of equilibrium was reached.

The results of the Close study supported the efficient market theory for stock purchases but also provided some evidence suppporting the price distortion theory.

A second test of the semi-strong form of efficiency based on Canadian evidence was conducted by J. Evans[13] in 1975. This study examined the impact of mutual fund transactions on stock prices. In essence, the theory of price distortion was supported by Evan's findings. He found a relationship between the abnormal returns and the volume of the transaction. The relationship was not significant for firms with a capitalization less than ten million trades.

A third study by J.A. Boeckh[14] investigated the rate of return and profits for industrial, mining and oil stocks. This examination revealed an externally efficient market since the rate appeared to decline with decreasing risk. This was not true for industrial stocks which demonstrated an efficient relationship of increasing rates of return for increased risk. Boeckh attributed this discrepancy to two possible factors: 1) oil and mining stocks may be treated as "long shots" which generally do not offer a reasonable return 2) investors may be optimistic in anticipating a large return. Overall, Boeckh's results confirm efficiency in some segments of the market but there is sufficient contradicting evidence to also suggest market inefficiencies.

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[13] J. Evans,"Mutual Fund Trading and the Efficiency of the Canadian Equity Markets" (Working paper No.214,Faculty of Commerce and Business Administration,University of British Columbia, 1975).

[14] J.A. Boeckh," Long-run Stock Market Performance in Canada : Implications for Allocational Efficiency " (P.H.D. Dissertation, University of Pennsylvania, 1968).

Finally, M. Findlay and A. Danan[15] conducted a study of the Canadian markets to determine whether a strategy of investing in low risk portfolios would obtain higher earnings than a portfolio consisting of stocks chosen at random. The theory of efficient markets predicts that a low risk portfolio will obtain lower earnings than a high risk portfolio. The same prediction holds for an earnings comparison between a low risk portfolio and a portfolio consisting of stocks chosen at random. Findlay and Danan's findings indicated the opposite conditions and therefore did not support the theory of efficient markets.

In summary, the Canadian evidence on external efficiency is inconclusive. Evidence of market efficiency was reported by Close in his study of the effects of stock sales and purchases on their value and by Boeckh in his review of industrial stocks' rates of return. These results were offset though by Boeckh's findings concerning high risk-low return mining and oil stocks, Findlay and Danan's evidence of low risk-high return portfolios and Evans's findings of a relationship between abnormal returns and the value of mutual fund transactions.

OPERATIONAL EFFICIENCY: Market Evidence

The direct observation of securities market costs is one method of assessing the market's operational efficiency. Transaction costs and profit trends in the Canadian securities market, prior to the industry restruturing in 1987, are key indicators of the market's efficiency prior to deregulation. First, efficiency evidence can be gathered by means of a comparison of Canadian and U.S. brokerage fees. These are the fees charged by a broker in the secondary market when a stock is traded. The statistical comparison will permit some observations on relative trading costs in the Canadian and U.S. securities markets.

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15 Alain A.Danan and M. Chapman Findlay III,"A Free Lunch on the Toronto Stock Exchange".The Journal of Business Administration,Vol.6 No.2 ,1975 pp.31-40

Secondly, Canadian and U.S. underwriting fees will be compared to determine whether the criteria for an operationally efficient market are met. The underwriting fee is the price charged by a securities firm to sell a new issue or the difference between the price at which the security is sold to the public and the amount received by the issuer. If firms are able to place issues at a lower transaction(underwriting fee) cost or if shares can be traded with lower brokerage commisssions in a foreign market, then obviously the Canadian market will not remain competitive in a global securities market. The larger profit margin in other countries' markets, not as adversely affected by transactions costs, will attract investors. High transaction costs may also act to discourage investment in the stock market while other investment instruments gain at the expense of stocks.

Thirdly, this section will examine the profitability rates of the securities industry. For this sector to be operationally efficient and thus keep costs low, there cannot be excessive profit taking. Furthermore, excess profits attract new entrants and drive profits downwards.

Finally, the impact of market concentration on efficiency is considered briefly.

BROKERAGE COMMISSIONS

As mentioned above, one of the major sources of revenue for investment dealers is brokerage commissions. This fee represents the charge applied to any trading activity carried out by a securities firm. This cost in turn plays a large role in the determination of the operational efficiency of the domestic securities industry. Although such statistics from the Ontario Securities Commission are not available to the public after 1985, data from the early 1980's can provide evidence of the overall cost trends in the Canadian industry prior to

deregulation. The cost data also serves as a basis for comparison with dealers in foreign markets during the 1980s period.

TABLE 6

SECURITIES TRADING BY

TYPE OF CLIENT

1980-1984
(percent)

TYPE OF CLIENT	DOLLAR VALUE					COMMISSION				
	1980	**1981**	**1982**	**1983**	**1984**	**1980**	**1981**	**1982**	**1983**	**1984**
INSTITUTIONS	37.7	42.3	52.6	50.5	56.4	22.7	25.9	34.3	29.6	35.0
INDIVIDUALS	55.5	51.9	43.1	45.2	39.9	72.8	70.2	62.4	67.4	62. 6
INTERMEDIARIES	6.9	5.8	4.3	4.4	3.8	4.5	3.9	3.3	3.0	2.5
TOTAL	100	100	100	100	100	100	100	100	100	100

SOURCE:"REVENUE AND MARKET ANALYSIS" (RAMA)
(THE TORONTO STOCK EXCHANGE-VARIOUS ISSUES)

Note: Tables 6-8 were based on information gathered from the RAMA Report.Unfortunately,this information is no longer generally available to the public and therefore the fee structures were studied for the most recent period published (1980-85).

Table 6 provides a summary of the trading activity by type of client. This table provides both the dollar value and commission fees earned from each client. The comparison demonstrates that in 1980 individuals were the largest traders by dollar value and also provided the largest share (72.8%) of brokerage commissions. When the share of trading by clients was

reversed and institutions became the dominant trader by 1982, the commissions (34.3%) earned from these clients did not grow correspondingly. Individuals continued to bear the largest share of commission fees even in 1984 with a significantly reduced market share based on trading by *dollar value. This table also shows that intermediaries accounted for a relatively small portion of the trading value but also managed to pay less than their corresponding share of commissions. There are probably several reasons for these developments. First,the type of client provides some rationale for the fee differentials. Individuals would generally be trading small blocks of securities and therefore would pay a transaction fee which is proportionately higher than the institutions' fees.

Institutions on the other hand deal with large blocks of securities in trading activity and therefore their fee as a percentage of the dollar value is reduced.As well their bargaining power as large clients provides the possibility of fee negogiation further reducing their commission fees. Perhaps more importantly, institutions also have the additional leverage of threatening to raise funds on a foreign market.

Intermediaries refers to other firms in the Toronto Stock Exchange and therefore these transactions among members may also be performed at a lower cost.

TABLE 7

TRADING AVERAGES BY TYPE OF CLIENT

1980-1985
(percent)

TYPE OF CLIENT	AVERAGE COMMISSION PER DOLLAR VALUE						
	1980	1981	1982	1983	1984	1985 (jan.- mar.)	1985 (apr.- jun.)
INSTITUTIONS	0.7	0.7	0.7	0.7	0.6	0.5	0.5
INDIVIDUALS	1.5	1.5	1.6	1.7	1.5	1.4	1.5
INTERMEDIARIES	.8	0.7	0.8	0.8	0.6	0.5	0.5
TOTAL	1.2	1.1	1.1	1.1	0.9	0.9	0.9

SOURCE: "REVENUE AND MARKET ANALYSIS"
(THE TORONTO STOCK EXCHANGE-VARIOUS ISSUES)

Table 7 displays a similar situation for average commissions per dollar value by type of client. Individuals pay the highest average commission throughout the years covered by the data(1980-85). In fact the difference in fees between individuals and institutional clients exhibit a widening gap. Brokerage commission averages for individuals were twice as high as those charged to institutions in 1980. By 1985 the ratio had grown to three to one.This was in spite of the trend towards lower commission rate averages overall. The total average commission rate fell steadily from 1.2 percent in 1980 to .9 percent by 1985 but this was not the case for

individuals who continued to pay the same in 1985 as in 1980; and they experienced even higher fees in 1982-83.

The decline in average commission rates was brought about by the elimination of a regulated fee structure in 1983. Prior to 1983, the industry's regulatory body (The Ontario Securities Commission) established commission rates, thereby ending fee competition. This end of the regulated fee structure created more competitive fees among securities dealers but apparently only to the advantage of larger clients.

Another way of looking at this situation is to compare trading averages in both Canadian and foreign markets to provide a comparison of the fees charged by Toronto Stock Exchange members in both domestic and foreign markets.

TABLE 8

AVERAGE COMMISSION PER DOLLAR VALUE

1983-1985
(PERCENT)

	1983	**1984**	**1985** (jan.- mar.)	**1985** (apr.- jun.)
CANADIAN MARKETS	1.2	1.0	1.0	1.0
U.S. & FOREIGN	0.8	0.6	0.6	0.7

SOURCE: "REVENUE AND MARKET ANALYSIS"
(THE TORONTO STOCK EXCHANGE-VARIOUS ISSUES)

Table 8 presents the average commission per dollar value charged by TSE members for the Canadian, U.S. and foreign markets. The schedule shows a substantial difference between the average commission fees charged by TSE members on these two markets. Canadian market fees are higher for all periods where data is available. This suggests two points i) more competitive U.S. and foreign markets induce TSE member firms to charge a foreign market fee comparable to their competitors' domestic market rates and ii) the U.S. and foreign market fees levied by TSE firms in foreign securities markets are lower in order to attract Canadian investors who would otherwise deal with foreign based firms trading on foreign securities exchanges.

The brokerage commission rates that have been examined provide one rationale for the regulators' move to relax the ownership restrictions in the securities industry. Indeed, ownership deregulation has brought about a change in the competitive framework of the securities industry and with it an opportunity to reduce investors' transaction fees. As the evidence has shown, the fees charged to individuals did not experience the same decline as institutional rates. This will discourage investment in stocks in favour of less risky alternatives offering lower transaction costs. This includes investment instruments such as Canada Savings Bonds, and Guaranteed Investment Certificates. The presence and success of discount brokers is proof that the securities market is price-sensitive and any reduction of transaction fees creates demand for securities investment. The same view also holds true for institutional investors whose access to other markets means that higher Canadian transaction fees will lead them to trading on other exchanges.

Increased competition may also have a beneficial effect upon underwriting fees. Underwriting fees are the costs assessed for the issue of a new series of a security such as a

stock or bond by a corporation, government or institution. The current underwriting fees are not generally available to the public and therefore any conclusive evidence is difficult to obtain. However, a 1971 study by J.R. Peters did examine underwriting fees in Canada and the United States. He reached the conclusion that the cost of bond flotation was lower in the U.S. than in Canada for public offerings of $5,000,000 and over. Offerings of $5,000,000 and over was the largest segment of the market for public offerings and therefore demonstrated a greater operational efficiency in the U.S. market. Peters also found that in the private placement market the U.S. was more operationally efficient. Underwriting spreads in Canada were more than twice that of the U.S. market for issues greater than $10,000,000.[16]

[16] J. Ross Peters, Economics of the Canadian Bond Market(Montreal and London:McGill and Queen's University Press,1971)p.54

TABLE 9

UNDERWRITING COSTS OF BOND ISSUES

BY SIZE OF ISSUE

		COST BY ISSUE SIZE[1] (PERCENT OF TOTAL BOND ISSUE)		
	BOND MATURITY (YEARS)	SMALL	MEDIUM	LARGE
CANADA	10	2.50	2.10	1.75
AUSTRALIA	5	1.57	1.61	1.60
BELGIUM	8	4.20	4.15	4.10
FRANCE	10	3.30	3.20	3.20
GERMANY	10	3.60	3.60	3.60
JAPAN	10	3.5+	3.5+	3.5+
NETHERLANDS	10	2.70	2.50	2.40
SWITZERLAND	10	2.85	3.00	3.00
UNITED KINGDOM	20	1.83	1.15	1.08
UNITED STATES	20	1.45	1.08	0.98

Underwriting costs = The fee assessed for the issue of a new series of a security by a corporation, government or institution.

1. Issue Size: Small - to U.S. $15M, Medium - U.S. $15M - $100M, Large - $100M+

SOURCE: OECD,FINANCIAL MARKETS:"SHAKING THE PILLARS" P.49

Cost data for 1982-83 in Table 9, shows that both the United Kingdom and the United States enjoyed a bond issue cost advantage over Canada for small, medium and large issues. In this

time period Canada did compare favourably with other financial centres. The relatively high costs may in part be due to two factors. Firstly,the Canadian domestic bond market is small in comparison with both the U.S. and U.K. markets and secondly the Canadian securities market has been protected from competition. This protection may have allowed investment dealers to charge higher underwriting rates than if the market were under competitive pressures.

Indeed, the increasingly competitive market forces have led to the securities industry changing its fee structure drastically. For example, pension fund managers have bargained commission rates down to five cents a share from its earlier high of fifteen cents or more. Underwriting is now handled through contract tendering, thereby creating a more competitive environment for issues as well. In addition to fee reductions, Canadian investment dealers realized, in the late 1980s, consolidation was required to challenge U.S. firms. The capital base and established worldwide network of the large foreign firms no longer made it feasible for a large number of small Canadian firms to survive in the global securities market of the 1990s. It was the necessity for a large capital base and an extensive network that led to the mergers with banks. These mergers provided in excess of $1 billion in additional capital. On a global scale, however, the capitalization of the Canadian securities industry was still relatively low. In 1988, Canada's securities market capital stood at U.S. $1.6 billion compared with U.S. $41.2 billion for Japan and U.S. $38.9 billion for the U.S. In fact, Japan's Nomura Securities' capital base was larger than that of all Canadian firms combined.[17]

The move towards increased competition through consolidation and entry did improve the brokerage industry's position for the future but not without economic costs. In spite of layoffs

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[17] The Economic Council,"Globalization and Canada's Financial Markets"(Ottawa:Supply and Services Canada ,1989) p.78

of 3,000 employees since 1987, nearly half of Toronto Stock Exchange members continued to lose money in 1989.

INDUSTRY PROFITS

One of the measures of the efficiency of a market is its profit margin. If an open or freely competitive market has proven profitable, entrants will be attracted until such time as these profits are driven downwards. Thus profit trends for securities dealers will give some indication of the competitiveness of this industry.

It is not altogether clear what measure should be used in determining the profitability of the securities industry. One measure is the pretax profit on capital employed. The C.D. Howe Institute used this measure to draw the conclusion that securities firms were earning high profit ratios in relative comparison to other industries.[18] In fact, an expanded analysis of these profit ratios for this paper confirms the C.D. Howe Report's earlier findings. Although all industries exhibit wide fluctuations of profit rates, the securities industry has consistently outperformed all other industries (Table 10).

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[18] Thomas J. Courchene with John D.Todd and Lawrence P. Schwartz,"Ontario's Proposals for the Canadian Securities Industry",Observation no.29,C.D.Howe Institute (Toronto:Prentice Hall Canada Inc.,1986)p.7

TABLE 10

PRETAX PROFIT ON CAPITAL EMPLOYED[1]

1980-1987
(PERCENTAGE PER ANNUM)

INDUSTRY	1980	1981	1982	1983	1984	1985	1986	1987
MANUFACTURING	14.7	11.5	3.6	6.6	11.0	9.1	10.8	11.7
TOTAL FINANCE	3.1	2.9	1.8	2.1	2.8	3.1	3.5	3. 0
SECURITY DEALERS	38.3	20.8	5.0	21.5	8.2	9.7	15.8	12. 2
ALL INDUSTRIES	8.4	6.6	4.0	4.9	6.2	5.8	5.1	5. 8
NON-FINANCIAL INDUSTRIES	11.9	9.2	5.6	7.0	8.9	8.0	6.6	8.6

1. PROFITS BEFORE TAX ON CAPITAL EMPLOYED = $\frac{\text{NET PROFIT BEFORE TAXES AND NON-RECURRING ITEMS}}{\text{TOTAL LIABILITIES AND EQUITY - TOTAL CURRENT LIABILITIES}}$ X 100%

SOURCE: STATISTICS CANADA, CORPORATION FINANCIAL STATISTICS
CAT. 61-207, VARIOUS ISSUES

During the period of 1980-87 the pretax profit rates for capital employed for securities dealers was higher than for manufacturing as well as non-financial industries except for 1984. The securities dealers profits were also higher than the rate for all industries combined. The figures alone indicate an encouraging environment to attract new entrants. What is more striking about these profit rates is the comparison between securities dealers and the total finance industry. Profit ratios in the overall finance industry are small and experience only minor growth even in years where the securities industry overshadows the profit rates of any other

sector. The finance industry has fluctuated between a low of 1.8 percent in 1982 pretax profit to a high of 3.5 percent in 1986. This is in contrast to the securities dealers where fluctuations cover the range from a low of 5 percent in 1982 to a peak of 38.3 percent in 1980.The evidence demonstrates that even in its years of poor performance, the securities industry is substantially more profitable than the rest of the financial sector. The profit differentials in the financial industries are of considerably more conseqence than the earlier comparison to all industries since entry into the securities industry would be much more feasible for other financial firms than for firms from other industry sectors.

The second measure of the securities industry's profitability is the estimated revenues and expenses of investment dealers. This information provides the net income before taxes and therefore demonstrates the earnings history and potential for this industry. In his 1971 study of the corporate bond market,J.R. Peters reported the net income of the eight large national dealers. This measure was used instead of the pretax profit rate examined above in order that the large salaries and bonuses paid to partners and employees would not escape the profitability comparison.[19]

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[19] J.Ross Peters,Economics of the Canadian Corporate Bond Market,p.80

TABLE 11

INVESTMENT DEALERS[1]

ESTIMATED REVENUES AND EXPENSES

1975-1987
($000)

	1975	1980	1985	1986	1987
UNDERWRITING AND TRADING PROFITS	140,217	382,868	719,445	893,631	903,931
BROKERAGE COMMISSIONS	178,769	766,160	903,058	1,180,430	1,645,288
INTEREST	127,683	401,177	565,948	665,852	792,013
DIVIDENDS:					
COMPANIES IN CANADA	488	872	3,756	6,076	26,035
COMPANIES OUTSIDE CANADA	56	1,392	32	93	961
OTHER REVENUE	10,260	30,700	90,330	118,617	174,144
TOTAL REVENUE	457,473	1,583,169	2,282,569	2,865,199	3,542,372
TOTAL EXPENSES	426,578	1,345,250	2,150,184	2,642,964	3,439,159
NET INCOME BEFORE TAXES	30,895	237,919	132,385	222,235	103,213
NET INCOME	14,814	127,948	79,475	118,323	58,100

1. INVESTMENT DEALERS - CONSISTS OF MEMBERS OF THE INVESTMENT DEALERS ASSOCIATION OF CANADA. INVESTMENT DEALERS ACT AS PRINCIPALS IN THE UNDERWRITING AND TRADING OF GOVERNMENT AND CORPORATE SECURITIES.

SOURCE : STATISTICS CANADA, FINANCIAL INSTITUTIONS, CAT. 61-006, VARIOUS ISSUES.

The estimated revenues and expenses for securities dealers for 1985-86 (Table 11) provides prospective entrants the proof of an industry with an impressive net income trend. As already mentioned, total expenses includes the often generous bonuses and commissions which securities employees earn. This represents almost half of total securities industry expenses and therefore unfavourably distorts the relative revenue-expense ratio and profitability of this industry.

A review of the industry's revenues from 1975-87 demonstrates a financial sector undergoing remarkable growth.The growth was no less impressive in 1987 when revenues reached $3.5 billion, the year of so called "Black Monday". Although the evidence displays a 50% decline in net income during 1987, attention should again be drawn to the brokerage commissions of over $1.6 billion for that year.

Both the net income and profit ratio analysis suggest that new entrants would normally be interested in gaining access to this industry. One can only assume that barriers to entry precluded this occurrence. A number of larger financial institutions had sufficient capital to establish a securities firm. Indeed, this did not prove to be a serious barrier. On the other hand a barrier did exist in the specialization of personnel within the industry. The only sure method of acquiring experienced personnel was to lure employees from existing securities firms but the number of experienced personnel was certainly limited. Therefore, this did create a barrier unless financial institutions were prepared to purchase or merge with an existing securities firm.

In fact, this situation predominated with both domestic and foreign financial institutions forming partnerships with existing securities firms. The effect of these partnerships between domestic securities firms and other financial institutions was obviously fewer financial

intermediaries and possibly a higher level of market concentration. Market concentration in this instance refers to the share of the financial services industry's total output accounted for by a small number of firms. As in any process of rationalization the securities industry has not been without short-term casualties. However, the long term prospect of more stable securities market participants and a stronger international presence in securities markets is definitely reason for optimism.

MARKET CONCENTRATION

Two of the standard market concentration measures are the four firm and the eight firm ratios. Data from 1985 shows almost 65% of securities issues were performed by the four largest companies. The same data also confirmed that eight firms account for 80% of the securities market. Therefore, the evidence suggests securities markets were highly concentrated prior to any industry consolidation begun in 1987.[20]

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[20] Economic Council of Canada, "A Framework for Financial Regulation", (Ottawa: Supply and Services, 1987)p.31

SECURITIES INDUSTRY

REGULATORY STUDIES

This section examines a number of studies conducted during the 1970's and 1980's aimed at regulatory reform in the financial sector. The studies reviewed for the purposes of this paper were chosen either for their measurable contribution to the most recent securities industry regulatory changes or their overall importance in determining the direction of Canada's financial sector policy. The financial market studies offered varied solutions to improve the strength and health of this sector. Clearly, the majority of securities industry studies recommended against deregulation measures likely to increase competition. Although the issue of increased non-resident ownership had both its proponents and opponents, preservation of the four-pillar structure gained almost unanimous support.

Supporters of non-resident ownership argued that the potential for additional capital and services provided by new entrants outweighed any fears of foreign dominance. Observers who concluded foreign ownership regulations should not be relaxed further did so on the basis of the financial service sector's critical role in the economy. Fears were raised that foreign ownership would inevitably lead to foreign control of Canada's economy.

Support for the maintenance of the financial sector's four-pillar structure was primarily based on the opinion that conflict of interest situations and increased financial market concentration would result from cross ownership. In fact the pillar system is a remnant of financial sector changes made as a result of the Depression. Securities dealing and banking were separated to reduce the opportunity for conflict of interest situations and to restore overall confidence in the

financial system. Even though significant regulatory changes have been made over the years to the Canadian financial system, the four pillar structure has remained intact.

THE MOORE COMMITTEE REPORT

The Report of the Committee to Study the Requirements and Sources of Capital and the Implications of Non-Resident Capital for the Canadian Securities Industry was submitted in 1970 by the Toronto Stock Exchange to the Ontario Securities Commission.

A cost-benefit analysis of non-resident ownership of Canadian securities firms, determined the benefits of foreign ownership to be 1)availability of improved research advice concerning U.S. securities 2) increased access to foreign markets for Canadian issues 3) investment by non-residents would increase if firms were able to sell to clients who would not otherwise invest in Canada. The costs of increased foreign ownership were outlined as 1)some underwriting would have to be done in the U.S. 2) desirable Canadian equity issues would be sold to non-residents 3) moral suasion might become a less useful alternative for the Canadian government if foreign firms dominated 4)foreign firms would be more likely than Canadian firms to arrange transactions which were not in Canada's best economic interests. The cost-benefit comparison also points out that access to the U.S. may not necessarily be increased. This is due to the fact that given the size of the Canadian market, entry barriers in Canada's securities industry were not likely to lead to similar action by the U.S.

The Committee also reviewed the concept of the securities industry as a key sector of the economy. This view holds that the nation's economy is so dependent upon this sector for resource allocation and therefore economic growth that foreign firms should not be allowed to

dominate any part of the financial sector. The Committee points out that no other country with an advanced economy allows foreign ownership for this very reason.

The overall conclusion of the Committee was that foreign ownership had already reached its maximum level. The basis of this statement was that foreign control over the economy would increase with the level of foreign ownership of securities firms. The Committee also remarked that even a small investment by a foreign firm(particularly a U.S. firm)in a Canadian firm could lead to control by this same foreign firm. For these reasons it was recommended that existing foreign ownership be permitted only for those non-resident firms which already held a majority share of a Canadian firm.

It is not surprising that reports undertaken by the investment industry recommended the status quo. The Moore Report's objective was obviously to prevent further competition from non-resident securities firms .On the subject of capital adequacy the Committee intentionally steered clear of any statistical analysis which might not support their conclusions. Their conclusion stating that sufficient capital was available came from industry questionnaires which were completed with full knowledge of the Committee's undertaking.

It should also be pointed out that this study only involved the capital adequacy of individual firms and did not deal satisfactorily with the Canadian economy's needs as a whole. Although securities firms may have been able to grow at their desired rate, it does not necessarily follow that business financing needs are being met. Another factor ignored by this Moore Committee's report was that if Canadian securities firms were to increase or even to maintain their share of the global market, then it is possible that additional capital would be required.

Finally, it is interesting to observe the Committee's stance on competition. Competition is viewed as preferable to regulation in order to serve the public interest. This translates into limited government intervention and reliance on self-regulation. This argument seems to conflict with the Committee's concern regarding non-resident ownership. If competition is indeed the preferred option, then it seems that the relaxation of entry barrriers forms an important part of this competitive securities industry. The increased number of firms would have several benefits. Primarily, it lowers service fees charged to the public and business firms alike as well as improving access to capital for Canadian firms.

Contrary to self-conducted industry studies, developments

in the market during the 1980s suggested that capital needs were not being met by Canadian securities firms. Evidence prepared by Morgan Stanley Canada demonstrated the extent to which the Canadian market relied on foreign issues.Euro-Canadian bond issues totalled $2.4 billion in the period from January to June 1985.From this total approximately $1 billion was raised by Canadian led issuers. Therefore the remaining $1.3 billion originated from foreign led issues. A C.D. Howe analysis of this same data also points out that two firms (Orion Royal Bank and CIBC Ltd.) accounted for 60% of the Canadian led issues. Eurodollar issues showed an even stronger foreign presence. The total Canadian led issues amounted to $584 million out of a total of more than $3 billion raised in this market. This reliance on foreign dealers applied to both government and corporate issues and offered proof of Canada's domestic securities industry's declining share of new issues.[21]

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21 Thomas J. Courchene with John D. Todd and Lawrence P. Schwartz, "Ontario's Proposals for the Canadian Securities Industry",p.9

THE GRAY REPORT

In marked contrast to the Moore Committee Report, the 1976 study on "Foreign direct investment in Canada"(The Gray Report) found four weaknesses in the Canadian capital market. The study concluded that Canada lacked: (1) venture capital for new and small firms, (2) expansion capital for small and medium sized Canadian controlled firms, (3) large pools of capital for major resource exploitations and other capital intensive projects under Canadian control and, (4) capital for general development in regions of slow economic growth. Also, this federal government study found that lenders tend to give preference to foreign controlled firms due to their larger size and better credit worthiness.

The study concluded that the capital markets are not sufficiently competitive, that there is inadequate capitalization in some capital market firms,some new institutions may be necessary for the market and that the markets are not sufficiently liquid. These factors have all led to a situation whereby Canadian capital markets are not financing Canadian economic growth as effectively as they could be. The lack of capitalization of the Canadian market affects both its ability to assume risk and its involvement in entrepreneurial activity. In more heavily capitalized securities industries, firms independently handle a new issue and securities firms syndicates compete for new issues. This produces more innovation,better service and lower prices.

Competition in the securities industry can be linked to its level of capitalization. Bids for underwriting are rarely a competitive process since new firms are unable to challenge established syndicates. Meanwhile,those financial institutions which are highly capitalized such as the chartered banks do not invest large portions of their resources in riskier firms. The securities industry's lack of competition from within and from other financial institutions means that there

is little incentive to finance aggressively. This competitive environment in turn has an effect on the cost of raising money in the capital market.

The Gray Report recommended that the solution to the shortcomings of the Canadian capital market was to eliminate the barriers between financial institutions and allow increased competition between pillars. This would bring the resources of larger financial institutions into the capital market and therefore improves liquidity,capitalization and competition.

Unfortunately, the Gray Report findings were not based on empirical evidence but rather on the opinions of politicians and interest groups represented before the inquiry. For this reason the Gray Report dealt almost exclusively in general observations and provided no clear direction for the future.

THE DUPRÉ REPORT

The Ontario Task Force on Financial Institutions (The Dupré Report, 1985) took the opposite stance to the Gray Report regarding foreign ownership. The committee expressed their belief that a 30% foreign owned firm could be effectively foreign controlled even with this level of ownership. The argument made by the task force was that the 30% foreign ownership is likely to be permanent while the significant industry investor that must make up 51% or more of the voting shares will be a changing group. Therefore, this significant industry may not have the singular interest that a foreign investor is likely to have due simply to the number of players involved.

The task force was also not swayed by further arguments for greater foreign ownership. Neither the idea that new technologies would be developed nor that access to improved investment ideas and products was made persuasive by the proponents of foreign ownership.

Finally, the theory that access to international markets would be improved could not be adequately supported in the committee's view. The task force argued in its report that foreign firms which were already operating successfully in the international markets would have no reason to support a Canadian firm's entry into this same market. The international markets, it was stated, are controlled by the large underwriting firms and banks and therefore only financial players of a similar size would be able to enter these markets successfully. The task force concluded that policy changes concerning foreign ownership and entry were probably better left to consideration in the context of trade in the services sector as a whole. This suggestion obviously drew some proponents since free trade negogiations did involve financial services. At the time all applicants who had submitted foreign ownership proposals under the new Ontario securities regulations were stalled pending negogiation of similar access to foreign capital markets(a condition which was later rescinded).

On the subject of domestic financial institutions' involvement in the securities industry, the Dupre Report suggested that these financial market institutions may be a source of untapped capital. This advantage aside,the task force made several cautionary notes. The first potential problem identified in the study was that conflicts of interest could arise from cross-ownership in these two areas of the financial market. For instance, if a financial institution used its securities branch to promote the sale of securities by one of its clients which also held a commercial loan from this same financial institution, this would be considered a conflict of interest. Furthermore,the task force pointed out that a universal banking system might result from the introduction of cross-ownership. Evidence suggested that countries which have universal banking systems have underdeveloped capital markets by comparison to those countries

where financial and market intermediaries ownership is segregated. Thus the task force's conclusion was that the depth of the Canadian capital market could be adversely affected by any change in the restrictions concerning cross-ownership of financial and market intermediaries.

The Dupré Report also recommended against investment by non-industry investors in securities firms. The report's argument against this ownership stems from the view that the real economy should be separated from the activities of financial intermediaries. If this distinction was eliminated, it is conceivable that business firms could rely on self-financing through its ownership of financial and market intermediaries.

The authors were concerned that this reduced regulation created more potential problems than benefits and thus recommended that the four pillar structure be maintained. This approach could have the effect of expanding the exempt market further and decreasing the size of the regulated market. Foreign firms would thus escape regulation and still have control of the largest share of trading activity. Overall, given the rapidly evolving situation in financial markets both in its globalization and domestically the overlapping of services provided by the four pillars, this report's recommendations did not anticipate present developments.

Policy development along the lines of the Dupré proposal would not have kept pace with the financial market's changes of the last three years, let alone the decade yet to come.

THE DEY REPORT

The Ontario Securities Commission report of 1985 (The Dey Report) formed the basis of the recent changes to the Ontario securities industry's regulations. The Dey Report maintained that the 10% limit on investment by non-resident registrants created the disadvantage of limiting the financial market's sources of capital. It was the belief of the committee that a Canadian

dominated industry could be maintained even with the easing of controls on non-resident ownership. The Commission also concluded that a 30% foreign ownership of domestic securities firms should be allowed. This included a provision to allow one non-resident to own 30% of a Canadian firm in contrast to earlier proposals that would have limited this level of foreign control to the sum of ownership shared among several non-resident firms. To counterbalance this relaxed ownership policy, the Dey Report also recommended that a significant Canadian industry investor be required to play a role on behalf of the domestic interests. The level of 30% was chosen in order that no foreign firm gained control of the firm but meanwhile this share of ownership likely presented enough incentive to attract non-resident firms. A further reason for the increase in the level of foreign ownership as compared to previous proposals was the desire to attract not only a financial investment but also technology, management expertise and business contacts. The Commission's report also emphasized that allowing non-resident firms to enter the Canadian securities industry would increase the access of Canadian issuers and investors to offshore markets.

The Dey Report chose to protect the four pillar structure of the financial industry by not permitting foreign financial institutions (eg. foreign banks) to register a securities firm of which it held more than 30%. This condition was included because domestic banks would be at an unfair disadvantage since they would not be allowed to participate in the securities industry at an equal level. The Commission further secured the four pillar principle by limiting the ownership share of domestic financial institutions to 30%. The separation of the pillars was maintained because this was deemed to be a public policy objective to limit the potential for

financial market concentration and conflicts of interest.[22] The Commission's stance on conflicts of interest was that guidelines already existed to guard against potential conflicts of interest. Therefore, similar controls could be outlined concerning potential conflicts of interest between a financial institution and its subsidiary securities dealer.

Concentration of financial power posed a more serious threat according to the Commission's study. The concern expressed in the Dey Report was that relaxation of the ownership regulations could result in a securities industry with fewer participants and have the opposite effect to the one desired since competition would be reduced.

The recommendation of the Commission was that non-resident access to the securities industry should be the first priority. The more difficult issue of financial institutions' and commercial enterprises' investment in the securities industry could be addressed later.

Finally, the Dey Report stated that ownership by other resident investors should also be limited to 30%. The rationale for this limitation was that large industrial corporations which use the capital market frequently as a source of funds may become too closely linked to a securities firm. In order to encourage a competitive and efficient capital market, it was considered important that a sufficient number of independent securities firms remain within the industry.

Although the Dey Report clearly encouraged competitive pressures for the securities industry, it also promoted the preservation of the four pillars. Under their proposals, non-resident firms would have easier access to the Canadian securities industry but would remain the only financial institutions able to provide brokerage and underwriting services.

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[22] Ontario Securities Commission,"A Regulatory Framework for Entry and Ownership of the Canadian Securities Industry",Report to the Minister of Consumer and Commercial Relations (Toronto,1985)p.(ii)

It is questionable whether this division was necessary or even sustainable given developments in the financial markets. The chartered banks discovered a means of offering brokerage services and some insurance to their clients and it is only a matter of time before services overlap further and the lines between the four pillars become more blurred.

SECURITIES INDUSTRY PLANNING COMMITTEE

In response to the Ontario Securities Commission Report on entry into and ownership of the Ontario Securities Industry (The Dey Report), the Securities Industry Planning Committee prepared comments on the proposal.

Overall, the Committee was favourable to the changes recommended by the Securities Commission and expressed the opinion that the approach would assist the Canadian securities industry in its development. At the same time, though, the Planning Committee did suggest a number of amendments to the original proposal. One of the Committee's fundamental concerns with the proposed legislation was that all financial institutions carrying out similar functions be subjected to the same regulations. The Planning Committee's reasoning was that only a uniform regulatory approach would produce a fair and equal treatment for all registered dealers.

The Committee also expressed concern over the broad range of activities carried on directly by financial intermediaries.

In reference to non-resident registered representatives, the Committee again emphasized its view that all registered representatives must be treated identically.

On the issue of non-resident ownership, the Committee recommended that reciprocal treatment for Canadian securities firms be sought in the United States and Japan. The Committee expressed its view that the proposal for 100 percent ownership of a Canadian

securities dealer by non-resident financial institutions be conditional upon similar access to foreign securities markets.

In summary , the recommendations were aimed at ensuring that all participants in Canada's securities industry were treated equally and fairly while at the same time promoting the development of this sector. The committtee's recommendations pointed to maintenance of the four pillars. No doubt the increased regulatory measures called for were directed to a similar goal.

C.D. HOWE REPORT

The C.D. Howe Institute produced an analysis of the new securities regulations for Ontario in 1986. In addition to providing a summary of the various proposals considered over the years including the most recent one,the Institute devised its own alternative policy approach.

This approach was developed as a means of Canada maintaining and expanding its position in international financial markets. On the issue of Canadian ownership,the C.D. Howe proposal suggested that concern over domestic ownership of the securities industry had led to an overwhelming emphasis on control of the regulated market. Control of this market would not produce a stronger domestic industry since foreign firms can conduct business in the exempt market.[23] Therefore over the long term the policy of Canadian ownership may lead to an ever

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[23] The "exempt market" refers to the unregulated segment of the securities market.Exemptions are provided for the trading activities of financial institutions, governments, pension and mutual funds and large private placements (not less than $97,000).Exemptions also exist for certain classes of securities such as government bonds and debentures, commercial paper and promissory notes in denominations greater than $50,000.These exemptions are based on the rationale that either the investor or issuer is already subject to its own regulatory safeguards or the investor is deemed to have sufficient knowledge or sophistication that regulation is unwarranted.

shrinking domestic industry reliant on the regulated market instead of a Canadian controlled industry ready to expand into the growing exempt market.

The four-pillar approach to ownership separation also appeared to be a regressive move for securities industry policy according to the C.D. Howe Report. This stance was the opposite taken by all other foreign financial markets with the exception of Japan which had already grown to be a dominant financial player. The risk of Ontario taking this approach was that other countries with more liberalized ownership regulations could surpass Canada in the competition for a share of global financial markets. The report also pointed out that financial innovation continued to make it increasingly difficult to distinguish between financial instruments and therefore regulatory borders between financial institutions would become increasingly difficult to define .

The C.D. Howe analysis also refuted the theory that the industry will suffer from entry by larger firms. The proponents of control by industry-insiders contend that large firms cannot offer the professional advice that the smaller firms offer. The regulatory framework has been supportive of this ownership and thus has made it difficult for new entrants to build a sufficient capital base. The Institute's counter argument suggested that this regulatory stance may backfire since foreign firms will have easier access to ownership of Canadian securities firms. This situation would surely be less desirable from a policy standpoint than relaxation of the current restrictions on entry of Canadian firms from other financial sectors.

Finally, the report emphasized that Ontario can no longer expect to wield the power necessary to enforce the existing regulations. In the past, securities markets were of a national scope but this has been replaced in the open economy by an international capital market. This

is especially true in the financial sector "because money and ideas are inherently fungible and because financial institutions are inherently mobile".[24] If Canada expects to have an international capital market of significance, it is necessary to allow major Canadian financial players to have access to this market. The large Canadian banks have already established themselves in international markets and therefore provide a possible if not the only route towards growth of this sector. Without the added financial strength of these large Canadian financial institutions, it seemed likely that foreign firms would dominate the industry.

The C.D. Howe Institute's alternative policy approach suggested a more liberalized ownership framework. This included permitting financial institutions to own one hundred percent of a securities firm. The Institute recommended that this be accomplished with a relatively hasty implementation schedule.

The model also proposed that foreign firms should be allowed to a) purchase up to 35 percent of an existing domestic firm or b) apply as a foreign dealer, which would enjoy relaxed restrictions. On the topic of ownership of securities' firms by chartered banks, the report took a similar direction towards relaxation of the current regulatory restrictions. This would hopefully prevent foreign firms from gaining an overwhelming foothold in the Canadian financial sector since the large domestic banks are already large financial players. Domestic banks would therefore be capable of injecting substantial amounts of capital into Canadian securities firms.

Finally, the analysis suggests that securities firms be given the same ownership freedoms as other financial institutions.In other words, securities firms be permitted to offer the full range of financial services and therefore be given the right to cross-pillar ownership as well.

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[24] Courchene,Todd and Schwartz,"Ontario's Proposals for the Canadian Securities Industry",p.29

Impact

The C.D. Howe report envisaged a significant beneficial impact from the changes outlined above. This included the fact that Canadian securities firms would be able to attract additional capital and therefore increase their role in global financial markets. Another benefit of this increased international presence was that Canadians might be less likely to invest in foreign markets. If the Canadian market had the necessary capital and offered the services available in other large financial centres, then this could influence Canadian investors and underwriters alike to look more closely at domestic firms first. Another important benefit of this proposal was that offshore securities activities would return to Canada according to the Howe Report. This repatriation creates increased demand for complementary services of the securities industry such as accounting and legal advice.[25] Access to securities investment would be increased through the creation of large distribution markets based on the existing financial institutions' branch systems.

Impact of Ontario Proposals

According to the C.D. Howe Institute's analysis, Ontario's 1985 proposal to limit ownership of securities firms by other financial institutions to thirty percent would be difficult to maintain. Ontario is subject to competition from other provincial securities markets, notably Quebec, and therefore may have to further ease its regulations to protect its share of the market. The C.D. Howe Institute also saw the revised regulations concerning the exempt market to be difficult to enforce. Ontario's policy of an extended exempt market seemed to ignore the increasing

[25] Ibid,p.34

internationalization of markets. As institutions continue to devise financial instruments which cannot be easily classified, so too will the divisions between these financial institutions become blurred. The C.D. Howe Institute's final concern was that schedule B banks were not included in the potential entrants to the securities industry. This seemed to contradict Ontario's desire to open up the securities industry. What is clear in the C.D. Howe proposal is the understanding that an effective securities industry policy depends largely on the cooperation of federal and provincial governments. These cooperative efforts are necessary to relax existing regulations while still maintaining the jurisdictional separation in the supervision of financial institutions.

FEDERAL GOVERNMENT REPORTS

In December 1986, the Finance Department released a White Paper entitled "New Directions for Financial Institutions" outlining the government's plan for the financial sector. The overall aim of this policy was to promote competition among financial institutions while at the same time developing a world-class financial market. Included in these proposals were specific changes affecting the securities industry. Financial institutions would be "allowed to hold subsidiaries in other pillars or to be affiliated with other financial institutions through a holding company structure."[26] This destruction of the pillar structure was based on the view that efficiency and innovation are best served in a competitive environment. The policy paper also recognized that trends in the global financial system dictated that Canada's regulatory approach keep in step with its international counterparts. Investment advice and portfolio management became services which financial institutions could offer. As stated in the policy paper,since

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26 Canada,Department of Finance,"New Directions for the Financial Sector"(Ottawa,1986)p.6

there are no solvency concerns associated with these services, there remained no reason to bar entry to this field. Specific provisions were also made to allow financial institution subsidiaries to become involved in securities activities.

On the issue of non-resident ownership the federal government policies followed existing guidelines. Foreign firms had been allowed to enter the Canadian financial market on a start-up basis as opposed to an acquisition method for a number of years. This regulation was to be carried over to other areas of the financial services industry so that foreign firms would be required to create new firms in the financial services area which they wished to enter. This gave foreign institutions the same treatment as domestic financial institutions and also ensured equal treatment for all foreign owned financial institutions. In the area of securities firms, international competition was encouraged but efforts were directed towards maintaining a strong Canadian presence. This was accomplished by the previously mentioned policy of allowing domestic financial institutions to own securities subsidiaries. Non-resident ownership of securities dealers was set at 50 percent as at June, 1987 and 100 percent at June 30, 1988. These changes were effective immediately and were reflected in a subsequent amendment to the Bank Act.

The Blenkarn Report also came out in favour of cross-pillar ownership but with greater flexibility allowed to achieve this result. Essentially the Blenkarn proposal would allow financial services firms to acquire other financial intermediaries through subsidiary or various holding company arrangements. The Senate Committee Report provided similar suggestions to that of the Blenkarn Report but also recommended that securities firms should have similar expanded access ownership in other pillars.

All three of these reports made the assumption in their recommendations that the provinces would agree to increased federal regulatory involvement in the securities sector.This was not likely to be easy due to two factors. Firstly,the provinces would be surrendering regulatory control of an extremely competitive financial sector. Quebec and Ontario have struggled openly to gain an advantage in attracting the investment industry and financial services in general to their respective provinces. Increased federal involvement in this sector would mean a more level playing field between provinces in this sector. This would likely work to Quebec's and other provincial exchanges' disadvantage since Ontario has a clear advantage in the present relative size of its financial services sector,its strong links to foreign countries' exchanges, and its stature as the business centre of the country.

ECONOMIC COUNCIL-A FRAMEWORK FOR FINANCIAL REGULATION

The Economic Council of Canada prepared a report on the Canadian financial system in 1987. It included a review of the four pillars and its regulatory framework as well as recommendations for revised financial regulation. There were several findings which offer insight into the present topic of the securities industry ownership. Although the Council's report was aimed at regulatory reform, it also contained important discussion of financial institutions' separation of functions and thus cross ownership issues as well. One of the trends mentioned frequently in all analyses of the financial services industry had the rapid changes in financial markets. The existing regulations did not account for recent developments and a considerable portion of the financial market therefore escaped regulation. One of the key problems of the current regulatory structure identified by the report was "that it does not provide for a level

playing field;rather it imposes different costs and constraints on different categories of institutions performing the same activity."[27] This is referred to as regulation by institution rather than regulation by activity. These difficulties in regulation were compounded by the competing jurisdictions of the federal and provincial governments. The division of powers for financial services had thus led to the potential for conflicting legislation. In the case of the securities industry,provincial legislation differed from province to province and where the distinctions between the pillars became blurred, federal legislation such as the Bank Act played a part.

While proposing regulatory reform the Economic Council's Report did add several cautionary remarks. Competition could undoubtedly provide benefits to Canadians through improved access and lower cost of financial services.However,it had to be recognized that competition could also breed financial failures for firms which are unable to meet the new demands of the marketplace. Diversification created improved access to financial services but at the same time it increased the opportunity for conflicts of interest or self dealing. Similarly regarding other effects, any reform process had to weigh the advantages and disadvantages involved in any restructuring of the Canadian financial system.

The Report recommended that financial holding companies be created to allow financial institutions to diversify into several functions. These holding companies were to be given the possibility to transfer assets or funds between functions in order to take advantage of opportunities in a particular function. The movement of funds would be limited but regulatory authorities could conceivably monitor these transfers due to the single function separation.

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[27] The Economic Council,"A Framework for Economic Regulation" (Ottawa:1986)p.76

Furthermore, the Council's Report recommended that networking, cross-selling and cross-referral be allowed. This would permit one outlet to offer a number of financial services from various financial institutions belonging to the particular holding group. Thus access to a range of financial services would be assured for Canadians even in small communities.

The separation of functions also necessitated formation of a separate capital base for each function. This according to the Council Report was an advantage over other models since holding company or subsidiary alternatives required only one capital base. The Council argument suggested this could lead to concerns over solvency if one part of the holding company experienced financial troubles. This benefit seemed to be exaggerated though since the holding company's capital base would essentially be a sum of all its parts. Whether a holding company would appear more or less financially stable dependent on the structure of its assets was questionable.It is more likely that in either scenario, a holding company with one capital base or a holding company with a smaller capital base for each function,the failure of one part should not precipitate the collapse of the entire financial institution. An earlier recommendation in the Council's model cast further doubt on this argument. If a holding group was permitted to sell assets or transfer funds between the various functions, then its stability seemed no more assured than other organizational structures.The inclusion of this condition eliminated almost entirely all significant differences between the holding company with one capital base and the holding company with a capital base for each function. Improved monitoring would likely serve to make either of these alternative models financially stable.

The proposed new structure for new financial institutions was also envisaged as a method of allowing individual firms to set up holding companies to meet their own particular requirements.

Financial institutions could choose to diversify or to continue to specialize depending on its needs.

The Council's Report also identified several costs associated with implementation of the proposed policy. Probably the most formidable barrier to overcome prior to realization of this proposal was the division of the regulatory powers between federal and provincial governments. The report recognized that cooperation was necessary but did not see this as impossible. The costs involved in setting up a holding company had been questioned in the past but the Council's report pointed to the number of holding companies emerging at the time as proof of the opposite.

The Council's stance on the timing of these changes agreed with that of the Ontario government's earlier proposals. To allow the smaller domestic firms time to strengthen their own positions, the Council recommended a phased approach whereby non-industry institutions would only be given gradual access to the domestic securities market.

The overlapping jurisdictions in the financial industry as well as the sometimes competing provincial legislation had led to a confusing regulatory framework. In addition to recommending cooperation between the federal and provincial governments the report also emphasized the importance of interprovincial cooperation. Although this was an admirable goal,it continues to be difficult to negogiate this cooperation at the provincial level. In the case of the securities industry, several provinces have been vying for the rights to this crucial sector. Quebec and Ontario in particular have made various legislative attempts to draw securities dealers to their respective provinces. Although Ontario is still by far the dominant province in this sector, other provinces would like to gain a share of this industry.Further evidence of this was the debate surrounding international banking centres(IBCs). The Federal Government had proposed tax

breaks to financial firms and their transactions if they located in Vancouver or Montreal. This proposal set off a provincial war of words with Ontario determined to protect its interests and Quebec and British Columbia eager to earn a greater share of the financial industry.

On the issue of ownership the Economic Council Report did not make any distinction between foreign and domestic ownership. Indeed the report set a limit for both domestic and foreign investors of 10 percent ownership of a financial institution or holding group with assets over 10 billion. Each institution organized by function could be closely held as long as the holding company met the ownership standard. This ensured widespread ownership while still permitting the holding company structure previously recommended. Further recommendations concerning ownership stated that i) financial institutions within a holding company be wholly owned by this same holding company or be publicly held to a level of 35 percent ii) an individual or non-financial corporation not be permitted to own more than 10 percent of each of several financial institutions if their combined assets exceed 10 billion iii) a purchase of more than 10 percent of a financial institution require approval of the regulatory authority. The first of these recommendations was aimed at reducing the potential for self-dealing while the second and third recommendations were directed towards preventing concentration of power in the financial industry. As mentioned previously, the Economic Council Report's recommendations applied equally to domestic and foreign ownership. The only additional condition which was applied to consideration of foreign ownership was that of reciprocity. Entry was to be permitted to foreign firms from countries which offered similar treatment to Canadian financial institutions. Obviously this would have delayed any entry by non-resident firms but this was not a completely

unwarranted position since it provided additional time for domestic institutions to develop.

RECENT DEVELOPMENTS

Although the Ontario securities industry changes were extremely significant in the development of today's financial markets, there continue to be other events which have profound effects on this economic sector.

For instance, the Canada-U.S. Free Trade Agreement included financial services and provided for the relaxation of some limitations on the entry and operation of U.S. financial institutions. In the case of the securities industry, the existing provision for U.S. entry was enshrined in the agreement. The United States in return will subject Canadian financial institutions to the same regulatory treatment as U.S. institutions. This national treatment also applies if the Glass-Steagall Act is amended to reduce restrictions in the financial sector. In addition the trade agreement allows for increased participation by Canadian financial institutions in the management and distribution of Canadian public issues in the U.S.

All of these measures help to ease restrictions in two areas i) capital movement between the two countries and ii) foreign ownership of financial institutions.

Additional developments brought about by the European Economic Community's (EEC) market integration will have an impact on the financial services sector. By 1992, financial institutions from a European Community country will be able to establish operations in any other EEC member country. This includes securities firms' right to register on any stock exchange within the Community. The regulatory changes do create the potential for new barriers to the entry of financial institutions from non-EEC countries. However, Canada's newly relaxed

financial sector regulatory constraints will likely mean reciprocal treatment for Canadian institutions.

Developments in other international securities markets, particularly the U.S. and Japan, support the direction taken by Canadian regulators. Although both the U.S. and Japan still maintain some degree of separation between commercial banking and securities business, the separation is being gradually reduced.

Japan, for example, allows banks to trade in corporate securities and to a limited extent the United States has allowed commercial banks to move into commercial paper, mortgage backed securities and corporate bond underwriting. For example, United States regulators have granted J.P. Morgan and Company, RBC Dominion Securities and CIBC Wood-Gundy permission to underwrite corporate debt and corporate equity up to a limit of 10% of total revenues. The United States Securities and Exchange Commission has also taken a number of steps to increase foreign securities firms' access to the U.S. market.

Even in the most recent round of General Agreement on Trade and Tariff (GATT) negotiations, held in Brussels, the financial services sector produced some of the most encouraging discussion towards removal of trade barriers. The negotiations achieved significant progress towards an international accord on trade in financial services. Unfortunately, talks surrounding other economic sectors were less successful and therefore the Uruguay Round has been suspended.

CONCLUSION

The Canadian securities industry and its regulatory environment have changed drastically during the past five years. Fundamentally, however, this part of the financial sector continues to fulfill the same role.

The securities industry's role as a resource allocator cannot be underestimated. Securities act as the link between savings and investment, thus stimulating economic growth. The review of funds flows has demonstrated the increased importance of securities in the Canadian financial sector. The level of currency and deposit holdings has steadily eroded during the past two decades. Financial assets such as securities, pension funds and life insurance have replaced currency and deposits as the leading assets. To business and government, securities provide expenditure financing. Public and public sector financing would be restrained without easy access to these funds. Canada and all industrialized nations' capital requirements continue to grow. Securities markets will expand and innovate to meet this need.

With the significance of the securities market established, I then examined how well the market has fulfilled its role. Efficiency measures the securities market's ability to allocate resources. An efficient market directs capital to its best uses and the economy benefits through growth. Canadian experience demonstrated that external efficiency does not always exist. In other words, securities prices do not reflect all available information. The evidence for transaction costs -operational efficiency - is clear. Ideally, transaction costs must be low to encourage both savers and borrowers to use the securities market. Brokerage commissions and underwriting fees in Canada have always been higher than fees on other major foreign markets

(i.e. United States, United Kingdom). Higher Canadian rates put domestic markets at a disadvantage. Increased globalization means that securities can be issued or traded on a number of exchanges. Prior to industry deregulation, Canadian securities market fees were higher than fees on competing markets. The success of discount brokers offer proof that the individual investor looks at transaction costs in making investment decisions. Profit margins in the securities industry also provide a measure of the industry's operational efficiency. In comparison to other industry sectors, profits in the securities sector were high. The high profit rates did not go unnoticed. In the financial sector, foreign and domestic banks wanted to gain a foothold in this lucrative industry. All of these factors led to a push for regulatory reforms in the securities industry.

Financial sector observers and participants warned that continued inaction by the federal government would jeopardize Canada's opportunities in a global financial market. This was especially true in the securities sector, where global markets were already a reality. As U.S. Federal Reserve Board Chairman Alan Greenspan pointed out "the globalization of markets is helping to produce large, multinational securities firms that act as underwriters, dealers and brokers in stock markets around the globe."[28] Evidence from the Economic Council of Canada suggested that Canada's financial institutions had been losing or barely holding on to their market share in managing Canadian dollar denominated issues.[29]This demonstrated the critical requirement that Canadian financial institutions not be impeded by regulatory obstacles. Less regulation would allow financial institutions to compete aggressively on the global market.

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[28] The Globe and Mail,"Greenspan Sees Risk,Promise for Brokers in Global Markets.",June 15,1989 p.B12

[29] The Globe and Mail,"Canadian Financial Firms Losing Global Share:ECC",May 3,1989.pps.B1,B4 (comments by Economic Council of Canada Chairman J. Maxwell to Trust Companies Association of Canada) c)

Otherwise, foreign issues would displace domestic financing and Canada's financial sector could stand to lose not only access to a key international services market but also lose some control over its own domestic economy.

The federal government has repeatedly postponed its own financial sector legislation. Only very recently has the federal government's first set of financial sector reforms been tabled in the form of amendments to the Bank Act and the Trust and Loan Companies Act. Financial sector executives have been lobbying hard for permission to offer previously prohibited financial services. At the same time these reform proponents stand guard over their existing markets.

There have been suggestions that the federal government will attempt to revive the notion of a federal securities act in order to eliminate the confusion and conflicts of provincial legislation. However, the Conservative government has publicly rejected a national securities commission in favour of continued shared federal/provincial jurisdiction. Meanwhile, the securities industry is experiencing rationalization as firms merge or are taken over and staff reduced. The rationalization and increased competition also has a positive impact on securities firms' pricing. Strong competition exists for both the corporate finance and individual investor's business. This has provided a reduction in commissions and fees for both types of clients. Large corporate clients have enjoyed equity trading commissions as low as a nickel a share or approximately one-third of rates prior to the 1987 crash. Retail firms have also cut fees in an attempt to lure back market-shy investors.

It is important to note that the individual investor stands to gain in a number of ways from relaxation of securities industry ownership regulations. Firstly, the commission fees for individual investors have been reduced with the increasing competition among retail brokerage

houses. This will not likely change in the near future as firms will continue to pursue this market aggressively. Secondly, the increased presence of large foreign securities dealers will facilitate investors' access to other capital markets and research. Thirdly, securities counters in financial institutions provide added convenience to the individual investor interested in one-stop shopping for financial services. This consolidation of services into the highly regarded banking sector may also attract new investors to the securities market where they will be able to earn higher investment returns on their savings. These factors combined with the emergence of large financial conglomerates in Japan, Europe and the U.S. underlined the necessity for Canada's regulators to quickly amend the necessary financial sector regulations.

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