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SECURITIES REGULATION IN CANADA

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CANADIAN SECURITIES REGULATION

SUMMARY

The idea of setting up a national securities commission in Canada has recently returned to the forefront. In October 2002, the Deputy Prime Minister and Minister of Finance of Canada asked Harold MacKay to define a process for determining the best securities regulatory system for Canada's needs. After an investigation which indicated "a range of problems with the present system", Mr. MacKay's recommendation was accepted: a committee was set up "to conduct the necessary review and to make recommendations to policy makers". The report is severe: "The current system, as presently operated, must be improved significantly, and in a prompt fashion". Similarly, the five-year report of the Ontario Securities Commission begins by recommending the creation of a single securities commission in Canada. The first chapter of that report is entitled "The Need for a Single Regulator".

The matter seems to have been settled. Nevertheless, Harris (2002) points out that the debate is not based on a rigorous empirical study and he criticizes the very limited knowledge we have of the real problems in the Canadian securities market. We have conducted an in-depth analysis of the various aspects of the problem to understand this apparent paradox—one in which the absence of rigorous knowledge does not exclude finding that serious problems exist and recommending that steps be taken quickly. Arguments made to justify centralization of securities regulation are not new. They have been put forward several times over the last twenty years:

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

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

- Regulation is confusing and sometimes not applied, and this situation hurts both the brokerage industry as well as financing for growth companies. The compartmentalization of Canadian securities authorities would make complex situations involving investors, intermediaries and issuers in various jurisdictions unmanageable.

- Costs related to the existence of differences in provincial laws and multiple jurisdictions penalize businesses, intermediaries and the entire market in Canada. This situation has changed little and is even unchanged since the 1964 Porter Report because of the relative ineffectiveness of harmonization efforts in Canada.

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

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

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

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

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

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

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

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

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

1) The debate and its key issues

The first argument put forward by the proponents of securities centralization in Canada is that participants have to deal with thirteen securities commissions, thereby increasing costs and reducing the competitiveness of the Canadian securities market. Of the 4,131 companies listed, 20% should be considered inactive. Also, four provinces monopolize almost all of the issues (97%), the companies listed on an exchange (90%), the population (85%) and economic activity in Canada. Thus, the vast majority of issuers deal with only one or two securities commissions and it is therefore difficult to argue that a Canadian issuer faces 13 commissions. To address almost all investors, it only has to satisfy four jurisdictions. In 2003, the disparities which remain only relate to relatively limited aspects of securities law.

The Canadian Securities Administrators (CSA) have set up various mechanisms to limit the problems caused by the existence of multiple jurisdictions. They are:

- a memorandum of understanding relating to the mutual reliance review system for applications for exemptive relief, the granting of receipts for prospectuses and the acceptance of AIFs, set up through the adoption of the Memorandum of Understanding between all Canadian securities commissions. The decision-maker in a particular securities authority may rely primarily on the analysis and review of the staff of another securities authority. This system is known under the acronym MRRS (Mutual Reliance Review System).

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

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

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

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

The procedures which have been implemented do not yet embrace the principle of mutual recognition which has been accepted in Europe, and the efforts to harmonize securities legislation are not entirely complete. The few differences which still remain relate to sections which could not be harmonized yet due to the highly diversified nature of the Canadian market, a market in which hundreds of mining securities from the West trade with large-cap securities based primarily in Ontario. They also result from the presence in Canada of two different legal systems. However, the passport system based on harmonized regulation is at the center of the proposal made by the ministers of the provinces and the territories responsible for securities which is found in the June 2003 consultation document.

2) Regulatory costs and inefficiency

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

Firstly, it is useful to point out the absence of any rigorous analysis of the costs of securities regulation in Canada or, for that matter, the United States, probably because of the difficulty of evaluating them. Regulation implies three types of costs: direct costs of organizations, indirect or supplementary costs incurred by intermediaries to comply with such regulation, and distortion costs. A comparative estimate of direct costs is difficult because of differences between the regulatory structures for the financial sector in different countries. Whereas the United Kingdom now has only a single authority, a number of other countries regulate separately the banking, insurance and securities sectors. Very little empirical study has been done on showing the additional costs related to regulation, and they almost all deal with specific aspects of American regulation. We are unaware of any rigorous study on the additional costs caused by Canadian regulation. It is, however, important to mention three major factors. They are the putting in perspective of regulatory costs, the taking into consideration regulatory benefits and the effects of regulation on initial offerings.

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

In Canada, only trading costs can be estimated, for the year 2001, at $5.7 billion if we use as a basis the rates in effect in the United States, which would certainly lead to under estimating Canadian costs. Regulation plays a small role at this level and the costs are essentially related to intermediary remuneration. The total expenses of the four main Canadian securities commissions can be estimated at $104.09 million for the same year. To impute solely to regulatory costs the relative inefficiency of the Canadian market overlooks the fact that trading costs are essentially related to market operations and brokerage commissions, which are mainly the responsibility of the brokerage industry itself.

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

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

There is very little evidence that the present structure of Canadian regulation greatly penalizes this country: issuers incur lower costs than in the United States, direct costs appear to be lower than those in Australia, which combined the securities commissions, and direct costs of regulation are only a small fraction of costs incurred by issuers and investors. It is possible that the total level of regulation is not optimal. However, we do not have any studies confirming this.

3) Various arguments

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

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

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

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

The accounting manipulations which lead to the American financial scandals would be avoided in a centralized securities system. It seems paradoxical to invoke financial scandals which mainly affected American businesses to support centralization of securities in Canada. These abuses took place mainly in a country where securities regulation respecting large companies is essentially under the jurisdiction of the federal government and a single commission, the SEC. In addition, the wish of the American federal government to impose a uniform securities law seems to have had indirect negative effects including, according to certain scholars, the recent financial scandals. These effects were reinforced by the inaction and lack of means of the SEC. Furthermore, observers generally believe that a lack of enforcement, not regulation, in particular by the SEC, is the origin of the recent scandals. Based on the American example, it does not seem that the Enron affair can be a very solid argument for the creation of a single commission.

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

The regulatory burden prevents growth companies from having access to financing. Provisions for private placements are still different depending on the Canadian jurisdiction, in particular for sophisticated investors. Significant efforts at uniformity have been made and are ongoing. The increased number of initial offerings, in particular for venture capital, the high mortality and the weak accounting and market performance of new listed companies leads us to believe that Canadian regulation gives start-up companies access to the stock market too easily.

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

4) Regulatory competition

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

For several authors, regulatory competition is therefore a necessary condition to counterbalance the excessive power of central authorities who do not necessarily act to maximize social well-being and to allow mechanisms which can lead to maximum social utility to be set up. The counter-argument to this proposal is based on the race to the bottom concept: placed in a competitive situation, organizations are encouraged to reduce their requirements to attract trading and issuers. Aside from the fact that such behaviour adversely affects the local market by increasing risk and the cost of capital for issuers, there are various mechanisms allowing limits to be placed on the race to the bottom, in particular the establishment of minimum common standards. Some evidence suggests, however, that a race to the top and not to the bottom exists in the securities field where, traditionally, the most exacting jurisdictions have attracted a greater number of issuers and investors.

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

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

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

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

5) Canadian and American financial systems: competition and regulation

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

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

On the contrary, the Canadian financial system is highly concentrated. For the Task Force on the Future of Canadian Financial Services (MacKay letter), Canada was the developed country with the most concentrated banking sector in 1997. The study by the Bank for International Settlements confirms this data and also shows strong growth in the concentration, which increased from 60.2 to 77.1% from 1990 to 1997. Such an increase is not seen in any other country. Canada, along with the Netherlands, seems to be the OECD country where the banking sector is the most concentrated. Despite this already high concentration, the largest banks have tried several times to merge. In 2001 the six main integrated firms belonging to the six largest Canadian banks had more than 70% of the business in the industry. All the large integrated brokerage firms in Canada therefore belong to six banks representing more than 90% of the total banking assets in 2002. These institutions are heavily involved in the holding of exchanges and in the boards of directors of various self-regulatory organizations, where they hold the majority of seats (54%) as opposed to 8% for issuers and none for investors.

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

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

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

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

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

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

Canadian stock market capitalization has more than tripled during the last decade, increasing from US$242 billion at the end of 1990 to US$771 billion in 2002. In 2000, Canada ranked behind France, Germany and Switzerland. The market capitalization of Germany tripled in 10 years, whereas that of Japan stagnated. If these variations are corrected to neutralize variations in the market index, the real Canadian capitalization increase is, however, much lower than that of other countries (with the exception of Japan). The net Canadian capital created was only 16% in ten years, as opposed to 62% in France, 52% in the United Kingdom and Germany and 24% in the United States. Real Canadian capitalization growth and trading volume is slow, not very different from that of the economy, and the relative position of Canada in relation to the main countries of the OECD is worsening. Canada is unattractive for foreign corporations and the presence of foreign corporations is symbolic: more than 99.9% of the trading value in such securities is outside the Canadian market. It appears that the Canadian stock market is no longer attracting trading in foreign stocks. On the other hand, the American market captures a significant share of trading in large Canadian inter-listed companies. More than one-third of heavily traded Canadian stocks are now traded in the United States rather than in Canada. This is a very worrisome situation, given the importance of a stock market for a country.

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

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

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

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

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

The progression of trades to the United States should continue. It represents a major challenge to the Canadian securities market. The TSX is meeting the criteria of world markets less and less. It corresponds more to a regional market, defined according to Galper (1999) as follows: *the Regional Exchange dominates its local economy. It has the greatest concentration of regional listings available and is the chief expert in these listings. By virtue of its intense national concentration, its index becomes a barometer of the health of the publicly quoted part of the regional economy. It may trade securities and derivative products. It draws its clientele primarily from regional investors, with a smaller share of international investors interested in benefiting from the available expertise and opportunities*. The TSX Venture Exchange is apparently a small and medium business market (SMB, Schulman, 1999), a category in which the NASDAQ also falls. To the extent that Canada has less than 600 corporations which can be listed and traded on the NASDAQ, the TSX should also be in that category. This appears to be all the more true as trading in large-cap securities progressively gravitates to the American market. The implications are significant, in terms of development and regulatory strategy. The main aspect to be considered for SMB exchanges is proximity: *an exchange provides a real estate function for companies in the sense that it is where companies locate their stock listings and it is where customers (investors) come to buy and sell that stock. Therefore, to enhance the profile of an SMB market, exchanges should create attractive SMB market communities with financial influence, recognized value, and uniquely beneficial services* (Schulman, 1999, p.14). As the few large-cap securities are gravitating to American markets, it seems inescapable that the Canadian market will progressively become a market of medium and small companies by international standards.

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

7) Conclusion

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

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

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

INTRODUCTION

The idea of establishing a national securities commission in Canada is not new. Anand *et al* (1999, chapter 11) provide a detailed history of the progress of various projects since the 1967 CANSEC (Canadian Securities Commission) initiative of the Ontario Securities Commission (OSC). However, as early as 1964, the Royal Commission on Banking and Finance (the Porter Commission) had raised the need for the federal government to regulate securities. The most structured initiative was undoubtedly the Anisman report (1979), entitled *Proposals for a Securities Market Law for Canada*, which contained a full, detailed description of securities law in Canada. In 1994, the federal government made a proposal which, even in the opinion of the chairman of the OSC, would not result in the achievement of the objectives expected from a reform of securities regulation in Canada. None of these projects came to fruition. More recently, a White Paper was published setting out a framework for analyzing the various possible options for securities regulation in Canada (Harris, 2002)[1]. However, the author wrote (p. iv): *the debate in Canada typically has not been informed by robust empirical analysis and suffers from a lack of empirical data on the central issues in respect of Canadian securities regulation*.

In October 2002, the Deputy Prime Minister and Minister of Finance of Canada asked Harold MacKay to define a process for determining the best securities regulatory system for Canada's needs. Mr. MacKay's findings (2002)[2], presented as a consensus, are as follows:

- Achieving a sound, efficient securities regulatory system is a matter of national importance. Dynamic and fair capital markets and their key components (including the securities regulatory apparatus) are essential to the health of Canada's economy and to the success of Canadian-based businesses. They are also essential to the personal lives of individual Canadians as underpinnings to their employment and their ability to accumulate financial assets (in particular those counted upon for retirement);

[1] Harris, A.D., *A Symposium on Canadian Securities Regulation: Harmonization or Nationalization?*, University of Toronto Capital Market Institute in association with the Canadian Foundation for Investors Education, Toronto, October 2002, available at http://www.mgmt.utoronto.ca/cmi/news/index.htm, (White Paper available in the text that follows).

[2] Letter from Mr. MacKay to the Deputy Prime Minister and Minister of Finance of Canada, November 15, 2002, available at http://www.fin.gc.ca/news02/data/02-094_1e.html.

- In an increasingly competitive world, Canada's regulatory structures have to be world-class, not run-of-the-mill. They should be designed to achieve competitive advantage for Canada and Canadians. This is especially true for securities regulation because of the ongoing challenge to define the role of Canadian capital markets in achieving Canadian goals in the face of the powerful influence of the US economy and capital markets;

- It is important to take regional interests fully into account in achieving improvements to the system and, in particular, to build on the expertise that exists among regulators across Canada;

- If the Canadian securities regulatory system was designed from scratch to achieve the objectives just noted, the system would undoubtedly differ greatly from the present one;

- The current system, as presently operated, must be improved significantly and quickly.

After reporting that there is "a range of problems with the present system," MacKay recommends that a committee be established without delay to "conduct the necessary review and to make recommendations to policy makers."

In this document, we attempt to understand an apparent paradox—one in which the absence of rigorous knowledge does not exclude finding that serious problems exist and recommending that steps be taken quickly.

Most arguments put forward to support the theory that securities regulation in Canada is inefficient are the usual ones that have been raised in most of the previous reports and studies. They often contain little discussion of the theory of securities regulation or financing and in general merely rely on statements, as pointed out by Harris (2002). Thus, the general objective of this study is to analyze the various arguments put forward by proponents of a centralized securities regulatory system. Moreover, Mr. MacKay's recommendations limit the debate on the vibrancy of Canada's capital markets to only one of its components: the regulatory aspect. Although the significance of this element cannot be ignored, it is clear that the dynamism of a securities market depends on many other factors, including trading mechanisms and costs and, more generally, the quality of the relevant market. We will address this aspect by analyzing the growth of the Canadian securities market since 1990.

This study therefore has a two-fold objective. Firstly, it sets out a detailed analysis of the principal arguments put forth by those who contributed to the discussion on this matter; to the extent possible, the analysis is founded on theories of the economy of regulation and finance. Secondly, it presents the results of empirical studies seeking to answer some of the key questions raised in the debate on a Canadian regulatory structure.

The study also highlights important issues affecting the future of the securities market in Canada—issues that have been curiously absent from the debate. Indeed, as proven and illustrated by Lacasse (1995), Canadian economic and regulatory policy decisions have more often than not been guided by myths put forward by pressure groups rather than by actual knowledge resulting from rigorous, independent research. It is disturbing to realize that some are considering reforming a system which has not been analyzed carefully, on the basis of assertions made principally by pressure groups. Consequently, it was necessary to provide the basic components for a structured analysis in order to respond to the proposals and assertions made with respect to securities regulation in Canada.

This study is divided into six parts. In the first, we sum up the principal elements of the debate, without, however, revisiting the history of the various attempts to amend securities regulation in Canada, given that such summaries can be found in the White Paper as well as in Anand *et al* (1999) and Ross and Neave (2001). The second part analyzes the arguments and evidence regarding the inefficiency of the Canadian securities market. In the third part, we examine the other arguments generally raised in order to justify an in-depth overhaul of the securities regulatory system. The fourth part analyzes the concept of regulatory competition. In the fifth part, we highlight some very significant differences between the Canadian and American markets which make it difficult to transfer the American regulatory system—sometimes cited as a reference—to the Canadian system. This part also sets out some of the criticisms levelled by many participants against the American system. Before concluding our report, in part six we examine the growth of the Canadian securities market and the challenges it will have to face. Indeed, no study of the regulatory system would be complete without considering the growth and the very nature of the industry being regulated. Yet this has often been the case in discussions regarding securities regulation in Canada.

PART 1

1- THE DEBATE AND ITS KEY ISSUES

Centralization of securities regulation in Canada is a recurring topic which was given new impetus by the Five Year Review Committee asked to review the Ontario Securities Act (OSC Report, 2003). Its first recommendation reads as follows (p. 7): *We recommend that the provinces, territories and federal government work towards the creation of a single securities regulator with responsibility for the capital markets across Canada.* Indeed, the first chapter of the report is entitled *The Need for a Single Regulator* and begins as follows:

> *We add our voice to countless others raised in support of the urgent need for a single Canadian securities regulator. This is the most pressing securities regulation issue in Ontario and across Canada. We urge the Minister to assume a leadership role in working with her colleagues across the country to resolve any remaining barriers to the establishment of a single regulator responsible for Canada's capital markets activity*.

In this first part, we present and analyze the arguments put forth by organizations and specialists proposing a centralized securities regulatory system (CSRS),[3] as well as the problems recently noted by MacKay (2002). We pay particular attention to the argument that participants have to deal with thirteen securities commissions, thereby increasing costs and reducing the competitiveness of the Canadian securities market. We also attempt to determine the scope of the remaining differences between securities regulations in the various jurisdictions. The arguments reviewed in this first part are analyzed in greater depth in the following parts.

1.1 Overview of the Arguments Put Forward by Proponents of a CSRS

The principal arguments put forward by proponents of a CSRS, or an in-depth overhaul of the Canadian regulatory system, are based primarily on the complexity of financial sector regulation in Canada[4] and, in particular, the existence of thirteen securities regulatory authorities (ten provinces and three territories). It is argued that

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[3] Otherwise also referred to as a single securities regulator with responsibility for the capital markets in Canada.

[4] The framework for financial sector regulation in Canada is described summarily by Mohindra (2002) and in greater detail by Ross and Neave (2001) and more specifically by Anand *et al* (1999). We have not repeated the description in this document.

this situation increases the costs of new issues and compliance and therefore, in general, adversely affects the competitiveness of the Canadian market. The argument continues that the overall regulatory costs, being greater than in other jurisdictions, are particularly damaging in Canada because of the smaller size of the Canadian market. The rules are said to be confusing—at times not even applied—a situation which adversely affects the brokerage industry (by limiting the entry of new firms) as much as it does the financing of emerging growth companies (MacKay letter). It is said that costs resulting from the existence of differences in provincial legislation and the multiplicity of jurisdictions penalize businesses, market intermediaries and the overall markets in Canada. Consequently, Canada's ability to compete in a global market, namely its ability to attract foreign businesses seeking equity capital and to hold on to Canadian businesses, is compromised due to the increased cost of capital for Canadian businesses resulting from the cost and complexity of transactions involving several jurisdictions.

According to the White Paper (p. 9), the situation has not improved much—in fact it has remained unchanged since the 1964 Porter Report—due to the inefficiency of harmonization efforts in Canada. For example, costs to issuers were not reduced at all by the implementation of the mutual reliance review system (the MRRS). Market globalization favours a single securities regulator in Canada and it is essential that Canada speak with one voice. The lines between jurisdictions are not clearly drawn and participants may have to deal with thirteen different jurisdictions for penal proceedings.

The compartmentalization of Canadian securities authorities also makes complex situations involving investors, intermediaries and issuers located in various jurisdictions unmanageable.

According to the Chair of the OSC,[5] the Canadian regulatory system is slow to respond to the rapidly changing market because the various agencies involved must consult one another. Only a single commission would be able to handle Enron-type accounting and financial problems, and the ever growing number of problems of this type favours centralized regulation. Finally, in the opinion of the Ontario Teachers' Pension Plan Board,[6] a uniform regulatory regime would avoid the race to the bottom which occurs when there is regulatory competition.

[5] OSC Annual Report 2002.
http://www.osc.gov.on.ca/en/About/Publications/AnnualRpt2002/en/messages_chair.html.
[6] Comments filed by the Ontario Teachers' Pension Plan Board with the FYRC.

Firstly, it should be noted that in the report of the Royal Commission on the Economic Union and Development Prospects for Canada (1985)—the result of the work carried out since 1982 by the Royal Commission which was chaired by D.S. MacDonald—the conclusion regarding securities regulation was as follows (Volume 3, p. 167):

> *In principle, there seems to be a strong argument for federal regulation. In practice, we have achieved much the same result with provincial jurisdiction because of the leading role that Ontario, the centre of the Canadian financial industry, has been able to play, often in partnership with Quebec. One research study[7] prepared for this Commission argues that there is no pressing reason to tamper with this arrangement: provincial regulation has satisfied national purposes.*

In the rest of this part, we analyze two major components of the prevailing discussion, which focuses on the existence of thirteen regulatory authorities but says nothing about the mechanisms for cooperation, the mutual reliance review system and the other initiatives which these bodies have implemented, or merely dismisses them as being ineffective.

1.2 Regulation and the Canadian Securities Market

The report of the Five Year Review Committee entrusted with reviewing the Ontario Securities Act (OSC, 2003, p. 30) asks the overall question regarding securities regulation in Canada as follows:

> *Because securities regulation in Canada is a matter of provincial jurisdiction, there are 13 different sets of securities laws administered by 13 provincial and territorial regulatory authorities. Many of the statutes are similar to one another. Some have provisions that are entirely distinctive. None of them is identical. Even where the statutory provisions are identical, they may be interpreted and applied differently from one jurisdiction to the next.*

[7] T. J. Courchene, *Economic Management and the division of Powers*, *The Background Studies for the Royal Commission on the Economic Union and Development Prospects for Canada,* 1986, 67, p. 154 à 170.

The argument based on the existence of thirteen regulatory authorities is also found in the MacKay letter as well as in most texts dealing with the reform of the securities regulatory system.

While one cannot deny the existence of thirteen provincial securities authorities in Canada, one must also consider that four provinces monopolize almost all of the share issues, the companies listed on an exchange, the population and economic activity in Canada. Thus, even if there are thirteen securities regulatory authorities in Canada, the vast majority of issuers deal with only one securities commission. By satisfying the requirements of both the Ontario and the Québec securities commissions, an issuer can access more than half of the Canadian population. By adding the Alberta and British Columbia securities commissions, an issuer can issue securities in four provinces representing more than 85% of the country's population.

1.2.1 Initial Public Offerings

Table 1 illustrates this situation as regards initial public offerings (IPOs). Of the 1,891 IPOs identified between 1991 and 2000, only 60 (representing 3.2%) were carried out by businesses without a head office in one of the following four provinces: Alberta, British Columbia, Ontario and Québec.

During that same period of time, there were fewer share issues by businesses from the other provinces and territories than by foreign companies (71)[8]. In actual fact, four regulatory bodies—not thirteen—supervise most issues in Canada.

1.2.2 Listed Companies

Using the CanCorp Financials database, we analyzed all of the companies listed on Canadian stock exchanges.[9] Publications and official statistics (Boisvert and Gaa, 2002; Prospectus of the TSX Group Inc., 2002) report a total of approximately 4,000 listed securities in Canada, placing Canada in second place worldwide for listed companies. However, of the 4,131 companies for which a recent stock exchange symbol is available,[10] 879 should be considered inactive because neither the database nor SEDAR report total assets or provide any financial statements after 2000.

[8] Most of the foreign firms that carry out an initial public offering in Canada do not subsequently list their securities on a Canadian stock exchange. The issues are generally offered concurrently in both countries.
[9] This database is prepared by Micromedia: http://www.micromedia.on.ca/AboutMML.htm.
[10] Stock exchange symbols that have been re-attributed have been omitted.

Table 2 provides a breakdown of those companies based on their place of incorporation. Over 90% of the active companies are located in one of the four most dynamic provinces in terms of IPOs. There are eight companies in Newfoundland, three in the Northwest Territories and two in Prince Edward Island.[11]

Therefore, most securities issues are concentrated in four provinces which, in July of 2001, represented over 85% of the Canadian population. Consequently, most issuers and intermediaries have to deal with four securities commissions, not thirteen. The Canadian Securities Administrators have undertaken and instituted several significant measures to limit the problems resulting from the existence of multiple jurisdictions, and an action plan was developed to further harmonize the regulatory system. It would be worthwhile to assess these efforts and accomplishments which make certain studies and analyses carried out at the beginning of the 1990's obsolete.

Table 1: Distribution of IPO's in Canada, 1991-2000, based on the location of the issuer's head office

Location	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	Total
AB	11	15	103	92	72	95	138	88	40	70	724
BC	28	25	39	44	42	54	77	46	69	77	501
FOR	7	2	3	12	11	13	13	5	4	1	71
ON	11	12	42	57	36	52	66	55	40	28	399
OTH	4	4	2	5	7	2	12	7	6	11	60
QC	0	4	19	9	11	24	21	15	12	21	136
Total	61	62	208	219	179	240	327	216	171	208	1891

Sources: *Financial Post, Report of New Issues, Cancorp Financials*, www.sedar.com and www.cdnx.com. Issuer's province of incorporation: QC: Québec, ON: Ontario, AB: Alberta, BC: British Columbia, OTH: Nova Scotia, Manitoba, Saskatchewan, New-Brunswick, Newfoundland, Northwest Territories, Prince Edward Island, Yukon, FOR: issues by companies with head offices outside Canada.

[11] The last part of this study, which deals with the attributes of the Canadian market, contains a more in-depth analysis of listed securities in Canada.

Table 2: Distribution of Canadian and foreign companies listed on a Canadian stock exchange in November 2002, based on their place of incorporation

	Active companies		Inactive companies	Total	
	Number	%	Number	Number	%
British Columbia	1175	36.13	222	1397	33.82
Alberta	802	24.66	270	1072	25.95
Ontario	691	21.25	177	868	21.01
Québec	304	9.35	54	358	8.67
Yukon	94	2.89	30	124	3.00
Foreign companies	80	2.46	92	172	4.16
Manitoba	33	1.01	12	45	1.09
Nova Scotia	24	0.74	14	38	0.92
New Brunswick	20	0.62	5	25	0.61
Saskatchewan	16	0.49	3	19	0.46
Newfoundland	8	0.25		8	0.19
Northwest Territories	3	0.09		3	0.07
Prince Edward Island	2	0.06		2	0.05
Total	3252	100.00	879	4131	100.00

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

1.3 Mutual Reliance and Cooperative Efforts

The Canadian Securities Administrators (CSA) is a forum for the 13 Canadian securities regulators to coordinate and harmonize regulation of the capital markets. Its mission[12] is to give Canada a securities regulatory system that protects investors from unfair, improper or fraudulent practices and fosters fair, efficient and dynamic capital markets, through development of the Canadian Securities Regulatory System, a national system of harmonized securities regulation, policy and practice. Its principal accomplishments to date are the mutual reliance review system, the Memorandum of Understanding about the Oversight of Exchanges and Quotation and Trade Reporting Systems (SuperMOU), the registration streamlining system (RSS), the national instruments and the uniform securities legislation project, all of which

[12] http://www.csa-acvm.ca/html_CSA/about.html

are discussed below.[13] The CSA's plans and objectives are set forth in a strategic plan available on its web site.

1.3.1 Memorandum of Understanding Relating to the Mutual Reliance Review System

In order to improve the efficiency of the Canadian capital markets by streamlining the review of filings, the CSA agreed to create the mutual reliance review system[14] (MRRS) so as to reduce unnecessary duplication in the review of filings made in multiple jurisdictions. On January 1, 2000, the Memorandum of Understanding (MOU) Relating to the MRRS[15] was implemented through its adoption by all the Canadian securities commissions. It applies to filings made in more than one jurisdiction. It deals with applications for exemptive relief as well as with prospectuses and annual information forms. The MRRS is the result of an initiative undertaken in 1971.[16] These matters now fall within the scope of National Policy 43-201, Mutual Reliance Review System for Prospectuses and Annual Information Forms (AIF), and National Policy 12-201, Mutual Reliance Review System for Exemptive Relief Applications. Corresponding notices were issued for Québec.

Mutual reliance means that, in exercising discretion under securities legislation, the decision-maker in a particular securities regulatory authority is prepared to rely primarily on the analysis and review of the staff of another securities regulatory authority. The MOU does not involve a delegation of power by the various securities commissions. A receipt is still issued by each of the authorities based on its own rules. The system facilitates the task of analysts in the various commissions and that of market participants with respect to applications for exemptive relief, the granting of receipts for prospectuses and the acceptance of AIFs.

The procedure under the system is as follows: an issuer designates a principal regulator which is the regulator for the jurisdiction in which its head office is

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[13] We should also mention other projects currently under development, such as the integrated disclosure system (IDS) and the system for electronic disclosure by insiders (SEDI), implemented in May 2003.

[14] This is a very brief presentation of the MRRS which deals only with those aspects relevant to our mandate.

[15] The Memorandum of Understanding Relating to the Mutual Reliance Review System was approved by all of the securities regulatory authorities in October 1999. National Policies 12-201 and 43-201 were attached to the MOU which therefore covers two systems (B.C.V.M.Q., 1999-10-29, Vol. XXX, No. 29).

[16] Prior to that time, distributions in Canada were governed by National Policy No. 1, Approval of Documents Across Canada, which dated back to August 20, 1986 and was inspired by the *Énoncé de politique national numéro 1, Permis pour émissions nationales*, dated March 1, 1971.

located.[17] The issuer deals only with this commission and receives a document from it confirming the decision of all the regulatory authorities involved with its application.[18] The securities regulatory authorities in Alberta, British Columbia, Québec, Manitoba, Nova Scotia, Ontario and Saskatchewan have agreed to act as principal securities regulators.

The initial year of implementation of the MOU was a year of adjustments. With respect to applications for exemptive relief, there were a few withdrawals of exemptions.[19] The system seems to be working well for prospectuses. In the autumn of 2001, an initiative to review certain examination procedures set out in the MRRS was undertaken. Ultimately, very few changes were made to the initial version of the MRRS regarding applications for exemptive relief. Notices outlining the MRRS for prospectuses and applications for exemptive relief are available on the CVMQ web site[20] (25-01-2002 and 12-07-2002).

A panel comprised of all of the staff involved with the MRRS within all the Canadian securities commissions—bringing together some 140 to 150 individuals—meets every two years to explain the document examination procedures (prospectuses and applications for exemptive relief) set out in the MRRS and to ensure consistency in the interpretation and application of new rules affecting distributions.

1.3.2 Memorandum of Understanding About the Oversight of Exchanges

The Montreal Exchange has been recognized as a self-regulatory organization since 1984. Since its demutualization, the Bourse de Montréal Inc. has since been recognized as a self-regulatory organization.[21] The arrival of The Nasdaq Stock Market Inc. in November 2000 created a precedent because it was recognized by statute as a self-regulatory organization under section 1 of *An Act respecting Nasdaq Stock Exchange activities in Québec* (R.S.Q., c. E-20.01). The TSX Inc. and the TSX Venture Exchange Inc. are covered by a temporary exemption[22] which should become a final exemption. This situation led to the drafting of a memorandum of

[17] Or that of its manager if it is a mutual fund. If the issuer's head office is not located within the jurisdiction of a participating principal regulator, the issuer must designate another participating principal regulator with which it has a reasonable connection.
[18] The Commission des valeurs mobilières du Québec concurrently renders its own written decision.
[19] Exemption withdrawals may be statutory, administrative (these two are infrequent) or the result of a condition which is unacceptable to a commission.
[20] http://www.cvmq.ca/Upload/fichier_pdf/norme/A-XXX-43ang.pdf and http://www.cvmq.ca/Upload/fichier_pdf/norme/A-XXXIII-27a.pdf.
[21] CVMQ Decision No. 2000-C-0729 dated November 24, 2000.
[22] Exemption provided for under section 263 of the *Securities Act* (R.S.Q., c. V-1.1), CVMQ decisions No. 2002-C-0227 dated June 28, 2002 and 2002-C-0189 dated May 31, 2002.

understanding—the SuperMOU—between the various Canadian securities administrators (CSA) for the purpose of regulating and simplifying the oversight of stock exchanges, except the Nasdaq Stock Market inc.

The SuperMOU is a memorandum of understanding about the oversight of exchanges and quotation and trade reporting systems. Each recognized exchange and recognized quotation and trade reporting system has a principal regulator responsible for its oversight and may have one or more exempting regulators. The principal regulator will inform the exempting regulator of its oversight activities and will provide the exempting regulator with all useful information requested by it[23]. The SuperMOU was signed by the participating commissions other than the CVMQ on September 3, 2002, and will come into effect in those provinces when it is approved by the Ontario Minister of Finance on November 7, 2002. In Québec, the SuperMOU came into effect on July 17, 2003 when it was signed by the Minister in charge of Canadian intergovernmental affaires, Mr. Benoît Pelletier[24].

1.3.3 Registration of Representatives

The registration streamlining system (RSS)[25] was set up by the CSA on October 1, 2002 in response to comments from industry to the effect that registration of securities representatives with thirteen jurisdictions was a costly and tedious process[26]. The RSS makes it possible for representatives to register with several securities authorities as follows:

1) A representative registered in an initial jurisdiction copies the form accepted by that jurisdiction and files it with the subsequent jurisdiction together with a letter from his employer and the required registration fees. The form must be signed by the firm and by the representative. The conditions for registration of each

[23] The SuperMOU will replace the Memorandum of Understanding Regarding the Oversight of the TSX Venture Exchange Inc. by the Alberta Securities Commission and the British Columbia Securities Commission which the CVMQ had signed with those commissions in September 2001.

[24] Under section 3.8 of the *Act respecting the ministère du Conseil exécutif* (R.S.Q., c. M-30), "Canadian intergovernmental agreements must, to be valid, be approved by the Government and be signed by the Minister [in charge of Canadian intergovernmental affaires]". See the *Act respecting the ministère du Conseil exécutif*, as amended by the *Act to amend the Act respecting the Ministère du Conseil exécutif as regards Canadian intergovernmental affairs*, S.Q. 2002, c. 60 (assented to on December 18, 2002 and which came into force on the same date). A "Canadian intergovernmental agreement" means an agreement between the Government or one of its departments or government agencies and another government in Canada or one of its departments or government agencies.

[25] http://www.sfsc.gov.sk.ca/ssc/files/nat-noti/31-305.pdf.

[26] A centralized on-line registration system, such as the one now in place in the United States, is currently under review.

jurisdiction continue to apply and each jurisdiction retains its right to evaluate the registration and require additional information.

2) The subsequent jurisdiction then sends a letter to the initial jurisdiction asking for confirmation that the representative's registration is in good standing. The commissions have agreed to register representatives within two days of receipt of the initial jurisdiction's reply.

Non-residents can also register under the RSS, provided that, for each province, they agree to submit to the applicable law of the province and to its courts in the event of a dispute with a client domiciled in that province. In this manner, Québec investors can institute proceedings against representatives who are not residents of Québec. The RSS is currently in effect in all the provinces. The RSS is currently in effect in all the provinces except Québec, which must obtain approval of the regulation authorizing its implementation from the Minister of Finance[27].

1.3.4 The National Instruments

Most securities activity in Canada is now governed by national instruments. Appendix 1 sets forth a list of national instruments and other texts of national scope which apply in the following areas:

- efficiency of the securities market and trading rules,
- registration and related matters,
- the distribution of securities,
- continuous disclosure,
- take-over bids and special transactions,
- securities transactions outside the jurisdiction,
- mutual funds,

in addition to the MRRS and the RSS discussed above.

Therefore, securities transactions in Canada are governed by a set of national instruments, with a few exceptions:

- Some national instruments have not yet been implemented in Québec due to the different approval process, but in many cases adherence to the national instruments takes place by means of internal directives.

[27] Paragraph 26 of section 331.1 of the Québec *Securities Act* allows the adoption of a regulation which must be approved by the Minister of Finance.

- There are still some differences, particularly as regards exemptions, which affect parts of some of the national instruments. They are the subject of discussion. These differences often reflect regional differences in market conditions.

Although securities regulation is a provincial matter, it is governed to a significant extent by national instruments and policies applicable to all of the provinces. This harmonization is the result of cooperative efforts undertaken through the CSA. The percentage of national instruments which are not currently harmonized is quite low. However, the existence of national instruments has not removed some differences in the provincial statutes, particularly as regards terminology. Nonetheless, the use of national instruments should allow a move towards a passport system. This subsequent step is the subject matter of the Uniform Securities Legislation (USL) project.

1.3.5 The Uniform Securities Legislation Project

Recently, as they had said they would, the CSA firmly undertook to eliminate the differences in provincial and territorial securities law by embarking on a uniform securities legislation project. The project resulted in a detailed proposal submitted for public comment in the various provinces in January 2003.[28] As stated in the CVMQ's notice, the proposal is the:

> [Translation] *fruit of a collaborative effort initiated over a year ago by a group of securities commissions in order to assess the relevancy and feasibility of formulating a common legislative framework for the various Canadian provincial and territorial securities authorities. As such, the proposal is not intended to reform the current system based on provincial jurisdiction, but rather, to develop a common language to facilitate the work of the regulators and reduce the legal and administrative formalities which issuers and industry intermediaries must satisfy, while at the same time safeguarding the interests of investors.*

In this area, the situation in Canada is similar to that in the European Union: the foundations of the law are not uniform and, as stated in the proposal,

> [Translation] *Québec is the only Canadian province with laws based on a civil code and with statutes and regulations having wording*

[28] See B.C.V.M.Q., 31-01-2003, Vol. XXXIV, No. 4 and its supplement at: http://www.cvmq.com/fr/publi/bulletin.asp?no=192&affBulletin=true.

> *based on a civil law system. All the other Canadians jurisdictions operate in accordance with common law principles. Consequently, any initiative aimed strictly at standardizing statutory and regulatory securities texts is only possible in the common law provinces: they can in fact achieve identical results by adopting uniform statutory and regulatory language. This is not the case for Québec which, to achieve the same results, must draft its texts in a different legislative context in accordance with civil law principles and adopt a legal language which is often different.*

Therefore, Québec participated in the project by adopting an approach based on harmonization. As stated by Mr. Godin, Chair of the CVMQ[29]: [Translation] *Québec must develop an approach which is based on harmonization and which will accommodate the specific nature of our industry and investors.* This project is part of a strategy of regulatory reform that aims to reduce the burden of regulation on market participants and make regulation more effective. The CSA recognize that much of the burden on market participants is due to the fact that each of Canada's provinces and territories has different securities legislation. The project's objective is to eliminate the adverse effects of such differences by developing harmonized statutes and regulations and, on the basis of this harmonized legislation, establishing mechanisms for delegating decision-making and for mutual recognition. The uniform securities legislation project would, in fact, be a harmonization project, resulting in the following principal changes (p. 2 of the project):

- The ability of a securities regulatory authority to delegate decision-making across all regulatory functions to another securities regulatory authority, subject to restrictions that would preserve each securities regulatory authority's autonomy and jurisdiction. This would allow the implementation of one-stop shopping. For example, an applicant for exemptive relief or a prospectus receipt would file an application with the principal regulator only and would receive one decision only from that regulator, which decision would be the decision of all the regulators named in the application;

- A streamlined system for inter-jurisdictional registration of firms and individuals. Harmonized registration categories and obligations together with the aforementioned delegation of powers would make it possible to implement a national registration system. Under this system a registrant in one jurisdiction could become registered in another jurisdiction simply by notifying the regulator in its home jurisdiction that it wishes to do business in the other jurisdiction and paying the appropriate fees;

[29] http://communiques.gouv.qc.ca/gouvqc/communiques/GPQF/Janvier2003/30/c5155.html.

- A civil liability regime for secondary market participants regardless of whether the issuer is a reporting issuer in the jurisdiction in which the security holder resides if the issuer is a reporting issuer in any jurisdiction of Canada;

- A streamlined securities act with details largely contained in rules to allow future changes to securities laws to be made in a timely and harmonized manner through the rule-making process. The uniform act would be "platform" legislation setting set out fundamental rights, powers and obligations. The uniform rules would contain detailed requirements.

The power to delegate set out in the project makes it possible to envisage a mutual recognition system similar to the model adopted by the European Union to solve the problem which arose as a result of the creation of a single market subject to the jurisdiction of various civil law and common law countries. The consultation period ended on April 30, 2003 and the CSA are hoping to introduce this significant change at the beginning of 2005.

Considerable progress has been made since the creation of the CSA, primarily the introduction of national instruments. The MacKay letter recognizes the significance of what has been accomplished. It states:

> *The regulators in the CSA have been conscious of the need for them to work together in the interests of investor protection and market efficiency. To that end they have implemented a number of harmonization and streamlining initiatives. Most market participants agree that these efforts have had some successes, particularly in the mutual reliance system of prospectus review and in a number of jointly promulgated national policy instruments.*
>
> *The CSA is also working on a number of other harmonization and streamlining projects, two of which deserve particular mention: (1) the continuing effort to develop common rules and procedures to permit a mutual reliance system of intermediary registration, and (2) the drafting of uniform securities legislation and rules for consideration by provincial and territorial governments. These are important initiatives which should be encouraged.*
>
> *The question remains as to whether these steps and other CSA harmonizing and streamlining initiatives alone will be adequate to*

> *assure Canada of a sustainable, effective and efficient securities regulatory system in the decades ahead.*

The MacKay letter was drafted before the consultation process regarding the harmonization project was begun and it does not seem to take into account the importance of the national instruments. Co-ordination efforts have led to the emergence of significantly harmonized national instruments and the timetable for implementation of the USL indicates that a harmonized framework may well be in place very shortly. These results were obtained without resorting to a single centralized regulator.

1.4 The Extent of Differences and Conflicts

The initiative of the Canadian regulators, as well as the CSA's action plan, indicate the high degree of awareness surrounding the continued existence of certain problems and, in particular, the differences which still divide securities legislation in Canada, as well as the conflicts and delays resulting from the existence of multiple jurisdictions. The measures which have been implemented do not yet embrace the principle of mutual recognition which has been accepted in Europe, and the efforts to harmonize securities legislation are not entirely complete, although, as of 2003, a very large proportion of the national instruments have been harmonized. The few differences which still remain relate to sections which could not yet be harmonized due to the highly diversified nature of the Canadian market, a market in which hundreds of mining securities from the West trade with large-cap securities based primarily in Ontario.

The most significant differences and problems which continue to exist and are felt by market participants can be divided into three categories.

- Rules governing distributions: despite the MRRS, in many cases regulators other than the principal regulator re-examine prospectuses. The mutual reliance system will most probably have to develop into a mutual recognition system in which the principal regulator issues a receipt that is valid in all the other jurisdictions. This is the proposal in the USL project;

- Multi-jurisdictional registration of dealers and representatives. In this area, there are still inter-provincial barriers which also exist in other professional sectors, including the construction industry! The passport-type systems that have been put to the test in the European Union are a potential solution to this problem;

- The British Columbia Securities Commission (BCSC) performed a cost-benefit analysis of the current disclosure and prospectus preparation system (Wolf, 2002). Using questionnaires administered to issuers, the author attempted to measure the costs of completing a prospectus and to link the costs incurred by issuers to the various regulatory requirements. The study indicates that it is possible to reduce issuance costs and cut the time to market by changing disclosure requirements. It also indicates that issuers spend 87% of their compliance time on compliance with securities regulations that are already significantly uniform, thereby confirming our estimates as to the existing degree of harmonization in 2003. The author concludes that harmonization has already been achieved to a significant extent (p. 16):

> *it suggests that those who look solely to harmonization or national regulation to reduce the regulatory burden may be sorely disappointed if they get their way. If only 13% of regulatory compliance effort is spent on areas that are non-uniform, the efficiencies to be gained merely from harmonization are slim, especially considering that harmonization will not reduce that 13% to zero—the requirements will remain, albeit in a harmonized form.*

As suggested by the findings of the BCSC, the Canadian problem is more closely tied to a comprehensive approach to securities regulation—an approach which is too onerous and costly—than to the effects of multiple jurisdictions.

1.5 Conclusion

Notwithstanding the assertions of proponents of a centralized securities regulatory system in Canada, most securities activity is managed by four commissions. Significant co-ordination and streamlining efforts have recently led to the implementation of systems to reduce the burden of multiple jurisdictions on the various types of market participants and to the introduction of national instruments. A major standardization/harmonization project is currently in the consultation phase, but it can be said that the current securities regulatory system has already been significantly harmonized. However, some differences in the rules and interpretation thereof remain, which can give rise to additional costs. The analysis of those costs is the subject of the next part. The analysis was carried out through observations made over a period of time when the degree of harmonization was lower than it currently is.

PART 2

2- The Costs Of Regulation And Inefficiency

2.1 Arguments and evidence

For MacIntosh (2002), *countries like the United States or associations of countries like the European Union have such a large share in markets, that they can afford to run excessive burdensome regulatory regimes without losing a lot of securities-related business. They have market power. We have not.* For MacKay (2002), there are serious problems of efficiency. He writes:

> *many issuers and registrants point to the excess cost and the time delays that flow from complying with often different laws, regulations, rules or policies (or different interpretations of the same laws, regulations, rules or policies) across Canada. They argue that these cost burden and time delays (a) create a barrier to entry for new investment dealers, brokers and other intermediaries, (b) prevent companies wishing to access public markets, particularly emerging growth companies, from doing so - and, for listed companies, impose unrealistic compliance burdens on an ongoing basis, and (c) prevent issuers and dealers from offering investment products to institutional and retail investors everywhere in Canada unless they navigate the rule complexity caused by the present system.*

Issuers and registrants complain about both the direct costs caused by reporting to several regulatory bodies and indirect costs, including substantial additional internal costs related to compliance. Concerns about costs and time delays seem to have greatest negative effect on small and medium-sized companies, least able to face the consequences of these problems.

Harris (2002, p. 34) summarizes the cost factors caused by the present situation in the following manner:

- *Disparate substantive rules among the provinces, leading to additional time and effort incurred by issuers and intermediaries to determine the requirements in all relevant jurisdictions and to structure transactions, or to make filings in connection with intermediary registration, accordingly;*

- *Disparate administrative practices among the provincial securities regulators, again leading to additional time and effort incurred by issuers and intermediaries to determine and comply with relevant issuance and registration requirements;*

- *Multiple regulators with overlapping and duplicative jurisdiction, leading to additional time and effort incurred by issuers and intermediaries in making multiple filings, and issuers and intermediaries paying multiple fees to those regulators;*

- *The opportunity cost to investors and intermediaries represented by domestic and foreign issuers who choose to bypass the Canadian capital markets in favour of other markets with more cost effective regulatory systems; and*

- *Lost economies of scale in the development and administration of regulatory policy by multiple jurisdictions, or, to consider the converse that might arise under a transition to a central regulator, inefficiency resulting from the consolidation of too much securities regulatory authority in a single body managed by regulators used to controlling and directing activity in a much smaller sphere.*

From these arguments we conclude that:

- Costs caused by the Canadian regulatory system prevent growth companies from having access to the public market by unduly increasing issuance costs and delays. Initial issuance costs and delays are thus abnormally high:

- The inefficiency of the system harms the brokerage industry by limiting access of new participants:

- Regulatory costs represent an obstacle for registration of foreign corporations in Canada.

In Part 1, we discussed the situation with the disparate substantive rules among the provinces. To the extent that Canadian standards are now used, local differences in securities legislation may not have significant effects.

2.2 Putting in perspective

Firstly, it is useful to point out the absence of any rigorous analysis of the cost of securities regulation in Canada or, for that matter, the United States. The authors show that the different methods used by researchers produce diverging results and point out the bias caused by methods presently used[30].

Evaluation of the costs and benefits of regulation is difficult because its direct and indirect effects are numerous and difficult to estimate (Gagné *et al*, 2001). According to Briault (2003), there are three broad types of regulatory costs: first, direct costs of paying for financial services regulators; second, indirect costs of regulation, namely the incremental costs of compliance; and third, the distortion cost[31]. Comparison of the direct costs of regulation is difficult, mainly because the nature and scale of the financial services industries in different countries vary significantly. Whereas the United Kingdom now has only a single authority, a number of other countries regulate the banking, insurance and securities sector separately. The FSA (2003)[32] proposes some indicators of the direct costs of regulation in different jurisdictions. It is important to note that Australia, which recently opted for a single regulator for the securities market, incurs significantly higher costs than Canada. The estimated cost of the Australian Securities and Investment Commission (ASIC) is estimated to be £73.8 million. The total cost in Canada, including the Bureau des services financiers, is £55.4 million. The Australian capitalization is 64.5% of the TSX capitalization[33].

The problem of the cost of securities regulation is important, but it should be put in perspective. Issuers and investors incur various forms of costs, of which regulation is only one component. In particular, it is useful to distinguish the effects on the primary market from those which may affect the secondary market. The primary market is for initial issuances, and we will analyze in detail the costs and delays in this market. It is possible that regulation, so pervasive with initial public offerings,

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[30] In particular, the bottom-up survey method (Gagné *et al*, 2001), used in works by Sawiak (1996) and Wolf (2002), leads to bias to the extent that corporations not very affected by regulatory costs are unlikely to participate in such surveys, which results in the overestimation of costs.

[31] C. Briault, Director of the Financial Services Authority, explains: "the 'distortion' cost arising from the way in which regulation may change the nature of markets, may prevent or discourage firms from entering or using markets, may constitute new markets that would not exist in the absence of regulation, and may therefore have a significant effect on the nature and availability of the products provided by the financial services industry". See The Costs of Financial Regulation, July 2003, http://www.fsa.gov.uk/pubs/speeches/sp140.html

[32] http://www.fsa.gov.uk/pubs/annual/ar02_03/ar02_03app8.pdf

[33] A share of the ASIC total is devoted to aspects of corporate regulation which may not be performed by the regulators in other countries. ASIC also regulates financial advice and advisers as well as the selling and retail marketing of financial products. This is why the cost of the Bureau des services financiers should be included for comparison.

may penalize issuers. The secondary market, in which already issued securities are traded, is by far the largest. This is the market which primarily attracts foreign issuers. Even if cost and the issuance process were efficient, a foreign issuer would have no interest in listing its securities if the secondary market is thinly traded, trading costs high and market quality generally average.

In the United States, for the year 2000 according to the *Securities Industry Association*[34], the total trading volume for shares rose to $34.118 trillion. A rough estimate of trading costs puts them at around .75%[35]. All trading costs for that year were thus around $256 billion. These costs include four components: the spread which separates the bid and ask prices, the price effect of the announcement of large orders which replaces the spread when blocks are exchanged on the upstairs market, brokerage fees and, finally, the cost of settling trades. The first two components result essentially from market organization and liquidity, and broker conduct.

To a large extent, brokerage fees depend on the level of competition but regulatory considerations may affect this level. For example, internal order matching, which facilitates trading by institutional investors (the *upstairs market*), is subject to less stringent regulation in Canada than on the NYSE. This difference may explain differences in total trading costs for institutional investors between Canada and the United States.

Revenue for the American securities industry grew in 2000 to $60 billion[36], including the trading costs referred to above. This estimate only takes into account, however, brokers listed on the NYSE, but incorporates the various sources of revenue of brokers, including fixed income securities. During the same year, 2000, the American Treasury collected $2.1 billion through the SEC. The operational costs of the SEC are estimated to be $377 million. The tangible and direct costs of American regulation are therefore a very small fraction of total costs incurred by issuers and investors in the American market. A small reduction in trading costs (from .75% to .7489%) would have more effect on total costs incurred by American investors and issuers than the total elimination of SEC costs. Investors are very sensitive to trading costs. Atkins and Dyl (1997), for example, show a significant inverse relationship between volume and trading costs both on the NYSE and on the NASDAQ.

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[34] http://www.sia.com/press/html/question4.html.
[35] http://www.quickmba.com/finance/invest/tradecost/.
[36] http://www.sia.com/reference_materials/pdf/RsrchRprtVol3-9.pdf.

In Canada, trading volume on the TSX reached $716 billion in 2001 (TSX Group Prospectus)[37]. If trading costs are similar to those in the United States, investors spent in total 716 x .0075 = $5.370 billion. Chant and Mohindra (2001) estimate the expenses of the Alberta, British Columbia and Ontario securities commissions at $72.9 million, which, when added to the expenses of the Quebec Securities Commission (CVMQ $17.3 million), total around $90 million. In 2002, these expenses amounted to $104.09 million (Schedule 2).

In Canada, a change in trading costs which would reduce them from .75 to .735% would have the same effect on total costs incurred by markets as the elimination of the four main securities commissions. Trading costs of mid or small-cap securities in Canada are extremely high. Cleary *et al* (2001), for example, put them at 1.3% for securities trading between $15 and $20 when a discount brokerage is used. They are 3% when the order is given to a full service broker. The .75% estimate used here is valid for Internet trades and high-priced liquid securities and institutional investors. In 2001, the sales volume of the securities industry in Canada was $10.1 billion and operational costs were $2.8 billion. These values are respectively 9.8 and 2.7 in 2002[38].

A reduction in the regulatory burden is certainly a laudable goal. Nevertheless, intangible costs have not been taken into account. However, it is clear that regulatory costs only represent a small fraction of costs borne by issuers and investors, in both Canada and the United States. To impute solely to regulatory costs the relative inefficiency of the Canadian market overlooks the fact that the essence of trading costs is related to market operations and brokerage commissions, which are mainly the responsibility of the brokerage industry itself.

It is, however, possible that costs caused by the regulatory system primarily affect new issuers more than companies whose securities are already traded or even investors. It would therefore be useful to analyze initial offerings.

[37] The volume was $640.9 billion in 2002. The 2001 data was used to ensure coherency with that of Chant and Mohindra (2001).

[38] http://www.ida.ca/Files/IndIssues/SecIndStatis/annual_totals_fr.pdf

2.3 The Effect on Initial Offerings

When a company initially asks for outside public capital, it conducts an initial public offering which requires the preparation of a prospectus. The prospectus may be waived in certain cases and under certain conditions. In order to issue securities in a given province, issuers must have the prospectus receipted by the securities authorities in each jurisdiction.

For MacIntosh (1997, p. 210), the present situation of securities regulation requires issuers to deal with several regulatory bodies and multiplies the direct costs of an issue. These are mainly fees of accountants, lawyers and other professionals involved in the preparation of a prospectus. In addition, because of the multiple review process for prospectuses, the issuer incurs additional internal costs (time spent by officers and employees) and opportunity costs. An issuer may be unable to benefit from a window of opportunity favourable to conducting an issuance or it may be unable to benefit from investment possibilities due to non-availability of funds.

Relatively little empirical evidence exists to support these statements. To our knowledge, only Sawiak *et al* (1996) have analyzed, in an unscientific manner[39], costs caused by Canadian securities regulation on initial and secondary issues and estimated at around $20,000 the additional costs related to the (secondary) issue in a province other than the one where the corporation already issued its securities. The study covered the year 1995. Differences between the hold period rules in the various provinces were an obstacle to issues conducted outside the province of origin.

For initial offerings, 30% of securities specialists estimated the registration costs in a second province at $5,000 or less, 60% of respondents placed them between $5,000 and $10,000 and 10% of them placed them at over $10,000. 40% of respondents believed that the additional costs represent less than 1% of the total direct costs of issues, and 40% of them put them between 1 and 5% of these costs.

MacIntosh states that the additional costs for a foreign issuer have not been measured, but that anecdotal evidence suggests that minimal additional costs may have a decisive effect on the decision of foreign companies to issue securities in Canada.

[39] In their testimony before the Standing Senate Committee on Banking, Trade and Commerce, on May 7, 1996, the authors of this study said: "We are not economists. We are not statisticians. We are not schooled in preparing questionnaires. We are securities lawyers. We prepared these questionnaires as securities lawyers trying to elicit that information which we thought would be useful to this committee in its deliberations. This report does not purport to be statistically reliable. We are not schooled in such matters. However, it does represent the canvassing of a number of individuals whose views now supplement our personal views…"

Data reported by Sawiak *et al* (1996) does not coincide with data respecting initial Canadian issues. Kooli and Suret (2003a) observe that the average size of Canadian issues (outside capital pools)[40] was around $17 million between 1991 and 1998. Even if listing costs in a province other than the province of origin are $10,000, which seems to represent an upper limit for 90% of the specialists questioned, they can only raise the issue costs expressed as a percentage of gross proceeds by 10 / 17,000 = .00058 or .058%, or 5.8 basis points for an average issue. It seems unlikely that the few thousand dollars which, according to offerings specialists, registration in another province represents could be a significant factor in increased costs and a barrier to issuances. This is especially true since we have measured the effect on costs for an average issue, and the probability of an issue in several provinces increases with the size of the issue. As a percentage, the additional costs become negligible for issuances of $40 million or more. Finally, these estimates were made before the implementation of the MRRS which, according to MacIntosh (p. 212), has reduced costs for users of capital markets.

It is thus difficult to argue that the existence of several securities authorities in Canada heavily penalizes market competitiveness, as four studies show that the cost of initial offerings is significantly lower in Canada than in the United States, which does not have multiple securities commissions. Higgins (1994) and Williams and Shutt (2000) demonstrate a net advantage for Canadian issuances. These two studies covered a small number of samples (16 issuances for Higgins, 49 for Williams and Shutt).

In a parallel study (Kooli and Suret, 2003a), we studied the direct and indirect costs of initial offerings in Canada and the United States during the period 1997-2000. The data and findings from this study are described below. The study covered 513 of 714 Canadian IPOs during the period and 1,188 of the 1,534 American issues. The issues omitted were those for which the obtaining of a prospectus seemed impossible. The following costs factors were measured:

- Brokerage fees;
- Other costs appearing in the prospectus, which are related to legal costs, fees and preparation of the prospectus;
- The initial undervaluation, which resulted in a cost for companies whose securities were issued at a lower price than that established by the market.

[40] Capital pool equity can only be offered in an initial offering to shareholders residing in Alberta or British Columbia. Their analysis in the case of issues in multiple jurisdictions is therefore not relevant. http://www.sfu.ca/~mvolker/biz/cpc.htm.

The observations are separated according to the method of subscription (agent or firm underwriting), size (measured by gross proceeds), and the market on which the security is listed following the issue.

We first showed the important effect of the size of issues, which results in significant differences between the various exchanges, as they attract different offerings customers. In Canada, commissions and other costs as well as undervaluation are much greater on the CDNX (now the TSX Venture Exchange Inc.) than on the TSE (now the TSX Inc.), especially because of the presence of capital pools[41]. Table 3 shows direct and indirect costs of firm underwriting initial offerings in Canada. They are 8.57% on average, for an issue of securities to be listed on the TSE, whereas direct costs are 19% for companies on the CDNX. These differences are related to the fixed cost of an issue, which penalize small offerings much more. We also note that IPOs on the TSE are less undervalued than those listed on the CDNX. This difference is largely associated with the existence of capital pools in the sample. These results are similar to those obtained by Williams and Shutt (2000) and Higgins (1994). The costs of an issue are directly affected by risk levels and inversely related to size. The smaller, the more junior and the riskier issuances on the CDNX command higher issuing costs.

Table 3: Average costs factors of a Canadian issue, based on exchange of listing

	Canada		
	TSE	CDNX	Total
Commission (%)	5.91%	9.52%	7.54%
Other expenses (%)	2.65%	9.47%	5.73%
Total direct costs (%)	8.57%	19.00%	13.27%
Undervaluation (%)	12.02%	62.71%	34.89%
Total costs of issue	20.59%	81.72%	48.16%

[41] Initially created under the name *junior capital pools*, these corporations became *venture capital pools* and then *capital pool companies* when the program was adopted by the CDNX and are now authorized in Quebec under the name Société de capital de démarrage (CPC). We will designate them under this acronym, although the regulatory framework for the successive versions of this program have evolved over the years and for different jurisdictions.

Table 4 summarizes the direct and indirect costs measured for firm underwriting initial offerings of equity in the United States. Direct costs are lower on the NYSE, but if we include the undervaluation factor, the AMEX has the lowest costs for IPOs in the United States. Corwin and Harris (1999) explain the differences between the exchanges by a) cost differences in exchange membership fees, b) broker recognition, with the most prestigious brokers potentially attracting more investors, and c) implicit certification resulting from access to a prestigious market and reducing the uncertainty and undervaluation associated with it.

Table 4: Principal components of initial offering costs in the United States

	United States				
Market	AMEX	NASDAQ	NYSE	OTC	Total
Commission (%)	7.76%	7%	6.33%	8.57%	7.1%
Other expenses (%)	7.14%	3.3%	1.89%	7.33%	3.33%
Total direct costs (%)	14.9%	10.3%	8.23%	15.91%	10.44%
Undervaluation (%)	3.08%	43.19%	12.91%	20.63%	37.76%
Total costs of issue	18%	53.49%	21.11%	36.55%	48.2%

Our results generally show that direct costs are significantly higher for small issues than for large issues. Costs can therefore only be compared for categories of similar size. Table 5 summarizes the different factors for costs of initial offerings by country for four groups on the basis of gross proceeds. The average total direct cost of a Canadian junior issue (US$1 to 10 million) is less (15.98%) than that of an American issue (17.99%). The direct cost for large-cap issues (more than US$100 million) is, however, similar in both countries

In the two countries, brokerage commissions constitute the largest part of total direct costs. They are 8.12% for issues from US$1 to 10 million and 5.53% for issues greater than US$100 million. In the United States, the average commission is 9.29% for issues from US$1 to 10 million and 6.09% for issues over US$100 million.

American brokers charge more than Canadian brokers do. On average, the commission is around 7%, confirmed by the results of previous studies in the United States on issues of between US$20 and 80 million.

Chen and Ritter (2000) explain the “7% principle” in the United States by collusion and the fact that those who issue shares pay little attention to costs. Kryzanowski and Rakita (1999) examined the possibility of collusion in Canada and did not observe an abnormally high level of commissions during the period 1993-1997. Our Canadian sampling also confirms this finding, and amounts collected by brokers are therefore higher on average in the United States than in Canada. However, these costs are significantly higher in Canada and the United States than in other countries. For example, in Japan the rate is 5.3% and in France it is 3.1%. The United Kingdom shows an even lower rate, 2.1%. However, amounts collected from initial offerings in European countries are significantly higher than those in Canada (Ljungqvist and Whilhelm, 2002), which partially explains the differences in cost.

Table 5: IPO costs according to size of issue, excluding capital pool issues for the period 1997-1999. The average percentages are statistically different from zero to the 1% level.

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

IPOs are generally undervalued and their initial return, measured between the day of issue and the first trades on the secondary market, is abnormally high in most countries (Ritter, 1988). On average, initial offerings of Canadian equity are less undervalued than American ones (18.95% as opposed to 37.5%). On a weighted average, the difference is even greater (5.11% as opposed to 38.38%). This result is related to the fact that several Internet and computer companies conducted large IPOs in the United States during the period corresponding to the bull market in technology stocks. These IPOs generated extremely high initial returns. The US$132 million offering by VA Linux Sys gave an initial return of 697.5%; Foundry Networks was 525% and CacheFlow was 426.58%. This phenomenon did not occur in Canada.

In Canada, direct costs that can partially be ascribed to regulation are 15.98% for small issues. Undervaluation, essentially related to broker conduct, is 30.61% for these issues. Here again, it is interesting to make a comparison between the two types of costs to put in perspective the possible effects of regulation on the issuing process and financing costs. Costs imputable to undervaluation are almost twice the total of direct costs.

<u>2.4 Regulation and delays for reviewing prospectuses</u>

For MacIntosh (1996, p. 210), *somewhat less obvious, but probably more important, are the opportunity costs created by the delay associated with multiple review of the issuer's prospectus*. Delays caused by the prospectus review process may have very negative consequences due to the cyclical nature of the initial offerings market, which experiences hot and cold periods both in Canada and the United States (Kooli and Suret, 2003b). The market is very receptive during hot periods and issuers may obtain significantly higher amounts for a given share of control during these periods.

Moreover, significant delays in the issuing process may cause companies to not have funds when needed for an acquisition or investment, considering that hot issues markets are of relatively short duration.

2.4.1 The American Situation

The duration of the prospectus review process has recently been examined in the United States. In his report on SEC operations, the American auditor general (GAO) wrote (GAO-02-302, p. 17): *SEC said that IPOs are a priority and that every IPO gets a full review process. Industry officials said that it generally takes SEC 4 to 7 weeks to complete a review process.* Requests for exemptions, however, require more time and the American auditor general mentioned average delays of three to six months, with extreme cases requiring more than one year: *A 1996 SEC inspector general report noted that is was not unusual for the length of time required for staff review to be a year or longer due to the complexity of the issues, the lack of delegated authority, or workload pressures.*

Practitioners have a more negative perspective than the GAO on the handling of prospectuses by the SEC, even though they recognize that there has been significant improvement. Michael Lytton, of Palmer & Dodge LLP, writes*: generally, the process of public financings has been significantly accelerated. Follow-on offerings now take about a month; IPOs about three—that's about a month less than usual for each.*[42] The review period of one to three months is also mentioned by Hausman [43].

2.4.2 The Canadian Situation

The average processing time for a receipt application for a prospectus filed in Quebec under the MRRS and outside the MRRS has been studied, using CVMQ data, from a sampling of 1,455 prospectuses, including 660 mutual fund issues and 795 prospectuses of other corporations.

Under the MRRS, the principal authority examines the documents and issues the comment letter within ten working days following receipt of the preliminary prospectus. Subsequently, each authority other than the principal authority must, within five working days following receipt of the comment letter from the principal authority, make its own comments, if any. The principal authority sends the comments to the issuer, who has enough time to respond. Once the authorities are satisfied, the principal authority issues a final decision document for the prospectus. The short form prospectus review is identical, except that the time for review by the relevant authorities is respectively three days and a day and a half.

Table 6 shows the results of an analysis of review times from a sample of distributions by prospectus conducted in Quebec and elsewhere in Canada under the MRRS or outside the MRRS from January 1, 1999 to September 30, 2002. The results are divided according to whether it is a mutual fund or not.

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[42] http://www.palmerdodge.com/dspSingleArticle.cfm?ArticleID=155.
[43] Hausman, M. *Going Public? Tips for Successful IPO Communications*. http://www.expertmagazine.com/artman/publish/article_195.shtml.

2.4.3 Companies other than mutual funds

The sampling includes 795 prospectus applications for which a receipt was obtained within an average of 19 working days. It is useful to distinguish long form prospectuses from short form prospectuses. The average review time is around thirty and eight days respectively. A distinction was also made between IPOs and other prospectuses for secondary issues, for which review is slightly quicker on average. Table 6 shows the results.

Receipts for IPO prospectuses and short form prospectuses are granted within similar times, whether the CVMQ acts as principal or secondary authority. Delays are longer for long form prospectuses for secondary issues when the CVMQ is the principal authority because of the type of corporation and the nature of the securities in question. Quebec-only distributions are often conducted by small corporations or for non-traditional securities, which calls for a more complete and detailed review. Overall, the MRRS has allowed a reduction in the time required to obtain a receipt from 36 to 30 days for IPOs, from nine to eight days for short form prospectuses and from 31 to 27 days for distributions where the CVMQ acts as secondary authority.

2.4.4 Mutual funds

The sampling includes 660 mutual fund prospectuses receipted within 41 days on average. Obtaining a receipt for a short form prospectus takes under 40 days on average when Quebec is the secondary authority, whereas it took 44 days before the MRRS.

The difference between review times for mutual fund prospectuses and other corporations is due to the nature of these distributions. They are permanent distributions which may be continued indefinitely, if the mutual fund meets certain conditions[44]. The mutual fund has at least fifty days and up to twelve months to have the prospectus reviewed in the following year and to thereby extend the distribution period. During this transition, the mutual fund may continue to distribute units, which gives it the necessary latitude to file its application for a receipt and answer comments made by authorities. The window of opportunity concept is thus much less significant for these institutions.

[44] Sections 33 and 34 of the Act.

Table 6: Average review time for applications for distribution by prospectus under the MRRS and outside the MRRS according to type of corporation and nature of prospectus: January 1, 1999 to September 30, 2002

Nature of Prospectus	MRRS CVMQ Principal Authority	MRRS CVMQ Secondary Authority	Outside MRRS	TOTAL
Corporations (other than mutual funds)				
Short form prospectus (Non-IPO)				
Number of prospectuses	24	64	27	115
Average time (working days)	32	27	32	29
Short form prospectus (IPO)				
Number of prospectuses	16	227	29	272
Average time (working days)	30	30	36	31
Short form prospectus				
Number of prospectuses	79	314	15	408
Average time (working days)	8	8	9	8
Total				
Number of prospectuses	119	605	71	795
Average time (working days)	16	18	29	19
Mutual Funds				
Short form prospectus				
Number of prospectuses	0	18	7	25
Average time(working days)	0	41	28	37
Short form prospectus				
Number of prospectuses	63	494	78	635
Average time (working days)	45	40	46	41
Total				
Number of prospectuses	63	512	85	660
Average time (working days)	45	40	44	41

Source: Commission des valeurs mobilières du Québec, 2002.

2.4.5 Venture capital exits

We can also learn about the obstacles that regulatory structures can put up for the financing of growth companies through a comparative analysis of the exit strategies of venture capital companies. Cumming and MacIntosh (2000, 2002) studied these strategies in the United States and Canada.

In an initial article, the authors submit that greater Canadian regulation could influence exit strategies for the following reasons:

- More strict regulation for direct investors (*angels*) and related investors (*love money*);

- The fact that regulation has inhibited the development of a secondary market for investment in small-cap securities;

- A regulatory environment seemingly more favourable to small companies in the United States than in Canada.

There are differences between the exit methods of venture capital companies as Table 7, taken from the results of Cumming and MacIntosh (2002), shows.

Table 7: Comparison of exit methods for venture capital companies

Exit Method	United States	Canada
Write-off	29.5%	20.1%
IPO	26.8%	26.9%
Acquisition	26.8%	11.9%
Sale	8%	9%
Buyback	5.3%	30.6%
Other	3.6%	1.5%

The proportion of initial offerings is identical in the two countries, and it is therefore difficult to argue that multiple jurisdictions inhibit this type of operation in Canada. This finding is consistent with results which show the efficiency in terms of cost and time of IPO review in Canada. Buybacks are more frequent in Canada, whereas acquisitions are more common in the United States.

It is difficult to attribute this difference to regulatory provisions and this result certainly has much to do with the much lower amounts Canadian venture capital companies invest. The authors write, moreover, that: *further study should be undertaken of the impact of securities regulatory requirements on small firms and on the venture capital community, in order to ensure that the regulatory burden is not excessive*.

The authors refer to findings on regulatory provisions by MacIntosh (1994), which clearly do not take into account recent changes to holding periods and private placements.

In a second article, Cumming and MacIntosh (2002) show that differences in return between venture capital companies in the two countries is, in part, associated with the choice of exit strategy for investments and whether the exit is partial or total. Legal considerations may explain discrepancies between the exit methods relating to hold periods, which are longer in Canada than in the United States. However, this period has been cut back recently (2001) to four months for most provinces. Moreover, many other factors, such as the average amount invested, experience of the officers of venture capital companies and liquidity may be used to explain the findings noted. Finally, regulatory factors referred to are related to differences which exist during the analysis period and not to the structure of Canadian regulation.

There are therefore differences between the exit methods for venture capital distributions in the United States and Canada, but nothing points to the Canadian regulatory structure, although certain provisions, now amended, could have been factors which would explain these differences. Here again, the level and nature of regulation is at issue, not the provincial structure of such regulation.

2.5 Regulatory Costs for Issuers and Intermediaries

The argument for diversity of securities legislation appears in the Porter Report (1964)[45], which notes only the *faltering progress made toward uniformity of securities legislation between the provinces*.

Harris (2002) considers that, with the exception of the lack of resources of provincial commissions, all the factors identified by the Porter Report are still relevant in 2002. Moreover, considerable efforts have been made to harmonize laws and regulations, and it is useful to update the Porter analysis.

To consider that the situation which prevailed in 1964 is still valid in 2002 for securities regulation in Canada fails to take into account significant efforts made by the CSA for several years which we discussed in Part 1. During this period, securities laws were largely harmonized and there are generally only differences in specific sections. The uniformity blueprint tabled in January 2003 completes this important work and may allow the use of passports. Although certain differences, such as the

[45] *Royal Commission on Banking and Finance, Report 561* (Porter Report).

characteristics of exempt investors, still remain, they are under review and will probably be eliminated. The situation in Canada in 2003 cannot be considered the same as it was at the beginning of the 1960s.

2.5.1 Prospectus Review and Exemption

The MRRS does not ensure uniformity in the administration of securities laws across Canada. Each jurisdiction keeps decision-making power and may apply Canadian standards as it pleases and apply local requirements to any matter submitted to it. In addition, a regulatory body may not participate in the MRRS if it is not in agreement with the decision made by the principal regulatory authority. The possibility that one or more bodies may not participate means that the MRRS has not created a completely transparent or uniform framework for securities regulation.

The MRRS has therefore not completely eliminated the additional costs of multiple regulation for issuers and intermediaries. Staff in non-principal jurisdictions may conduct an independent examination of documents filed in several jurisdictions. Market participants still have to pay fees in each jurisdiction as they did before the adoption of the MRRS. Only a system of mutual recognition would allow incontrovertible cost reduction[46].

Provincial laws are not uniform but decisions are made based on national standards. USL should therefore increase the degree of uniformity.

For the moment, there are differences, for example with respect to exemptions from the prospectus and registration requirements, public offerings, continuous disclosure and power of enforcement. The MRRS does not exempt participants from the requirement of being familiar with the different requirements which exist across the country, obtaining advice about them and complying with the different systems. According to the proponents of centralization, enormous costs are associated with this process. However, we have not found any estimate of these additional costs, and the use of national standards makes the existence of such costs unlikely.

[46] In Part 4 we will discuss the difficulties the European Community had setting up such a system.

2.5.2 Disclosure

At the beginning of 1997, the CSA launched an electronic system for meeting filing requirements by public corporations and mutual funds in Canada. SEDAR (System for Electronic Document Analysis and Retrieval) allows the transmission, receipt, approval, review and dissemination of documents filed electronically. More than half a million documents have been filed since 1997. The procedure is the following[47]. Issuers file their disclosure documents with the CSA through SEDAR and, after reviewing them, the regulatory authorities make the appropriate documents public. Certain documents are not systematically reviewed by the authorities: these are disclosure documents such as financial statements, press releases, notices of meetings and annual returns[48].

SEDAR facilitates the filing of documents with securities authorities. It allows filings to be made electronically, in a single step, with all Canadian authorities. Electronic filing is governed by National Instrument 13-101, which is enforced in each jurisdiction through local legislation. In certain cases, the local legislation changes provisions of the National Instrument. Filers must be aware of the National Instrument, local enforcement legislation and the securities legislation and directives of each province or territory.[49]

We have not discovered any empirical evidence which would allow us to state that multiple jurisdictions lead to additional disclosure costs in Canada.

2.6 Regulatory Costs for Governments

MacIntosh (2002) believes that costs for securities regulation on a per capita basis are higher in Canada. Chant and Mohindra (2001) criticize the higher costs of the Canadian system for governments.

2.6.1 Problems of measurement

Very little data exists allowing a comparison of costs, for governments, of securities regulation. Moreover, in any analysis of this type it is useful to take into account both costs and benefits, which are difficult to measure, as the ultimate goal is to

[47] http://www.cds.ca/cdshome.nsf/Main-F?OpenFrameSet&Frame=content&Src=Pages%2F-FR-SEDARSCRIBE%3FOpen.
[48] Although these documents are not systematically analysed, they may be studied in detail. In March 2003, for example, the CSA undertook an analysis of the management reports of public companies.
[49] SEDAR Filer Manual, p. vi.

arrive at a situation where the marginal cost of regulation is equal to the marginal benefit issuers and investors derive from it. Several studies, for example Chant and Mohindra (2001, p. 39), use comparable data presented by the U.K. Financial Services Authority (FSA, 2001) to show that securities regulatory costs related to total market capitalization are higher in Canada than any other country.

Such comparisons, however, are very difficult to make for several reasons. The structures and missions of various securities regulatory organizations differ from country to country. In several cases, entities other than securities commissions are involved. For example, France has, in addition to the *Commission des opérations de Bourse* [stock exchange commission] (COB), created in 1967, the *Conseil des marchés financiers* [council of financial markets] (CMF), created in 1996, and the *Conseil de discipline de la gestion financière* [disciplinary council for financial management], created in 1988. The FSA figures only take into account the COB. In addition, FSA data for the United States does not take into account State securities commissions (CESR report). Nevertheless, as Ciocca (2001) points out, *the United States has remained faithful to a division of responsibilities in which the types of body entrusted with supervision are highly diversified, with (...) 6 for financial supervision (covering markets, insurance companies and pension funds with 137 local offices and some 8000 employees). In addition, it is necessary to consider the self regulatory bodies of the 9 most important financial markets.* Aware of these limits, in 2003 the FSA fine-tuned the calculation of costs and henceforth takes into account four components of the cost of securities regulation[50]. Direct costs associated with these components are £73.8 million in Australia, 56.8 in Canada, 37 in the United Kingdom and 977.3 in the United States. Reported as total capitalization, the percentages are 0.029 %, 0.015 %, 0.004 % and 0.014 % respectively. However, the duties of regulatory organizations are more a function of the number of reporting issuers than capitalization. It is possible to calculate a cost per reporting issuer. It is $123,000 in Australia, $33,600 in Canada, $37,300 in the United Kingdom and $324,700 in the United States (Schedule 2). It is therefore difficult to claim, on this basis, that the direct costs of regulation are higher in Canada than in other countries with similar market practices.

Secondly, outside the regulatory structure, the amount of oversight is a key element which may affect the expense level of the organizations. It was clear in 2001 that the level was inadequate in the United States and additional funding was given to the SEC, the budget of which went from $372 to 473 million between 2000 and 2002. Under corporate clean-up legislation, the SEC budget should reach US$776 million.

[50] These headings are: *1) Securities firms and fund management firms - prudential supervision, 2) Supervision of and standards for exchanges / clearing and settlement systems / market service providers 3) Supervision of, and standards for conduct on, capital markets (including transaction reporting but excluding exchange's own rules) et 4) Standards for / approval of listing of securities.*

American authorities have thus recognized the inadequacy of SEC funding. Finally, a comparison of amounts devoted to funding commissions should take into account the level of activity they face. Capitalization is, in this respect, a mediocre indicator. The number of listed corporations and especially the number of new issues should be used. On this point, Canada cannot be compared to European countries. From 1991 to 2000, there were 1,891 IPOs in Canada, whereas during the period 1990 to 2000, Ljungqvist and Wilhelm (2002) count 2,861 IPOs for fifteen European markets, including the main ones. In 2000, Canada was the 2nd world market in terms of number of listed corporations, whereas France was in 8th position, and the first European country, the UK, was in 4th place.

2.6.2 Costs and benefits of regulation

Chant and Mohindra (2001)-type comparisons assume that it is best to spend as little as possible to regulate the financial sector. Three points should, however, be made. Firstly, the comparative analysis of the FSA (2002) does not lead to the conclusion that the cost of securities regulation is abnormally high in Canada in relation to the United States. The under-financing of the SEC, as confirmed by the GOA, is significant and we cannot say that it is the cost of optimal regulation. Secondly, the 2003 study of the FSA clearly shows that costs related to capitalization or per listed company are lower in Canada than in the United States.

Thirdly, financial and accounting problems in the years 2001 and 2002 have demonstrated the enormous costs which may be caused by inadequate securities regulation. The Enron bankruptcy and other scandals, associated in large part with oversight failures in the United States, have cost it hundreds of billions of dollars, an amount far beyond the cost of regulation. Moreover, it is not clear that centralization of securities in Canada will result in significant cost reduction. A Canadian commission should probably keep offices in most provinces, as the SEC does in eleven regions.

2.6.3 Regulatory cost and taxation

In the United States, the cost of securities regulation paid by issuers and intermediaries represents an actual tax, paid to the Treasury, of which the SEC only gets a small part. In 2001, the SEC collected around \$2.1 billion, and its total funding was \$423 million. Amounts paid by issuers and intermediaries thus represent five times the cost of operating the regulatory body. This amount is even higher than what the United States spends on all regulation and oversight of the "business" sector, including the commerce department and bodies related to international trade and competition, which, including the SEC, had a total budget of \$1.8 billion in 2001.

Legal changes in 2001 reduced amounts collected by the SEC, which no longer expects to collect more than \$1.3 billion in 2003, for an anticipated operating cost of \$467 million. It seems that this onerous tax on operations related to regulation has not affected the rapid development of the American securities market.

In Canada, commissions also collect amounts higher than their operating costs, but the difference between amounts collected and operating costs is less than the United States (Chant and Mohindra, 2001). In addition, a refund system allows commissions to reimburse the overpayment of fees collected, not required for reserves.

In conclusion, it appears, firstly, that securities regulation may be a profit centre rather than a cost centre for some governments. A tax reduction given by various governments to issuers and intermediaries may well be a more efficient and rapid way to reduce the regulatory burden for companies than any regulatory restructuring. Secondly, incomplete data given respecting the cost of certain regulatory bodies does not allow us to qualify regulatory costs in Canada since no type of regulation has so far been proven to be the optimal one. As with several arguments put forward to date, we can only conclude that available empirical results are very incomplete.

2.7 Conclusion

To a large extent, we must agree with the conclusions of Daniels (1992) and Harris (2002) to the effect that very little evidence can support statements respecting costs caused by the current regulatory situation for securities in Canada. Daniels observed in 1992 that statements by participants in the regulatory debate were supported by practically no proof and deplored the almost total lack of empirical research on these matters.

In 2002, Harris (p. iv) wrote that *the debate in Canada typically has not been informed by robust empirical analysis and suffers from a lack of current empirical data on the central issues in respect of Canadian securities regulation.* He states (p.83) *there is, therefore, a pressing need for a comprehensive and methodologically sound study of the incremental costs associated with the current regulatory system, focusing in particular on each of the categories of incremental costs*.

Empirical proof with respect to the costs of initial offerings is convergent and it shows that the initial offering process is less costly in Canada. This work is not, however, specifically dedicated to pointing out the additional costs related to regulation. In other words, it is possible that changes, and in particular moving in the direction of mutual recognition (studied in Part 4), will allow additional cost reductions. The works show, however, that the present structure does not create a comparative disadvantage as compared to the more centralized American structure.

Data relating to the costs caused by regulatory bodies does not lead to any conclusion, since the balance of the regulatory costs and benefits is the key element in the debate. The reduction in SEC operating costs, as a function of the activity to be overseen, can certainly not be characterized as optimal.

Finally, no attention is given in the current debate to the problem of trading costs or market quality. It is as if the dynamism of the Canadian market is solely related to regulatory costs. This is a mistake which we will try to partially correct in Part 6.

PART 3

3- VARIOUS ARGUMENTS

We will now study various arguments regularly invoked to justify revision of the Canadian regulatory system. They are: Canadian weakness on the international level, response times, accounting manipulation and the ineffectiveness of attempts at uniformity.

3.1 Canadian weakness on the international level

This argument in put forward by MacIntosh (2002), who believes that market globalization argues in favour of a single securities regulator in Canada. Canada must speak with one voice. This argument is also repeated in the MacKay letter.

Market globalization clearly raises the question of the possible uniformity of rules and regulations. As Carmen Crépin, Chair of the CVMQ, points out, the CVMQ and other Canadian securities regulators are actively participating in making uniform rules, at both the national and international level[51].

The CVMQ brief to the Standing Senate Committee on Banking, Trade and Commerce respecting the report of the Task Force on the Future of the Canadian Financial Services Sector (October 23, 1998, p. 20) is explicit:

> [Translation] *We believe that it is incorrect to say that Canada has less international influence in the securities industry that in banking or insurance. As proof, the International Organization of Securities Commissions (IOSCO), an umbrella group of securities authorities from 90 countries, was created by private statute in Quebec (S.Q. 1987, chap. 43). Since that time, the role of the Commission and the other CSA's in that international body has certainly not diminished.*

IOSCO was created with the goal of exchanging information to develop efficient markets and implement common standards. The principles of cooperation in

[51] June 8, 2000 speech by Ms. Crépin, "La vision stratégique de la CVMQ face à la mondialisation des marchés financiers" [the strategic vision of the CVMQ in view of the globalization of financial markets].

securities matters defined by this body are the following (*IOSCO Objectives and Principles of Securities Regulations, February 2002*):

1. *The regulator should have authority to share both public and non-public information with domestic and foreign counterparts.*

2. *Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts.*

3. *The regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers.*

On the other hand, the multiple solutions proposed by the European Community range from multilateral agreements establishing a minimal level of requirements which local authorities may reinforce as needed (the current situation), to complete uniformity (Cox, 2002, Di Giorgio and Di Noia 2002); while Di Giorgio *et al* (2002) present a very uniform and centralized vision of European financial market regulation, contrary opinions come in particular from England. There are two ways to address the problem:

1) The issue of globalization put Canada squarely in a situation of regulatory competition, not internally but in relation to other countries.

   The issue is therefore to determine how Canada can give itself the highest performing regulatory system possible to attract foreign companies and keep domestic ones. We should therefore ask how to achieve the best level of regulation. For some it is regulatory monopoly, while for others it is by creating regulatory competition. These two arguments are analysed in depth in Part 4.

2) The second way consists in analysing the strategy set up by the European Community. As we will also show in Part 4, Europe has set up a model which avoids a regulatory monopoly and leaves room for regulatory competition within a framework, however, of minimal standards.

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

3.2 Jurisdictional conflicts

Jurisdictions are blurred and participants are faced with thirteen different jurisdictions for penal proceedings. The compartmentalization of Canadian securities authorities also makes complex situations involving investors, intermediaries and issuers located in various jurisdictions unmanageable. Very recently, the argument appeared (MacKay letter) that securities laws are not always applied.

We note firstly that the jurisdictional problem exists world-wide, not only in Canada. The few cases generally put forward to illustrate the Canadian problem have their equivalent in the international market. One answer to the problem of multiple jurisdictions is the principle of cooperation.

This principle was acknowledged in 2000 by the Supreme Court of Canada[52], which reversed the lower court decisions and upheld the power of securities authorities to collaborate in their areas of authority. Moreover, the revision of the European directive deals directly with this question, which is solved with the help of: 1) a clear definition of roles and responsibilities, 2) the setting up of a process of complete cooperation between authorities and 3) an agreement on the exchange of information. The problem of interjurisdictional authority is, moreover, one of the elements which lead to the European investment service directive (ISD 93).

The plan to establish uniform securities legislation in Canada is the tangible result of work which sought to assess the relevance and feasibility of a common legislative framework for the different provincial and territorial authorities in Canada. In this regard, according to Ms. Crépin, Chair of the CVMQ, [Translation] "Quebec has made its position known on this issue and has agreed to work towards harmonization rather than seeking uniformity"[53]. Quebec is the only Canadian province governed by a civil code, as the legal systems of the other provinces are all based on common law. Uniformity in this matter is therefore not possible in Quebec, given its distinct

[52] British Columbia Securities Commission v. Global Securities Corporation (2000) 1 S.C.R. 494.
[53] Introductory notes by Carmen Crépin, CVMQ Chair, January 17, 2002, Bar of Quebec, p. 8.

legislative framework. Bill 57 (S.Q. 2001, c. 38) gave additional regulatory authority to the CVMQ, which may allow rapid harmonization.

3.3 Response times

The Canadian regulatory system responds slowly to rapid changes in the industry because of the need for cooperation from the different organizations involved. We wonder whether response by a large specialized commission would be any faster.

Response times of a regulatory body in the face of changes can be broken down into three parts: acknowledgement, analysis and the decision to act, or changes and implementation. It seems clear that multiple commissions must cooperate with each other before implementing change and this part of the process may be slower in a decentralized system than in a single system. This may or may not be counter-productive, as the consultation process often allows the final "product" to be improved. However, the effect of decentralization on other aspects of the process is largely undetermined, and arguments may be made either way.

Acknowledgement of the problem:

- A central commission may have greater research and examination resources and acknowledge changes or problems more quickly;
- However, provincial commissions are closer to companies and investors and may be better at discovering the needs of participants and local problems;
- Several regulatory departments may see different problems, with different approaches.

For example, the Alberta Securities Commission reacted in 1986 to the problem of market entry for small-cap companies with the capital pools program. We can only guess if and when such a program would have been created in a centralized system, but it should be pointed out that Ontario and Quebec, respectively, only adapted and then adopted this program several years after it was launched out west.

Analysis and proposals for solutions:

- A centralized commission may have more resources and devote more staff to the study of a problem and consultation on possible solutions; but

- The decision-making process in large organizations is not necessarily more rapid; and

- The undue influence of pressure groups is less likely when there are several regulatory organizations.

In conclusion, although solutions may be implemented more quickly in a centralized system, it is not clear that the discovery of problems and proposals for a solution are faster. It is also likely that local problems will simply be forgotten.

<u>3.4 The accounting manipulation argument</u>

It seems paradoxical to invoke financial scandals which mainly affected American businesses to invoke securities centralization in Canada, as the chairman of the OSC did[54]. These abuses occurred mainly in a country where the essentials of securities regulation for large companies are under the jurisdiction of the federal government and a single commission, the SEC. A study of this argument is, however, an interesting occasion to gauge the steps and effects of intervention by a central government in the securities industry.

For several authors such as Coffee (2002a), the Enron affair and other cases are the result of federal intervention in the field of securities regulation, in two main ways. A group of statutes has greatly limited the possibility of lawsuits in securities and the resources of the SEC have progressively weakened. According to Coffee, a series of decisions of the U.S. Supreme Court has reduced the possibility of lawsuits in the field of securities and various elements have played a decisive role in the progressive weakening of barriers able to limit malfeasance by directors. These elements are set out below, after a brief survey of the American regulatory context for securities.

Up to 1933, American securities markets were regulated at the State level. The *Securities Act* of 1933 set up a system whereby businesses must comply with federal rules as well as those of the States. Under pressure from businesses and the securities industry, which complained of inefficiencies caused by a double layer of regulation, in 1996 Congress significantly changed securities regulation. The adoption of NSMIA was a step towards a single regulatory system which, however, left certain powers to the States.

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[54] OSC Annual Report 2002.
http://www.osc.gov.on.ca/en/About/Publications/AnnualRpt2002/en/messages_chair.html.

The States could therefore no longer register or require compliance of securities known as "covered securities"[55], which henceforth are the responsibility of the SEC. It can define what is included in the category of covered securities itself, by adding exchanges to the list drawn up by NSMIA or by defining the term "qualified purchaser". For example, under NSMIA, securities listed on the NYSE, the AMEX and NASDAQ are covered securities. In 1998, the SEC decided that securities listed on Tier 1 of the Pacific Exchange, the Chicago Board Options Exchange and Tier 1 of the Philadelphia Stock Exchange are also covered securities. The States retain the power to investigate and penalize for fraud and malfeasance respecting securities, disclosure and fees.

NSMIA mainly benefits large issuers by significantly lessening regulatory requirements and costs of issuance. Issuers of covered securities are no longer required to register in each State. Certain States conduct an in-depth analysis of offers submitted to them (merit review), and may refuse to authorize an offer perceived as too risky for invertors. The SEC essentially makes an analysis based on disclosure (disclosure review). Its objective is not to prevent an investor from making a bad investment, but to ascertain whether the investor has sufficient information to consider the quality of the offer. By eliminating the merit review for covered securities, NSMIA may have indirectly helped reduce investor protection[56]. Finally, the *Uniform Securities Act* (2002), a framework securities statute for the States, was adopted on January 4, 2003 by American securities authorities[57]. It allows the States to harmonize their securities laws while recognizing that they may keep local differences potentially important for investor protection.

The taking over of regulation and the power to sue by the federal government is recent. The 1995 *Private Securities Litigation Reform Act* (PSLRA), intended to limit the risk of frivolous lawsuits in the field of securities, was adopted despite the veto by President Clinton. The main provisions of this statute were: 1) raising the standards for lawsuits in the securities area well above the level which existed for cases of fraud, 2) substitution of the concept of proportional liability for the concept of joint

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[55] This category includes securities of businesses or investment funds traded on the national level and subject to federal registration requirements, securities proposed to sophisticated investors and securities of which the offering is exempt, at the federal level, from registration and periodic disclosure.

[56] For some non-covered securities, the *Coordinated Equity Review Program*, implemented in 1997, allows the analysis procedure to be coordinated between different States. An issuer makes its offer to the administrator of the program (the State of Pennsylvania) and provides a list of all States in which it intends to sell its securities. The administrator appoints a State to conduct the merit review and another State to conduct the disclosure review. These two States centralize comments and then decide on behalf of everyone within 30 days. For a more detailed description, see http://www.michigan.gov/documents/cis_ofis_protocol_23847_7.pdf.

[57] www.nasaa.org. This Act has to be passed by each State legislature next.

and several liability, and limiting penalties which could be imposed on auditors and brokers, 3) restricting the scope of RICO (*Racketeer Influenced and Corrupt Organization*) status so that lawsuits in securities can no longer go from damage proceedings to triple damage proceedings and 4) the adoption of safe harbour protection[58] for past information which makes conducting a lawsuit much more difficult

The first effect of the PSLRA is to change the nature of evidence. Henceforth, it must be shown that management of the business sued committed fraud deliberately. The PSLRA also imposes penalties on plaintiffs convicted of frivolous lawsuits. For many, the provisions of the PSLRA discourage not only frivolous lawsuits but also well-founded lawsuits. President Clinton thus wrote in his notice of opposition that the PSLRA *have the effect of closing the court house doors on investors who have legitimate claims* (Ali and Kallapur, 2001). Several researchers and American organizations have tried to measure the effects of this Act. Its coming into force was accompanied by abnormally low returns for securities in the sectors most likely to be sued, such as computer technology, electronics, pharmaceuticals and biotechnology as well as individual portfolio management. The PSLRA was therefore viewed unfavourably by investors because of the restrictions imposed on potential private lawsuits in the field of securities. California Proposition 211, which reversed the majority of elements of the PSLRA, was defeated and this announcement also negatively influenced markets in the sectors concerned (Ali and Kallapur, 2001). Several researchers also studied the rate of lawsuits after adoption of the Act. A temporary lessening was observed in lawsuits over securities, of which the frequency later increased (Bajaj *et al*, 2000 and Stanford University[59]), without significant variation being detected. The post-PSLRA period saw a very high number accounting readjustments and therefore the possibility of lawsuits. It is therefore difficult to say that the post- and pre-PSLRA eras are similar. Thomas and Martin (1997) maintain that the PSLRA *substantially increase the difficulty of uncovering securities fraud* and recommend using State legislation.

In fact, this is what a majority of plaintiffs do, as the Bliley Report on PSLRA to the House of Representatives[60] reports that *since enactment of that legislation considerable evidence has been presented to Congress that a number of securities class action lawsuits have shifted from Federal to State courts*. The more restrictive

[58] See Poullet, Y., *The Safe Harbor Principles –An adequate protection?* Text presented at the meeting of the IFCLA, Paris, June 15 and 16, 2000, http://www.juriscom.net/uni/doc/20000617.htm for a study of this idea.

[59] The Stanford University law faculty web site entitled *Securities Class Action Clearinghouse* gives a great deal of data and several articles on securities lawsuits in the United States: http://securities.stanford.edu/.

[60] http://securities.stanford.edu/research/reports/19981001slusa.html.

conditions for lawsuits under the PSLRA have therefore lead to a transfer of cases from the federal level to that of the States (*Ten Things* Report*)*[61]. To counter this movement, the American government adopted the *Securities Litigation Uniform Standard Act* (SLUSA) in 1998. This statute governs lawsuits at the State level. It is based on the argument that s*ecurities class actions belong in federal court because they are national in character.* This statute lead to opposition by a large number of securities law specialists as well as the chairman of the SEC, A. Levitt, who later backed it (Painter, 1998).

For several authors and jurors, the PSLRA had the advantage of placing issuers and intermediaries under the same statute, which was not the case when lawsuits were taken at the State level. Thus a national market applied a national law. However, as writers Weiss *et al* (2000) and Loomis (2000) described, different circuit courts applied the uniform act in an extremely varied manner, by taking diametrically opposed positions on significant aspects such as insider trading[62]. The experience of the PSLRA shows that the imposition of centralized regulation and the referral of lawsuits to the federal level is not synonymous with setting up national criteria. The authors agree that lawsuits have become more difficult, and that cases were first transferred to the State level. As Perino mentions (2002):

> *The picture that emerges (...) is that the PSLRA did not work as intended. This article demonstrates that as many or more class actions are filed after the Act as before. High technology issuers remain at significantly greater risk than issuers in other industries. There is statistically significant evidence, however, that suggests that the Act improved overall case quality at least in the circuit that most strictly interprets one of the Act's key provisions, a heightened pleading standard.*

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[61] See: *Ten Things We Know and Ten Things We Don't Know About the Private Securities Litigation Reform Act of 1995*, *Joint Written Testimony of Joseph A. Grundfest and Michael A. Perino before the Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs, United States Senate*, July 24, 1997 http://securities.stanford.edu/research/articles/19970723sen1.html (*Ten Things* Report).

[62] Loomis illustrates these differences in the following manner: *The 9th Circuit has articulated the most defence-friendly standard. Its 1999 decision in re Silicon Graphics Inc. Securities Litigation, 183 F3d 970, affirming a 1997 decision from the Northern District of California, requires pleadings to provide "in great detail, facts that constitute circumstantial evidence of deliberately reckless or conscious misconduct." Stock sales before a steep drop in stock market value alone do not satisfy the standard. The winds blow in a different direction on the East Coast. In 1998, the Southern District of New York ruled that a plaintiff claiming fraud need plead only that the defendant had "motive and opportunity, "a standard that can be met, for example, by alleging stock sales by corporate executives before a surprise announcement that causes stock prices to drop. This year, the 2nd Circuit affirmed the ruling in Novak v. Kasaks, 216 F3d 300, although the parties disagree as to the grounds of the affirmance.*

At the end of 2001 and 2002, the SLUSA tried to put an end to several lawsuits initially commenced at the State level. They dealt with the issue of fixed-income securities[63] and brokers against whom three cases had to be abandoned[64]. In particular, the lawsuit against Merrill Lynch[65], was considered to fall under the SLUSA and was prescribed. In all the cases, the courts considered that the lawsuits taken at the State level could not have been because of the SLUSA.

For Coffee (2002a), the PSLRA and the SLUSA are in keeping with the wish to impose national rules for securities lawsuits and may be directly associated with the reduction in the possibilities of lawsuits and the emergence of much financial and accounting fraud. It is still early to judge the long-term effects of the important changes made since 1997 to the provisions governing securities lawsuits. In particular, it must be determined whether or not the cases abandoned at the State level are taken up at the federal level. For the moment, it is possible to conclude that the wish to uniformize has not reached its goals, has limited the possibility of lawsuits and made proof more difficult. Several indicators and several authors show that these statutes have not only limited frivolous lawsuits, but also closed the door on well-founded lawsuits.

However, as Painter points out (1998, p. 7), *State private rights of action for securities fraud will continue to play a significant, albeit much reduced, role in the US securities markets*[66].

Finally the *Gramm-Leach-Bliley Act,* signed in November 1999 (which allowed the deregulation of the financial sector like the 1987 statute in Canada), abolished the provisions of the *Glass Steagall Act* which separated commercial banking from investment banking. Part of the problems related to conflicts of interest of analysts may also result from this change in the law.

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[63] Lander v. Hartford Life & Annuity Insurance Co., Docket No. 00-7849 (May 25, 2001).

[64] See Block, D.J. and J.M. Hoff, *SLUSA Preclusion Of Claims Against Brokers*, New York Law Journal – 227 (79). April 25, 2002.

[65] McCullagh v. Merrill Lynch & Co., S.D.N.Y., 01 Civ. 7322 (DAB), 3/6/02.

[66] Painter (1998) concludes his in-depth analysis of SLUSA in the following way: *This Article concludes that for two main reasons, Congress should have taken the initial advice offered by Chairman Levitt in 1997 and refrained from pre-empting state law in this area. First, many of the arguments in favour of pre-emption did not rest on proven statistical evidence or a complete evaluation of political developments likely to occur at the state level. Second, it is still unclear how federal courts will interpret the 1995 Reform Act. Instead of enacting sweeping legislation that closes the doors of state courts to almost all class action plaintiffs, Congress should have drafted a more narrow statute designed to address the problems that dual-forum class action litigation does create.*

The wish of the American federal government to impose a uniform securities law seems to have had indirect negative effects. These interventions are seen by certain researchers as direct, although partial, causes of recent financial scandals. The exclusion of the States from lawsuits for securities having national scope eliminated several lawsuits and does not seem to have allowed uniformity of decisions. However, this effect was reinforced by the inaction and lack of means of the central regulatory body, the SEC[67]. Based on the American example, it does not seem that the Enron affair can be a very solid argument to require uniform securities legislation in Canada.

3.5 The SEC situation

The existence of a single securities commission in no way guarantees the ability of a market to detect and control occurrences such as those which lead to the series of financial scandals in the United States.

On this point, the analysis of Coffee (2002a) is completely parallel to that of the October 2002 Senate Committee *Financial Oversight of Enron* (FO Enron)[68] report. This report is extremely critical of the SEC. It states (p. 5):

> *The SEC staff failed to review any of Enron's post-1997 financial filings even though the company was undergoing significant growth and substantially changing the nature of its business and the SEC itself was aware that other gatekeepers, such as boards of directors and auditors, were proving increasingly unreliable…Had SEC staff reviewed these filings, they would have had an opportunity to uncover some of the problems with the company's financial practices that appear to have been signalled in those documents. In addition, the SEC staff made administrative determinations that allowed Enron to engage in certain accounting practices and exempted the company from certain regulatory requirements. Whether or not these decisions were reasonable at the time, what is particularly troubling is that the SEC lacked any procedures by which to monitor the effects of these determinations to see whether they were being applied appropriately by the company and/or whether the circumstances that underlay them had changed. The leeway afforded Enron by these determinations in certain*

[67] For a critique of the role of the SEC in the Enron affair, see: *Financial Oversight of Enron: The SEC and Private-Sector Watchdog*, Report of the Staff to the Senate Committee on Governmental Affairs, http://www.senate.gov/~gov_affairs/enron100702.htm.

[68] *Financial Oversight of Enron: The SEC and Private-Sector Watchdog*, Report of the Staff to the Senate Comity (*sic*) on Governmental Affairs, http://www.senate.gov/~gov_affairs/enron100702.htm.

> *cases appears in fact to have been abused by the company in ways that ultimately played a role in Enron's collapse. In short, the SEC's interactions with Enron reveal the downside to the Commission's largely reactive approach to market regulation and should provide an impetus for the Commission to reorient some of its activities toward more proactive anti-fraud measures. Unfortunately, although the Commission has stepped up its enforcement activities post-Enron, it has been less than proactive in attempting to address fraud at an earlier stage, before it becomes a corporate calamity.*

The committee notes the limited means of the SEC, but asks whether: *the SEC is effectively functioning as the lead market watchdog that it was meant to be*. For Romano (2002, p. 61): *the pattern of rapid behavioural and procedural adjustment by market participants in the fallout from Enron's collapse is a powerful indicator that increasing the regulatory authority of the SEC is not the sole or even a primary mechanism for deterring corporate fraud.* It therefore seems risky to take the American model as a reference when determining how to fight fraud and accounting manipulation. It is essential to understand why the centralized system failed to such an extent.

Various reports and studies, including the FO Enron report, Coffee's study (2002) and various reports of the American Auditor General (GAO or *United States General Accounting Office*)[69] isolate the main explanations, which are full of information for studying Canadian proposals. The GAO-03-302 report indicates that, from 1980 to 2000, trading volume increased thirty times in the United States and that the number of initial offerings in 2000 was fifty times what it was in 1980. The percentage of households investing in mutual funds went from a few percent to 52%. During the same period, according to Dudley and Warren (2002), the SEC budget went from $72 million to $372 million. It therefore increased five times. The GAO estimates that between 1990 and 2000 the SEC's workload increased by 80% and its resources by only 20%. Not only are financial and human resources insufficient, information systems, including EDGAR, are considered inefficient and incomplete. In 2001, the percentage of documents filed by companies subject to analysis or a mere overview was around 8%, whereas SEC officers believe this rate should be around 35%, which would allow review for each company every three years.

[69] The main GAO studies respecting the SEC are: *SEC Operations: Increased Workload Creates Challenges*, GAO-02-302 , 5 March 2002; *Securities And Exchange Commission: Human Capital Challenges Require Management Attention*. GAO-01-947 17 September 2001; *Securities and Exchange Commission: Reviews of Accounting Matters Related to Public Filings,* GAO-01-718 14 June, 2001; all these studies are available at: http://www.gao.gov/.

Chant and Mohindra (2001) compare pay for SEC officers and members with that of the Ontario and Alberta securities commissions, and suggest that Canadian pay scales are excessive. The GAO puts the pay problem at the centre of the SEC problem, where almost a third of the staff left the institution between 1998 and 2000, for reasons essentially related to pay (GAO-01-947).

Pay at the senior levels is 50% lower than in the private sector, and significantly lower (18 to 39%) than that which exists in comparable government institutions.

High turnover, the fact that a number of positions remain unfilled and the inexperience of part of the staff partially explain the problems experienced by the SEC. Here again, we hesitate to conclude that Canadian pay scales are abnormally high in comparison with the American situation. Those of the SEC seem to be overly low.

3.6 Harmonization and diversity

Despite national instruments and current initiatives, securities legislation is not completely harmonized. We have analysed these aspects in the section dealing with costs, as the main effect of a lack of uniformity is financial. The cooperation process set-up through the CSA is relatively recent and certain major initiatives (MRRS, SEDAR) were put in place after 1997, although attempts at cooperation through policy statements (C1 to C49) date back to the 1970's. This means that many of the conclusions of studies covering the previous period require major updating. Moreover, the CSA Strategic Plan[70] indicates clear acceptance of the problems still posed by the current situation. The harmonization process is continuing. It is, however, not clear that complete uniformity is desirable. The very diverse nature of the Canadian market and local peculiarities mean that it can be considered a group of markets rather than a single market.

Diversity of the Canadian securities market is revealed by the characteristics of companies on one hand and provincial initiatives on the other. Small western businesses have little in common with those at the heart of the Ontario economy, which are also different from medium-sized businesses central to the Quebec economy. Moreover, independence with respect to securities has been used by various provinces to initiate programs meeting the needs of their respective customers—companies and investors.

[70] http://www.csa-acvm.ca/francais/html_ACVM/presentation.html.

3.6.1 Characteristics of companies

Around 21% of Canadian corporations listed in 2002 are inoperative (Table 1, Part 6.1.2). Most listed companies are very small: 67% of operating companies have shareholder equity of less than \$10 million. More than 70% of companies with less than \$10 million of equity are from British Columbia and Alberta. Table 8 shows that 35% of traditional issues[71] in Canada are made by resource companies (mining, oil and gas) and essentially concentrated in two provinces. Half (47%) of British Columbia issues are from mining companies. This province represents 58% of all mining company issues in Canada between 1995 and 2000. Alberta has 75% of oil and gas issues. Ontario has more than 70% of issues by financial services companies, more than half the issues in the consumer products area and 39% of issues in technology. In Quebec, 28% of issues are in technology and 22% come from manufacturing and the pharmaceutical sector.

Table 8: Breakdown by sector and province of head office of traditional issues between 1991 and 2000

Sector	AB	BC	F	ON	O	QC	Total
05 Agriculture and fishing	2	1		1			4
10 Mining	20	148	13	48	8	20	257
11 Oil and gas	126	20	7	3	2	2	160
15 Real estate (construction)	4	2	1	2			9
22 Consumer products	7	6	1	23	2	4	43
25 Technology	31	55	18	96	6	38	244
26 Manufacturing and others	16	18	4	32	2	17	89
28 Pharmaceutical products	7	6	3	13	2	12	43
40 Media and telecommunications	2	5	2	10	5	5	29
50 Business	1	7		19	2	5	34
60 Financial services, insurance, real estate	6	6	5	26	1	3	47
70 Services	4	11	1	16		2	34
71 Transportation, electricity, gas, and health care	4	2		7	2	2	17
99 Unclassified	2	3	4	4	1		14
Total	232	290	59	300	33	110	1024

Data from *Financial Post* lists, excluding capital pool company issues. Technology issues exclude biotechnology, reclassified as pharmaceuticals AB: Alberta; BC: British Columbia; F: Foreign; ON: Ontario; O: other provinces; QC: Quebec.

[71] Companies not participating in the capital pools program.

3.6.2 Provincial initiatives

These initiatives include specific programs intended to encourage small business financing, such as capital pools launched in the West and *programmes d'encadrement du développement* in Quebec. The relative importance of government intervention is another source of differences between the provinces. We will examine these two aspects successively.

3.6.2.1 Programs promoting company financing

The first *junior capital pool* was launched in Alberta jointly by the Alberta Securities Commission and the Alberta Stock Exchange in November 1986. In 1997 the British Columbia Securities Commission and the Vancouver Stock Exchange adopted a similar program, the *venture capital pool*. The current venture capital pool of the CDNX, started on March 1, 2000, replaces the two previous ones following the merger of the Vancouver and Alberta stock exchanges in November 1999. It is the result of joint work by the Alberta, Saskatchewan, Manitoba[72] and British Columbia securities commissions and the CDNX. In Ontario, the program has been in force since June 15, 2002, and in Quebec since November 12, 2002. According to Policy 2.4 of the TSX Venture Exchange[73], the goal of capital pool programs is to give companies an instrument to obtain financing more quickly than through a traditional public offering. This program allows the creation of a listed corporation with no assets or business plan, no operating history, no assets except cash, and the sole goal of finding and acquiring assets or companies as take-over targets. Once the transaction, called a *qualifying transaction*, is complete, the new entity may be listed for regular trading.

Table 9 shows the importance assumed by this program during the 1990's: there are 868 issues relating to capital pools, as opposed to 1,023 traditional issues. The second part of Table 9 shows that almost 81% of capital pool issues are from Alberta and British Columbia.

A comparison of Parts A and B of the table shows the relative importance of the capital pool program as a proportion of the total number of issues. In Alberta, there are twice as many capital pools as conventional issues. The capital pool program was later adopted by other provinces, in particular Ontario and Quebec (2002). It is a product typical of the competition which exists between the provinces in securities

[72] The Winnipeg Exchange joined the TSX Venture Exchange in November. A similar program, the *keystone company program*, existed previously.
http://www.osc.gov.on.ca/en/Regulation/Rulemaking/Policies/pol_41-601_20020412_np.pdf.

[73] http://www.cdnx.com/listing/corpfinanceppmanual/defaultpolicies.htm.

matters. Experience in Alberta allowed, with successive adjustments, adoption of the program in most of Canada. It is neither certain nor even likely that a single authority would have been able to design and promote such a program of an initially regional nature, which was responsible for more than half of IPO's in Canada between 1995 and 2000 (682 capital pool issues, as opposed to 659 traditional issues.)

Table 9: Breakdown of activities of initial issues in Canada, 1991-2000, by province of head office of issuing corporation

Part A
Traditional Canadian IPO's

Province	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	Total
AB	4	4	52	28	17	30	52	23	10	12	232
BC	28	22	34	27	26	39	46	24	22	22	290
F	7	2	2	8	9	13	9	5	4		59
ON	11	9	39	46	26	38	50	28	29	23	299
O	4	3	1	3	3	1	7	4	2	5	33
QC		4	19	7	9	18	20	9	6	18	110
Total	54	44	147	119	90	139	184	93	73	80	1023

Part B
Canadian IPO's under capital pool program

Province	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	Total
AB	7	11	51	64	55	65	86	65	30	58	492
BC		3	5	17	16	15	31	22	47	55	211
F			1	4	2		4			1	12
ON		3	3	11	10	14	16	27	11	5	100
O		1	1	2	4	1	5	3	4	6	27
QC				2	2	6	1	6	6	3	26
Total	7	18	61	100	89	101	143	123	98	128	868

Sources: *Financial Post, Report of New Issues,* and *Cancorp Financials*, www.sedar.com and www.cdnx.com. Province of incorporation: QC: Quebec, ON: Ontario, AB: Alberta, BC: British Columbia, O: Nova Scotia, Manitoba, Saskatchewan, New Brunswick, Newfoundland, Northwest Territories, PEI, Yukon, F: Foreign.

From 1970 to 1990, Quebec set up several programs to help capitalize and develop companies, and in particular the *Quebec Stock Savings Plan* (QSSP). When it was created in 1979, the QSSP had three goals: reduce the tax burden of high income taxpayers, encourage stock holding and facilitate the growth of long-term capital of companies. It offered investors the possibility of deducting from their taxable income the cost of certain shares provided they were held for two years. At first, the deduction granted was the same no matter what size the issuing company was. As a result, from 1979 to 1983 investors mainly purchased shares of large companies. Large and medium-sized companies were the main beneficiaries of the program. The program was subsequently redirected to small-cap stocks.

In 1983, the percentage of acquisition costs which could be deducted was changed according to size and type of securities[74]. In addition, from 1987, the deduction given for stocks of large corporations was limited to $1,000 per taxpayer. The various amendments to the program directed investors towards shares of small-cap companies[75] and the QSSP became, in part, a program to help companies obtain capital.

There are (or have been) other initiatives such as the *Programme d'aide à la capitalisation* (PAC), investment in Quebec business investment companies (SPEQ's), and a tax credit for amounts invested in the Quebec Solidarity Fund (FTQ). These last two tax deduction programs lower the tax of taxpayers who, directly or indirectly, make an unsecured investment in eligible, generally small companies. Implementation of these programs is the result of successive interventions by various pressure groups, which based their arguments on the existence of disparities in financial markets. The QSSP and labour fund programs were subsequently adopted by other provinces. Lacroix (1987a and b) describes how the program was progressively adjusted and then adopted in the western provinces. Labour funds have also been set up in several provinces, which have thus progressively adopted programs of the same type but still differ greatly on the relative significance of government intervention in the area of corporate financing.

[74] There are four categories of companies: large, intermediate, emerging and others as well as two types of securities: common and subordinate. Large companies have over $250 M of assets (since 1987) whereas the assets of emerging companies is between $ 2 and 50 M. Intermediate companies are between these two limits whereas the category of "other" companies includes those whose assets are less than $2 M. For each category, a lower deduction percentage was attached to subordinate securities.

[75] Since January 1, 1988, an investment fund may also be eligible for the QSSP. A QSSP fund agrees to use all or part of the funds collected to make investments in shares eligible for the QSSP, and lets investors benefit from deductions similar to those allowed by the direct acquisition of QSSP securities.

The net effect of these programs in terms of optimal allocation of funds and corporate development is probably not totally positive, but their existence demonstrates the creativity provinces have shown faced with the problem of venture capital. Different approaches have been used to meet local needs: capital pools were created, firstly, to meet the needs of resource companies. The purpose of the QSSP, in addition to company financing, was to increase the rate of shareholding in Quebec. Differences of context and approaches are thus sensitive and the uniform regulation approach has great difficulty taking account of this diversity.

3.6.2.2 The importance of government intervention

Government intervention in financing growth companies is particularly strong in Quebec; it seems much less important in the other provinces. Quebec governments have implemented a vast group of measures intended to facilitate financing and growth of businesses in the new economy, to which are added measures initiated by the federal government. For many years, Quebec was over-represented in terms of the number of financings and amounts invested in the venture capital area. Most of this capital was directly or indirectly related to government action.

Direct intervention in the area of venture capital has been made by the Innovatech corporations. Indirect intervention has also taken place through the labour fund and the Société générale de financement. The participating loan and loan guarantee area has been entrusted to Investissement Québec, while government pension plans intervene on a large scale in private investments and venture capital through the Caisse de dépôt et placement and its subsidiaries. These measures were in addition to those arising out of federal programs (BDC).

Table 10 shows the relative importance of venture capital financing relating to government intervention in Quebec: 138 of 160 investments made in four months (October 2001 to February 2002) are related to government initiatives. Despite these actions, entrepreneurs still frequently mention the difficulty of financing technology companies[76].

The Canadian securities market is thus extremely diverse, both with regard to the nature of the companies involved in it and to provincial initiatives, and the relative effect of these initiatives in the economy.

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[76] To illustrate differences between sources of venture capital among the provinces, see the reports of M. Macdonald & Associates Limited (www.canadavc.com).

Table 10: Venture capital investment in Quebec:
October 13, 2001 - February 28, 2002

Government and para-government	Number of investments
Business Development Bank of Canada	20
Local development centres	4
Centre québécois de valorisation des biotechnologies	3
Labour fund – SOLIDE	57
Hydro Québec Capitech	6
Innovatech	40
T2C2 (Caisse de dépôt et placement du Québec)	8
	138
Other	
Techno Cap	13
Investissement Desjardins	7
Miscellaneous	2
	22

Source: Canadian Venture Capital Association (web site, 2002).

3.7 The access to financing of growth companies argument

This argument was put forward by Mackay, who writes that *many issuers and registrants point to the excess cost and the time delays that flow from complying with often different laws, regulations, rules or policies*. (…) *these cost burden and time delays* (…) *prevent companies wishing to access public markets, particularly emerging growth companies, from doing so*. In Part 2 of this study we analysed the cost and delays incurred by issuers, and showed that in Canada there are shorter time delays and lower costs than in the American market.

Several studies have been conducted on the exit method of venture capital and the barriers to financing junior companies. These works allow us to complete the study of costs and time delays. They approach two main aspects, namely private placements and market entry following an investment in venture capital. MacIntosh (1994) and Riding (1998) approach the whole problem, whereas Cumming and MacIntosh (2000, 2002) discuss exit from venture capital investment.

3.7.1 Private placements

A private placement is a method of financing whereby a company obtains capital by selling securities to one or several investors. This method of financing thus differs from a public offering in several ways. Firstly, the private investor(s) keep the securities, as opposed to brokers under conventional issues, for a time determined by law (holding period). A private financing may thus, for the purchaser, have a significant impact on the balance and diversity of his portfolio. Secondly, the issuer is not required to prepare a prospectus—it may obtain an exemption. In most cases it prepares a notice of distribution or offering memorandum. Asymmetrical information is therefore potentially significant, which explains legal provisions limiting access to private placements to 1) institutional investors such as banks, trust companies or investment companies, 2) sophisticated investors and 3) special situations between the company and investors. Access to this type of investment is therefore reserved for investors who have the ability to manage the effect of investments, often large but illiquid, on their portfolio and those able to evaluate and adequately structure the investment. Companies which decide to finance in this way and investors who enter the private market must be subject to special conditions under the exemption system. These complex provisions are not the same in all provinces and have recently been changed.

Securities laws also cover holding periods for private investments. They attempt to establish a balance between two contradictory situations. A long period leads to an increase in the cost of financing, since a liquidity premium is required by investors holding illiquid stocks. This premium increases in proportion to the length of time before an investment may be resold (Das *et al* 2002).

A short period allows investors to circumvent provisions of the law on public offerings. Provisions for private placements are still different depending on the Canadian jurisdiction, even though attempts at harmonization have been made.

Exemptions for distribution to a limited number of investors:

All provinces, with the exception of New Brunswick, offer prospectus and registration exemptions for the issue to a limited number of investors, under certain conditions. As Anand et col. (1999, p. 257-260) mention, conditions differ greatly from one province to another. However, these differences should have little effect given the local scale of issues which may, in the case of Quebec, affect more than twenty-five investors (except in the case of inflation hedges, where the maximum number of investors is fifty). In Ontario, British Columbia and Alberta these provisions have recently been amended and the concept of closed corporation have been introduced. The most important differences are related to the definition of sophisticated investor. Recent changes have amended the definitions in Ontario, Alberta and British Columbia[77].

Exemptions for sophisticated investors:

These relate to institutional investors and individuals whose high net worth assumes significant investment knowledge. The rules vary from one province to another and have also recently been amended.

3.7.2 Recent evolution

Ontario Rule 45-501 on Exempt Distributions:

The Ontario Securities Commission Rule 45-501 on Exempt Distributions replaces a group of seven exemptions by two categories called the *closely held issuer* exemption and the *accredited investor* exemption. The closed corporation exemption allows a lifetime maximum of three million dollars to be raised from thirty-five non-accredited investors, without regard to their sophistication or qualifications in the area. These investors may resell their securities as long as the other shareholders and officers approve the transactions. Special provisions apply for tax shelters.

The exemption for sophisticated investors replaces several exemptions, including distribution to a limited number of investors. Sophisticated investors may invest without limitation in distributions without a prospectus. This exemption governs in particular institutional investors, sophisticated investors and those whose net worth exceeds $1 million. Other provinces have also amended the rules in this area.

[77] See National Instrument 45-101, *Rights Offerings* and the CVMQ document entitled: *Régime de dispense de prospectus et d'inscription en regard de la nouvelle règle ontarienne 45-501* [prospectus and registration exemptions under the new Ontario Rule 45-501], attached as a schedule to Weekly Bulletin 2002-03-15, Vol. XXXIII, No. 10. These documents are available on the CVMQ web site.

Multilateral Instrument 45-103[78]

This exemption came into force in April 2002 in Alberta and British Columbia in order to harmonize the exemption rules in these provinces.

A private issuer exemption allows issues to family, friends and associates, as well as sophisticated investors. The limit is fifty subscribers under Instrument 45-103 as opposed to thirty-five in Ontario, and the $3 million maximum issue amount is not found in Instrument 45-103. Accredited investors have similar characteristics to those defined under 45-501. There are slightly different provisions between the two provinces. The Ontario rules are therefore different from those of Alberta and British Columbia but they constitute a step towards greater uniformity of exemption rules, which directly affect private placements. Harmonization of holding periods completes this evolution. A consultation launched in January on small business financing should help this standard evolve.

Multilateral Instrument MI 45-102

The adoption of Multilateral Instrument 45-102 in November 2001 introduced a new Canada-wide[79] system respecting the resale of securities acquired under an exemption. This is an important subject related to the problem of the resale of private placements and in particular those made by venture capital companies. Resale restrictions are intended to give some stability to prices, which may be greatly influenced by the rapid transfer of large blocks held by these investors.

The provisions affect several categories of securities and apply to various circumstances and the application is technical and complex. The complexity results from the CSA's wish to create a uniform system, but the exemption rules are not the same in the various provinces. While there has been some progress, the exemption system is still diverse and significant differences remain among the provinces. It is possible that the former, much more diverse situation *...inhibited the development of a secondary resale market for investments in small and medium sized enterprises to a greater degree in Canada than in the U.S.* (MacIntosh 1994). However, Cumming and MacIntosh (2002) also point out (note 14, p. 37) that further research must be conducted to measure the effect of regulation on small businesses and the venture capital industry before we can say that the regulatory burden is excessive. Other

[78] *Multilateral Instrument 45-103: Capital raising exemptions.*
[79] Quebec is not a signatory to this agreement, but the CSA issued a general decision to uniformize the holding period with that set out in Multilateral Instrument 45-102.

factors such as market liquidity may also influence the exit strategies of venture capital investors, as well as the lesser skills of venture capital investors. Cumming and MacIntosh (2002) show that the exit method of venture capital investors influences returns in this industry[80]. However, once again, the role of factors of a regulatory nature remains to be defined and measured. Moreover, similar studies on European venture capital show significant differences as compared to American venture capital with regard to exit strategies. Schwienbacher (2002) attributes these differences to liquidity differences in the various markets. It is not certain that completely uniform regulation is best. Moreover, in many provinces, regulatory provisions for securities have become a tool for economic development. Experiments have been conducted, particularly respecting venture capital financing and public financing of small businesses. Although these experiments probably cannot be qualified as successful in all cases, we note a migration to provinces other than the home province, which shows their interest for large economic players. The argument that uniform legislation is preferable disregards these realities. The ability to innovate in the securities industry is a direct consequence of regulatory competition in Canada. Part 4 is devoted to an analysis of this concept.

[80] See on this subject section 2.4.5.

PART 4

4-REGULATORY COMPETITION

Arguments put forward by promoters of the uniformity and centralization of securities regulation in Canada rely essentially on the concept of the immediate effectiveness of such regulation: a single authority would be able to regulate the securities field in an optimal manner and at a lower cost and perfectly homogeneous regulation would be preferable to the situation which currently prevails. The imposition of this homogeneous regulation by a central authority was put forward by Breton (2000) as the strong harmonization method. This idea is opposed to that of regulatory competition. Instead of monopolistic regulation, its defenders propose a market approach to regulation, whether for tax, environmental, company or financial market regulation. According to certain promoters of this approach, competition should lead to less complete and stable harmonization than that of imposed harmonization but more in accordance with the real needs of participants. Breton calls this approach weak harmonization. There has been a debate surrounding regulatory competition for a number of years in the United States. The creation of a European arena, gaps noticed during recent financial scandals, and market globalization have given new life to this important area of study, where not only internal regulatory competition, which operates between the State and organizations, is considered, but also external competition. In fact, American and Canadian regulation is confronted by that of other jurisdictions, particularly for securities due to the emergence of integrated European markets[81].

Imposed harmonization and centralization may appear as a means of optimizing the regulation of securities or companies in a country, federation or union such as that being built in Europe.

This regulatory model is not, however, the only one presently in place and the United States is a perfect example of an approach diametrically opposed to that of centralization for company law. In this area, the United States uses competitive regulation: there are as many company laws as there are States and certain States have laws substantially more attractive for companies than others. This is especially true for Delaware, where almost half of American companies listed on the stock exchange are incorporated.

[81] See Geiger (1997) or Perry (1994) for an analysis of these concepts with respect to securities, in particular following the publication of the *Market 2000* report (SEC: *An Examination of Current Equity Market Development*, Jan. 1994).

Between the two extremes there is a middle position which leads to models of mutual recognition (or reciprocal delegation). Harris (2002) presents the advantages and disadvantages of each approach. Maykut (2001) believes that reciprocal delegation is reasonable and viable in Canada. Anand (2001) and Scarlet (2001) criticize this idea. Anand observes that the mutual recognition approach requires "*a real commitment to the harmonization of provincial securities statutes"* and believes that uniformity can only be attained by setting up a national regulatory body. The reciprocal delegation solution is, however, used by the European Community in the securities field. It is also clearly found in the blueprint for uniform/harmonized securities laws proposed by the CSA in January 2003.

In this first part we will discuss the concept of regulatory competition, and then we will study its application in the United States in the area of company law. A third section is dedicated to the idea of competition for accounting standards, then for securities. We will then analyse the steps taken by the European Community towards a mutual recognition system also known as the European passport. We will conclude with the lessons learned from these experiences and thoughts on the debate presently taking place in the Canadian securities industry.

4.1 Regulatory competition: principles

Regulatory competition is part of a broader framework of interjurisdictional competition which we will describe here by the acronym IJC. IJC is defined as the rivalry among governments in which each government is trying to win some scarce beneficial resources or to avoid a particular cost (Kenyon, 1997). This competition has many aspects. Direct and indirect taxation, grants and tax expenditure programs intended to encourage or keep business are an important element of it. Quality of health care, education and infrastructure are also part of it. In the regulatory field, labour law, company law and environmental law are the most frequently used. The various components set out above determine the competitiveness of jurisdictions. This competitiveness depends, however, on the relevant economic agent. A paper company does not use the same criteria in its choice of location as a retiree. Globalization of stock exchanges has led to the internationalization of the concept. Perry (1994) defines international regulatory competition (in the securities field) as *a contest among regulatory jurisdictions to attract activity by offering the most efficient regulatory environment in which to operate. A regulatory environment is efficient if it offers participants precisely the regulation for which they are willing to pay.*

There are several theoretical models of IJC, from Tiebout (1956) to Breton (1996). Kenyon (1997) offers an overview of them. They apply to different aspects of government intervention but, unlike those of Breton, these models are largely focussed on taxation. We are interested here in concepts, work and results which affect the underpinnings of IJC directly related to company law and securities law, while incorporating the dimension of accounting standards associated with it.

Theoretical models of IJC stem from the work of economists such as Oates (1998, 1999), Tiebout (1956) and Breton (1996), who observe that regulatory authorities are not necessarily motivated to regulate for the better. For example:

> *If we discard the assumption that politicians and public sector bureaucrats are somehow motivated to maximize a social welfare function, as the most superficial observation of the world entreats us to do, the most important reason for decentralizing the public sector is that decentralization makes possible and, in effect, stimulates intergovernmental competition.*[1] *Indeed, once it is accepted that public officials are like everyone else in society in that they are motivated, to a significant degree at least, to pursue their own interest, intergovernmental competition is required for two different, if related, reasons: a) as a check on political power much like market competition acts as a check on corporate power; and b) as an invisible hand mechanism capable of producing a maximum of social utility.*

Regulatory competition is therefore a necessary condition to counterbalance the excessive power of central authorities who do not necessarily act to maximise social well-being and to allow mechanisms which can lead to maximum social utility to be set up.

Vietor (1994), following a comprehensive analysis of several cases of regulation and deregulation in the United States, makes the following observation. All regulation produces undesirable effects which are generally ignored. It tends to oppose market forces and technological progress rather than support them and sooner or later the process takes the upper hand over permanency. These three strong tendencies end up creating regulatory dysfunction and block the process of adjustment of regulations and organizations to the reality of markets changing more and more quickly.

An ideal regulator must, to the contrary, anticipate the impact of its decisions, develop regulations which guide rather than constrain market forces, limit the procedural burden and regularly review its methods and regulations.

For Vietor, regulatory competition is a means of attaining, at least partially, these various objectives. Levich (1993) suggests measuring the net regulatory burden (hereinafter NRB) to which businesses are subject. NRB represents the incremental regulatory cost less the marginal benefits of regulation[82]. When there are several jurisdictions, companies locate their business in the least costly regulatory environment. This regulatory arbitration causes companies to choose jurisdictions with a low NRB. This does not necessarily mean that these entities are less exacting, but that the advantages and costs of each regulatory element are offset. Authorities in high NRB jurisdictions must therefore reduce their requirements and eliminate all regulation of which the marginal cost is greater than the marginal benefit. International regulatory competition thereby imposes discipline, which limits excessive regulation. As Tung (2002) mentions, *in the areas of corporate, securities, and bankruptcy law it (regulatory competition) forces governments and their regulators to compete to offer regulation that firms and their investors prefer*. Two schools disagree as to the ultimate result of this competition, which may involve a race to the bottom or a race to the top. They also disagree in terms of ability and rapidity of the systems to adapt, whether they are subject to competition or not.

For promoters of regulatory competition, it would also have the effect of causing a certain legislative uniformity. Provisions of which the net cost is to a large extent greater than the benefit should be abandoned, while overly flexible provisions should also be abandoned, as they cause an increase in the cost of capital in the fields of securities and company law for example. This adjustment would be for the best, but may oppose the power of the various jurisdictions if competition is not perfect.

Company law competition in the United States seems to have led to the emergence of relatively uniform laws in the various States (Romano, 1985; Black, 1990).

4.1.1 Race to the bottom or the top

Race to the bottom

This basic argument of opponents to regulatory competition suggests that various jurisdictions will reduce their requirements to attract economic agents. For example, with respect to laws governing takeovers, Bebchuk and Ferrell (1999) argue, conceptually and based on observation, that American States use competition to put

[82] This is of course a simple illustration. A company will not benefit directly from regulation, for external reasons. For example, more stringent disclosure requirements may lead to greater confidence in the market, improve the situation of investors by reducing information imbalance and reduce the risk premium and thus the cost of capital for all companies.

forward mechanisms for protecting existing directors against takeovers. There are, however, various mechanisms allowing limits to be placed on the race to the bottom, in particular the establishment of minimum common standards. Hertig (2001) describes them in the European framework. The main argument against this is, however, an economic one and allows for a race to the top, in particular for disclosure of financial information and securities regulation.

In fields other than securities there are several examples of the race to the bottom, which Breton (2000) calls *decentralization failure.* Tariff wars between countries, grant programs to attract and keep business and tax wars betweens the States in the 1930's are examples of it. However, Breton observes that at the international level these wars have lessened and mechanisms have been put in place to contain them.

Race towards the top

This argument rests on the fundamental relationship of finance which associates risk and reward. The lessening of regulation below the NRB limit increases the level of risk of investors who will require a risk premium resulting in a higher cost of capital for businesses subject to the reduced regulation. Certain evidence suggests that this situation occurs in particular in the field of securities where traditionally the most restrictive jurisdictions have attracted a high number of issuers and investors.

As Warren points out (1990, p. 189), *the New-York and London markets have emerged as the largest international securities markets despite having the two most comprehensive securities regulatory systems in the world.* The first beneficiaries of this action are shareholders because an optimal regulatory system increases share value. The race towards the top argument is defended by Romano (1993, 1998, 2001, 2002) and Winter (1977, 1989), among others. Jackson and Pan (2001) recapitulate the various empirical works and professional studies which confirm that issuers tend to comply with the highest standards (those of the United Kingdom in Europe) in choosing their disclosure strategy. Some of the works cited also show that issuers exceed minimum disclosure standards in an attempt to positively influence the market. There is therefore a great deal of evidence of the principle of the race towards the top respecting the disclosure of information. The reaction of issuing companies in the European Community after the adoption of the European passport directive is also consistent with this behaviour.

4.1.2 Stability and ability to change

Centralized and competitive regulatory systems also differ in terms of stability, ability to change and ability to implement new measures, as well as in terms of total or partial possibility of capture.

Stability: for Harris (2002), a single centralized regulatory system is more stable than a competitive system. It is therefore more foreseeable, which represents a definite advantage for issuers and investors. However, a stable system represents a disadvantage in a rapidly changing environment, as in the case of securities. A stable system is in fact synonymous with less capacity for change.

Capacity for change: this capacity has two dimensions. Legislation must be able to adapt to change (time adaptation) and geographical differences (place adaptation) when a jurisdiction has disparities, which is the case in Canada.

Time adaptation: MacIntosh (1997, p. 232) notes that setting up a centralized regulatory system leads to decreased responsiveness.

The securities field, as well as company law, are in rapid evolution. Decentralized regulatory bodies may be able to innovate more rapidly to respond to these changes. However, regulatory response must be followed by an implementation phase which, in a decentralized system, is necessarily longer because it requires cooperation.

Place adaptation: proponents of decentralization argue that this system allows better adjustment to local realities and more flexible adjustment to local changes in conditions.

Implementation: even if regulatory bodies detect changes and adapt to them, these changes must still be implemented at the global level. Proponents of a centralized system argue that fragmenting responsibility imposes a long and costly process, since cooperation is required. Within the framework of the capture theory, which says that regulatory bodies are sooner or later captured to their advantage by the regulated entities, this process may have certain advantages. It limits the power of the largest pressure groups.

Regulatory centralization and decentralization thus both present advantages and disadvantages which are easily described but which cannot be easily measured: we must therefore turn to an analysis of existing situations to attempt to determine to what extent one model may be considered preferable. We will analyse successively the situations which exist in the areas of company law, accounting standards, and securities and will pay special attention to the European Community. In several ways, the Community must deal with a problem similar to that in Canada.

4.2 Regulatory competition in company law

In the United States, regulatory competition is the standard for rules governing the relationship between directors and shareholders, falling under the jurisdiction of the States. However, the statute in force in the jurisdiction of incorporation governs the entire company, wherever its operating location, and companies freely choose their State of incorporation. An identical situation has also existed for a short time in Europe, where companies can choose their country of residence. This competition has caused several important differences between the abilities of American States to keep companies which are physically present in their territory. Bebchuk and Cohen (2002) observe that Illinois and California only incorporate 11 and 22% of "their" companies while Indiana and Minnesota keep 70 and 75% respectively. Delaware gets 85.23% of companies incorporated outside their State of location and this movement is increasing. From 1996 to 2000, Delaware incorporated 90.22% of new companies which chose a State other than their State of origin. These indicators caused Bebchuk and Cohen to conclude that the market domination of Delaware is even clearer and growing more than indicated by the figure usually quoted. According to these authors, 57.75% of all American public companies and 59.46% of Fortune 500 companies have their head office in that State, as opposed to less than 5% in the State of New York, which, however, comes second in terms of number of incorporations. Delaware also grants a very large proportion of IPOs. Daines (2001) shows that in 1996 this State attracted 64% of all U.S. IPOs, attracting 36.5% in 1981.

Considering the similarities of the implications of company and securities laws, competition in company law is an essential object of study to analyse and understand the effects of regulatory competition for securities. Moreover, a great number of works have been devoted to this subject involving the special situation in Delaware.

4.2.1 The Delaware situation

Delaware has systematically adopted its laws to corporate needs. This State is the only one to offer a special court to settle disputes in company law and offer companies significant protection against hostile takeovers. Legal protection broadly authorizes defensive manoeuvres against takeovers. It has been reinforced by the development of a doctrine permitting recourse in particular to poisoned pills by the

Delaware courts. Jurisdiction shoppers recognize that Delaware's provisions are extreme but other States have adopted provisions which go further still, without however attracting as many companies as Delaware (Bebchuk and Cohen, 2002)[83]. However, as these authors indicate, the ability to attract companies is directly associated with protection against takeovers.

The main legal characteristics of Delaware are the following:

- Greater protection for directors against hostile takeovers;
- Lower transaction costs on the sale of companies;
- Less limits on defensive tactics of directors for takeovers;
- A body of law and vast experience in takeovers.

From the outset, Carey (1974) states that the willingness of Delaware to attract businesses, for tax revenue, should result in the lowering of legal requirements, mainly in the area of shareholder protection. Carey argues that directors profit from less restrictive laws at the expense of shareholders in a number of areas. Delaware would therefore initiate a race to the bottom which would align its laws with the wishes of directors. The only way to counter this mechanism, for this author, would be recourse to a single statute at the federal level. Carey's argument has the advantage of allowing empirical verification of the effect of regulatory competition. Less investor protection represents increased risk which should translate into a greater cost of capital. As company value is determined by the value of future changes actualized by this cost of capital, all things being equal, a company registered in Delaware must have a lower value than it would have in another jurisdiction. Changes of jurisdiction to or from this State must also translate into changes in company value. This theoretical statement is not confirmed empirically.

4.2.2 Empirical work

There are many empirical studies of the effects of regulatory competition in company law and summaries of them are proposed by Bhagat and Romano (2002), Romano (2002) and Bebchuk *et al* (2002). We will only set out here the main methods and the

[83] Pennsylvania, Ohio and Massachusetts

principal results of tests dealing with either of the following hypotheses: if regulatory competition benefits shareholders, changes of domicile to a more favourable jurisdiction should lead to an increased share price (and *vice versa*); all things being equal, a company registered in a State having a favourable jurisdiction must be worth more than one located in a less favourable jurisdiction.

Using event analysis techniques[84], a few studies show an abnormally positive return on the announcement of reincorporation in Delaware (Romano, 1985; Wang, 1995; Hyman, 1979). However, Wang's results are more significant when he divides the sample as a function of a State to which the companies go and Hyman's study is based on a summary methodology. Contrary to what Romano states (2002, p. 65), evidence of the effect of a transfer of head office to Delaware is not systematically positive or significant at the conventional 5% threshold. As Daines (2001) indicates, a change of head office is often associated with a change of strategy and the effect of the two events is combined. For Bebchuk *et al* (2002), it is difficult to infer from existing studies that a Delaware incorporation has a significant positive effect on shareholder wealth. Table 1 of Bhagat and Romano (2001) shows moreover the rarity of significant statistical results in studies covering the period after 1983. Romano (2002, p. 65) retorts, however, that an abnormal return of 1% may be economically significant.

A second approach was used by Daines (2001), then by Subramanian (2002) and a few other authors to determine to what extent the types of law to which companies are subject influence their value.

Daines uses a measure of the company's value relative (Tobin's Q ratio)[85] and shows that, all things being equal, Delaware companies are worth more than those of other States. The study covered 4,481 companies listed on a stock exchange during the 1981-1990 period. The results are statistically significant for twelve of the sixteen years studied, and also economically significant. For example, in 1996, the difference in value is of the order of 5%. However, a similar study, conducted during the following period, shows that Delaware's advantage is decreasing. Subramanian (2002) estimates it at 2.8%.

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[84] These studies seek to measure the effect of an announcement on the market price of securities which are the subject of the announcement, taking into account other factors which may influence the price. In particular, the variation of the trading price is taken into account and the results of these studies are most often expressed in terms of excess return (as opposed to that of the reference index) still called residual.

[85] This common measure of the relative value is obtained by dividing the market value of the business by its adjusted book value, to take account of the replacement cost of its assets.

Although it is not perfectly clear that a transfer to Delaware has a significant effect on shareholder wealth, the fact remains that this State has been able to attract a very significant portion of American companies, which could not have been done if shareholders were against it. This movement does not seem to have caused major problems in terms of governance or executive behaviour. In the framework of regulatory competition, Delaware has therefore succeeded in developing a body of law which appears optimal for a majority of companies. Several provisions have been copied by other States and Delaware therefore seems to be contributing to an improvement in the company law system in the United States. This observation is the cornerstone of the argument developed by Romano (2002) in the field of securities law. This model, however, has raised criticism.

4.2.3 Criticism of regulatory competition in company law.

Arguments and research results showing the advantages of regulatory competition in the field of company law are not unanimous. Bebchuk and Ferrell (1999), Bebchuk *et al*(2002) and Bebchuk and Cohen (2002), present different criticisms of this proposal. Certain criticisms are centered on a race to the bottom (from the shareholders' point of view) as States would be in competition to protect as best as possible executives from takeovers which may discipline them. However, for Bebchuk and Cohen (2002) or Kamar (1998), the American situation is no longer one of competition but of a monopoly over new incorporations, where the body of law and knowledge of company law constitute a barrier to entry.

Despite these criticisms, Bebchuk recognizes that regulatory competition may produce beneficial effects. However, in the particular area of protection against takeovers, the effects would be negative.

<u>4.3 Competition in accounting</u>

The idea of regulatory competition has also been studied and put forward for the establishment of accounting standards[86]. Sunder (2001) proposes and shows that: *a competitive regulatory regime for accounting standards, within and across national jurisdictions, that allows individual firms to choose from a set of accounting standards, is more efficient*. The arguments are developed by Dye and Sunder (2001).

For Sunder, delegation by the SEC of the exclusive power to establish accounting standards has created a regulatory monopoly, the FASB, which was the object of

[86] The case of regulatory competition in the auditing profession is analyzed by Dunmore and Falk (2003).

severe criticism due to its inability or slowness in establishing firm rules in several key areas.

Accounting for inflation, oil industry exploration costs, pension plans and employee remuneration based on shareholders' equity are some examples of the lack of effectiveness of the FASB. The problem of revenue recognition, for which the SEC has used its power of intervention and imposed the *Statement of Accounting Board* 101 (SAB 101), should also be added to this list, as well as the problem of special purpose entities. These entities have proliferated since the beginning of the 1980's. The problem was apparent, however, beginning in the 1970's, and the FASB Emerging Issues Task Force was put in charge of the matter at the end of the 1980's. As Jensen shows (2002)[87], almost all the members of EITF came from the financial sector or very large companies and were associated with the main beneficiaries and users of SPE. The first intervention of the FASB mentioning the SPE occurred in 1996 (FAS 125), but it was only following the Enron affair, where the use of SPE played a key role, that FASB issued complete and precise directives. Beginning in 1997, directors of large American companies were asking for an in-depth review of FASB or its disappearance[88].

Although he says that the American system is still the best in the world, the person in charge of accounting at the SEC, Robert K. Herdman[89], has asked the FASB to deal with the following three problems:

- *The current standard – setting process is too cumbersome and slow;*

- *Much of the recent FASB guidance is rule-based and focused on a check-the-box mentality that inhibits transparency;*

- *Much of the recent FASB guidance is too complex*.

Criticism addressed to the FASB actually results in large part from its status as a regulatory monopoly, which has the following consequences:

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[87] See Jensen, B., *What's Right and What's Wrong with SPE*, web site, documents and associated articles, at http://www.trinity.edu/rjensen/theory/00overview/speOverview.htm

[88] *Corporate America is Fed up with FASB*, *Business Week*, April 21, 1997.

[89] Herdman, R.K. *Testimony concerning the Role of the SEC and the FASB in Establishing GAAP*, May 14, 2002.

- In an extremely complex environment, it is becoming impossible to study the effects of different standards. Only a competitive system will allow it;

- A regulatory monopoly easily becomes subject to significant pressure by various groups when important decisions are made;

- A regulatory monopoly is unable to use the criteria of the reduction of the cost of capital to establish or change rules and standards. For Sunder (2002), as for a number of other authors, the ultimate object of the process of accounting standardization (as, moreover, the process of regulating the securities market) should be a reduction in the cost of capital. Good quality financial statements and an efficient disclosure process increase the quality of information available to investors, reduce asymmetry and lower the rate required by investors which is also the cost of equity. A company which benefits from a lower cost of capital has a significant competitive edge. Socially this criteria is superior to that of the maximization of shareholder wealth (or share value) since its advantages are distributed among several categories of participants in the company.

Sunder (2001) observes that, in the United States, company law has been able to improve because of competition between States. The functioning of exchanges has benefited from competition between the NYSE, NASDAQ and other exchange organizations, including the electronic exchange networks. On the other hand, nothing has allowed competition at the level of the establishment of standards. In addition, the United States is protected from any foreign competition by refusing to list foreign companies using standards other than US GAAP.

Arguments against competition in accounting regulation are not lacking. These arguments are, however, the same as those put forward by proponents of a Canadian regulatory monopoly for securities. They concern the race to the bottom, the abandonment of an optimal uniform system, and the difficulties and cost of implementation.

The race to the bottom argument is raised to counter any proposal for regulatory competition. For accounting standards, it seems established that broader disclosure of more information translates into a reduction in the cost of capital for small companies not often followed by analysts (Botosan, 1997, Schrand and Verrecchia, 2002) and for large companies (Botosan and Plumlee, 2001, O'Hara and Easley, 2001).

Companies wishing to reduce their cost of capital must accordingly use high quality accounting systems. In a system open to competition, companies do not necessarily use an existing model which, in the particular case of accounting standards, is considered the best in the world. However, recent stock market scandals and university studies prevent this opinion, often put forward in the United States, from being defended[90]. For example, Leuz (2001) observes no significant difference in the level of various indicators related to the cost of capital for a number of companies which choose IAS or GAAP standards in Germany. He concludes that: *the choice between IAS and GAAP is of secondary importance.*

Finally, Sunder (2001) contemplates the practical dimensions of the implementation of competition between IAS and GAAP standards in the United States. Supervisory responsibility of the various accounting standardization bodies may be delegated to IOSCO and the role of the SEC in reviewing various documents submitted by companies would remain unchanged. The same type of analysis is proposed by Dunmore and Falk (2003) in the area of audit regulation. He maintains that competition in this field is an efficient substitute for government regulation, which would offer a reliable means for auditors to indicate the quality of their services.

4.4 Regulatory competition and the securities industry

4.4.1 General principles

In a sector subject to rapid changes, the ability of laws and regulations to adapt quickly and the rapid detection of problems and trends is essential. As the primary goal of a stock market is to provide issuing companies with capital at the lowest possible cost, regulation should be made to correspond to the needs of investors. The issue is therefore whether a competitive system will allow this double objective to be reached more efficiently than a regulatory monopoly. Also, because of international competition, it is important to define a regulatory system which is attractive to both local and foreign companies so as not to lose a share of the financial market. According to Choi and Guzman (1998) and Romano (1993, 1998, 2001, 2002), competition is preferable to reach this objective. The proposed forms of regulatory competition and, in practice, the existing forms of competition are two types, which, as Tung (2002) points out, are very often confused. The form proposed by Romano, and which prevails in company law in the United States, is direct regulatory competition. Choi and Guzman (1998) propose a type of model used in Europe, called portable reciprocity. The Canadian system, for the time being, resembles neither of these models, although certain forms of competition in terms of provisions may be observed. Tung analyses the differences between direct competition and the

[90] See Herdman, id. ed.

passport and shows the very important differences between them in terms of effects and policies.

Romano's main argument is the success of regulatory competition in the field of company law in the United States. To the extent that this system has allowed an optimal legal framework to be developed, it should be the same for securities. The model proposed by Romano is a transposition of the situation which prevails in company law. However, we have shown that, for several authors, the success of competition in that legal field is questionable.

Issuers choose the jurisdiction, i.e. the place where they file their prospectus and ask for registration (federal regulation is becoming optional) and other jurisdictions recognize the laws and regulations of the state or province of registration[91].

The choice of place and therefore of regulatory system is clearly disclosed to investors, in particular by brokers when the securities are sold. The system chosen by a company may subsequently be changed with shareholder approval[92]. Romano (2002, p. 115) recognizes that this system may lead to different treatment of the same situation for investors[93]. However, application of the doctrine called *internal affairs,* already applied in company law, would solve this problem. This doctrine refers to the original jurisdiction all cases involving a corporation which is registered there. Romano recommends that the State of registration differ from that where the company carries on its principal business to allow competition to fully come into play.

The portable reciprocity approach of Choi and Guzman (1998) is an extension of the concept of bilateral recognition. In the classical system, two countries agree that an entity meeting the requirements of the original jurisdiction may operate in the host country. This is the principle used between Canada and the United States within the framework of the *Multijurisdictional Disclosure System* (MJDS). The portable reciprocity approach extends this approach to a situation involving several jurisdictions, where the issuer is entitled to choose the principal regulatory entity. Approval by this entity will be recognized by the other jurisdictions, but the principal jurisdiction must be indicated to investors (in the case of the issuance of securities). Although similar to the approach of Romano, reciprocity has very different

[91] Romano's analysis (2002) deals mainly with notions of disclosure, which ignores important aspects of securities regulation, notably those for intermediaries.

[92] The international extension of Romano's model will not be discussed here. See Tung (2003), or Ferrarini (2002).

[93] We observed (section 3.4) that this situation currently prevails in connection with the application, heterogeneous before American courts, of the provisions of the PSLRA.

implications and implementation requirements. In particular, and the case of the EC is a clear illustration of this, the regulatory competition approach can only function if the various jurisdictions agree on minimum standards. Otherwise, jurisdictions will use various techniques to block access to their market.

The advantages of this type of approach to regulation are quick reaction time and especially limits on over-regulation, which, in the opinion of certain participants in favour of deregulation, seems to be a tendency of authorities in the area[94]. Over-regulation is particularly penalising in the securities industry because of the mobility of capital. Laws and regulations developed in a context of competition take the real needs of participants into account to a greater extent. Regulatory competition leading to a bottom-up approach may be preferable to the classic top-down approach which seems to lead to over-regulation. In fact, regulatory competition allows the creation of a feedback effect which allows the preferences of agents to be revealed: these preferences translate into a flow of issuers to the preferred systems. Romano (2001, 2002), but also Fox (2001), Choi (2001) and Jackson (2001), point out the advantages of regulatory competition for securities. The importance of the over-regulation argument warrants a special section all to itself.

4.4.2 Over-regulation, particularly with respect to disclosure

A single regulator may impose disclosure requirements without regard for investors. This argument is based on two observations. Firstly, in the absence of regulation, companies would still disclose information which would, in many cases, be certified by an independent body. Modeling this behaviour has given rise to a large body of work, of which Verrecchia (2001) gives a partial summary. Disclosure would have the effect of increasing liquidity and reducing information asymmetry, which allows the cost of capital to be reduced. In addition, imposition of disclosure regulation could produce positive external effects. The benefit of disclosure by companies would have overall positive effects greater than the effect on each company by allowing a more efficient, more liquid and less volatile stock market. However, regulating disclosure also has net costs and benefits of which the disclosure requirements have not been proven by the different analytical studies (Admati and Pfeiderer, 2000).

The intervention of the regulator in this field comes from the proposition that the quantity and quality of the information which would be available in such a case would not be optimal. The regulator has therefore generally sought to increase the

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[94] For an analysis of the heavy regulatory burden in the Canadian securities industry, See BCSC, 2002, “Making Securities Regulation Work for BC’s New Economy”, December.

quantity and level of detail of information disclosed, which sometimes limits the disclosure of certain aspects of information considered potentially harmful such as management forecasts.

Empirical research in the field of accounting has effectively shown the lack of effect of several of the SEC's disclosure requirements. As Verrecchia (2001) mentions, it is almost impossible to show the positive or negative effects of additional disclosure requirements on the American market. Bushee and Leuz (2002) show that imposing disclosure requirements on companies whose shares are traded over the counter has had positive effects on the price and liquidity of these shares, from which companies not subject to this requirement did not benefit[95]. The imposition of these rules would therefore seem to have had positive external benefits but the study shows that 74% of companies subject to this new obligation preferred to leave the OTCBB for the market known as the *Pink Sheet* of the *National Quotation Bureau*[96], which indicates that they believed the cost of compliance greater than the loss caused by their transfer to a less liquid and transparent market. This study evidences the positive and negative effects of a new regulatory requirement. In fact, although disclosure and liquidity increased for approximately one-third of companies involved, they decreased for two-thirds of the securities.

Lo (2000) studies the economic consequences of a change imposed by the SEC in 1992 requiring the disclosure of executive compensation. The objective of the SEC was to improve governance by requiring the disclosure of the methods and amounts of executive compensation. Lo distinguishes companies opposed to the change from those that did not conduct any lobbying.

The first had abnormally high levels of compensation and saw their rate of return increase sharply after the adoption of the new standards. The performance of companies which did not oppose the regulatory change remained unchanged. This result is consistent with the hypothesis that increased disclosure causes a reduction in agency problems and improved governance among companies where it was relatively weak.

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[95] Before 1999, companies whose assets did not exceed $10 million and who had less than 500 shareholders, and whose shares were traded over the counter (OTC Bulletin Board) were not obliged to file the documents required by the SEC for other categories of issuers. The change made by the SEC in 1999-2000 has the same effect for these companies as the adoption of the *Security Exchange Act* of 1934 for large companies.

[96] This very illiquid and untransparent market in terms of price is available at the following address: http://www.nqb.com/.

The effects of fair disclosure (FD) regulation, which requires companies to disclose the same information to analysts as to all investors, was studied by Straser (2002), Bushee *et al* (2002) and Eleswarapu *et al* (2003) who obtained different results respecting this additional requirement on the quantity and quality of information issued by companies. Analytical and empirical studies therefore seem to point out the inherent difficulty in determining the optimal level of regulation in terms of disclosure.

4.4.3 Illustrations of regulatory competition in the securities field

There are fewer illustrations of regulatory competition than other fields because of the dominance of American and British models. Perry (1994) presents the development of the Euro-bond market as a successful example of competition as compared to the American market, due to lower regulatory costs. Several authors attribute lower borrowing costs in this market to an NRB close to zero, which is not the case in the American market. As Niemeyer (2001) states, securities regulation may be influenced by pressure groups:

> *The regulator has to have the ability and the motive to impose adequate regulation. It is not obvious that a given regulatory body fulfills both of these requirements. Ability here refers to both the information available to the regulator and the enforceability of the regulation. For all rules and regulations, especially non-government regulation, it is important to scrutinize the motives of the regulator. Weak and diffuse groups, such as consumers and retail investors, often have difficulties in influencing regulatory solutions. Furthermore, strong interest groups are more likely to affect the regulatory solution for specific regulations, like securities regulation, than for more general forms of legislation and regulation. Conflicts of interest may therefore be important in securities regulation. In some cases, these conflicts may result in inappropriate regulation and therefore a non-regulated situation may be superior.*

There are factors other than regulation which guide the choices of issuers and investors. Liquidity is one of those factors[97].

In Europe, several authors agree that we are witnessing a race to the top. Choi and Guzman (1998) say that *European firms often choose to comply with the disclosure*

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[97] The various inter-market competition factors, other than regulation, are analyzed in section 6, on the growth of the Canadian market.

requirements of British securities laws even though it would be permissible to comply with the weaker requirements of their home countries. Also, according to Romano (1998), *in addition, European firms listing in London typically comply with the higher United Kingdom disclosure requirements rather than with the lower ones of their home countries, although they need not comply with U.K. rules under the European Community disclosure directives*.

Because of its regulatory structure, Canada has found itself for several years in an imperfect system of regulatory competition. The various jurisdictions can develop different regulations, but issuers and intermediaries remain subject to the jurisdiction of the provinces where they operate or offer securities. There are no mutual recognition agreements as in the case of the EC, or agreement for regulatory transfer from the state of incorporation as is the case under U.S. company law.

However, despite its partial nature, regulatory competition for securities in Canada has attracted the attention of several researchers. For Daniels (1992, p.94-96), *a dramatic shift in power to the federal government is not unequivocally desirable from a functional perspective, nor practically feasible from a political perspective.* Daniels describes the advantages of regulatory competition, which has allowed provincial regulations *extremely sensitive to the rapidly evolving needs of investors, issuers and registrants.* In particular, he notes that this structure has allowed the creation of distinct regional markets and an *enviable record of innovation and experimentation in regulatory products.*

Without drawing up an exhaustive list, the effects of competition in Canada may be illustrated through several examples. The creation of programs such as Junior Capital Pool (which have become capital pool companies in Quebec) or stock saving plans, described in the previous Part, are examples of innovation started in one province and copied in others. The fact that certain companies of these other provinces relocated to Alberta to benefit from the Junior Capital Pool program probably helped its adoption outside of Alberta. The case of negotiated brokerage fees, initiated in Quebec and subsequently accepted by the other provinces, is another example of the positive effect of competition. However, provincial securities initiatives are often ignored in later documents, which limits their visibility and underestimates the effect of regulatory competition in Canada. For example, the Fraser Institute[98] attributes the creation of labour funds to a federal government initiative in 1987, although the Quebec Labour Fund was created in June 1983 as a result of an initiative of the government of Quebec. Similarly, Todd (1983), in his analysis of the evolution of negotiated

[98] http://oldfraser.lexi.net/publications/forum/2000/07/section_04.html.

brokerage fees in Ontario, does not mention the fact that the movement was initiated in Quebec.

As Roy points out (1985, p. 57), regulatory competition has also played a role in the area of brokerage firm ownership. He writes:

> [Translation] *From the beginning of the 1970's Ontario limited to an overall maximum of 25% and an individual ceiling of 10% ownership by non-residents (of Canada) of brokerage firms registered with the Ontario Securities Commission. Self-regulatory bodies followed the movement started by Ontario and incorporated into their own by-laws similar standards for their members. In opposition, following the Parizeau, Bouchard and Tetley reports, Quebec adopted an open policy vis-à-vis foreign investments in this area, preferring to ensure minimal local control of participants. The Quebec Securities Commission supported this policy by reversing decisions of the Montreal Stock Exchange harmful to foreign investors or prohibiting any restriction of such nature respecting public brokerage firms registered in Quebec.*

Finally, competition and existence of multiple jurisdictions also plays a role in the adoption of certain solutions. The Candeal Inc. case is an illustration of this.

Candeal is a parallel trading system specialised in fixed income securities for institutional investors. Candeal Inc. is majority owned by six brokerage firms (subsidiaries of the large banks) which together occupy a dominant position in the Canadian fixed income securities market and two technology partners. In July 2002, the TSX Group inc. took a 40% interest in Candeal[99], through its TSX Markets division. Given the heavily concentrated structure of the Canadian stock market, the issue of competition was raised. Candeal Inc. asked for recognition as an ATS and the CVMQ registered it as a broker. In its decision, the CVMQ explicitly mentioned that it did not intend to exempt Candeal Inc. from the application of the relevant competition laws. The Ontario decision, to the contrary, made no reference to this idea[100].

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[99] http://www.finextra.com/fullstory.asp?id=6110.

[100] The Quebec and Ontario decisions respectively are available on the following sites: http://www.cvmq.com/Upload/bulletin/v33n27.pdf and http://www.osc.gov.on.ca/en/Regulation/Orders/2002/ord_20020719_215_candeal.htm.

4.4.4 Criticism of regulatory competition in securities

The main arguments opposed to regulatory competition are information externalities (Fox, 2001), the race to the bottom, instability and the absence of harmonization. For example, Cox (1999) predicts that if issuers have the possibility of choosing their jurisdiction of issue, they will choose the least demanding. Regulatory competition would then lead to relocation to the least stringent jurisdictions. However, the attraction of the most strictly regulated markets for foreign issuers appears difficult to reconcile with this statement. Other arguments may also be put forward, such as the difficulty for investors to sue issuers and intermediaries internationally. We will now analyse these arguments which have not been discussed before.

Instability

Breton (2000) cites the case of securities in Canada as an example of non-convergence to an optimum. For Breton, this situation results from the dynamic instability caused by competition. Changes in one jurisdiction lead to more significant changes in competing jurisdictions, which leads to a new reaction. It seems to us that two other explanations should be considered in this specific case. Regulatory competition can only lead to harmonization at the top if the agents (issuers and investors) have similar concepts of utility. The need for information and propensity to risk of Alberta investors interested in junior gas exploration stocks are probably very different from those of an institutional investor which holds a large position in stocks of banks or insurance companies in Ontario. Furthermore, the Canadian system is not one of pure regulatory competition because regulation of the province of origin is only valid in that province. Provincial bodies therefore retain local monopoly power.

Breton examines three ways to solve blockages. The first two destroy the competition mechanism and *whether they have worse effects than some types of instability is surely a possibility* (p. 12). The methods are centralization or the imposition of uniform standards. Breton prefers what he calls *weak harmonization* to *strong harmonization*. Control of instability can be achieved while preserving regulatory competition and instituting clear mechanisms for dispute resolution. This is the path the European Community seems to have chosen.

Absence of harmonization

Regulatory competition is often seen as being incompatible with harmonization. Tung (2002) argues that this is not the case, for several reasons. Firstly, minimal harmonization is required for certain forms of regulatory competition to exist such as the portable reciprocity which underlies the European passport.

Secondly, in cases of direct regulatory competition, the law of the jurisdiction of origin applies in the host jurisdiction. There must therefore be minimal agreement between the regulatory bodies.

In the European Community (EC), regulatory competition is seen as a means of harmonizing regulation by meeting the needs of agents as opposed to imposed harmonization (top-down approach), considered unrealistic. In theory, competition should cause a tendency toward harmonization provided economic agents have similar concerns. However, there are several examples where the mechanism does not work. In U.S. company law, it seems that the system has led to a quasi-monopolistic situation of one State which has been able to build a significant comparative advantage. Moreover, Choi and Guzman (1998) recognize that the regulatory competition model does not necessarily lead to regulatory uniformity. They admit that regulatory needs differ depending on the investors and argue that the portable reciprocity model allows different regulatory systems to coexist, thereby eliminating costs caused by the imposition of uniform regulation on vastly different issuers and investors. The question then becomes the following: in a highly diversified community, should we consider one or more regulatory systems? On this point, and more broadly on the experience of regulation of a heterogeneous confederation, the European experience warrants careful analysis.

4.5 The European situation

The building of a common Europe is full of lessons because the Community was confronted with the necessity of analysing and reforming securities regulation in 15 countries. As Jackson and Pan (2001) write, *the European Union currently provides a regulatory structure analogous to what proponents of issuer choice advocate for the United States. Thus, Europe presents a natural laboratory for testing theoretical disputes arising out of the regulatory competition literature.* Numerous works and reports have been produced and may be used to put the Canadian situation in perspective and especially to analyse, in the real world, the idea of regulatory competition in the field of finance.

Jackson and Pan also write:

> *The notion that the legal structure of the European Union might present a venue of regulatory competition has been recognized for*

some time now. In fact, the principle of mutual recognition has been associated with regulatory competition since its inception. Mutual recognition, as envisioned by the European Commission in its 1985 White Papers and applied in the Listing Particulars Directive (1980) and Public Offers Directive (1989), was meant to generate a "competition among rules" and force regulatory harmonization among the member states. Several commentators predicted in the early 1990s that the passport concept could force all member states to lower regulatory protections to the minimum standards of the directives (a race to the bottom)[27] *while others speculated that member states might converge on some other standard (potentially a race to the top).*

Steil (2002) expressed the wish that regulatory competition would allow a real European financial arena to be developed. However, the Lamfalussy Report[101] (2001, p. 13) makes an observation strangely similar to that observed in Canada by Mackay: *The Committee notes that an almost consensual view has emerged that the European Union's current regulatory framework is too slow, too rigid, complex and ill-adapted to the pace of global financial market change. Moreover, almost everyone agrees that existing rules and regulations are implemented differently and that therefore inconsistencies occur in the treatment of the same type of business, which threatens to violate the pre-requisite of the competitive neutrality of supervision*. The situations are, however, very different. Canada already has a very harmonized regulatory framework, which is not the case in Europe.

The current steps following the Lamfalussy Report, the revision of ISD 93, new directives on prospectuses and the FSAP constitute different means used by the EC to ease dysfunctions in the mutual recognition system instituted in 1993. This system is one of the components of regulatory competition under the European model.

4.5.1 Different situations

The European situation differs greatly from that which prevails in Canada. A market structure based on bank financing in Europe is different from the much more disintermediated market structure in Canada, where the capital markets have a more important role in financing companies, probably due to the proximity of the United

[101] European Commission, *Final Report of the Committee of Wise Men on the Regulation of European Securities Markets* (Lamfalussy Report), 2001, http://www.europa.eu.int/comm/internal_market/en/finances/general/lamfalussyen.pdf.

States[102]. The diversity of regulatory structures, legal systems, traditions and languages is very strong in Europe.

Gros and Lannoo (2000) describe very important differences which exist for tax, accounting standards and governance policies. They observe, in particular, (p.113) that *the harmonization of accounting standards has not gone sufficiently far, and consequently mutual recognition does not work.*

Warren (1990) describes as follows the situation which prevailed at the beginning of the 1990's:

> *European securities regulation has been described as "virtually non-existent outside the United Kingdom." Although corporate law is fairly well-developed in the various jurisdictions, European stock exchanges have been self regulating, with little or no direct oversight by national governments. Most European states have not mandated full disclosure systems for the distribution and trading of securities" nor have they prohibited insider trading" or other manipulative practices generally proscribed by United States securities laws for most of the 20th century. (..) Furthermore, most European states have lacked governmental "competent authorities" or regulatory bodies to administer those regulations that were in force or to supervise self-regulatory organizations in the securities industry.*

Warren admits that efforts made in connection with establishing the common market in 1992 led to a rapid evolution toward the adoption of higher and more coherent standards but important differences remain ten years later. In his summary of answers made by member states to a series of questions respecting the treatment of prospectuses, the CESR (2002) illustrates very important differences between Community countries.

These differences affect the organizations in charge (exchanges, commissions, banks in certain cases), their powers to inspect, to delay takeovers or halt trades or simply their statutory authority to approve prospectuses. Laws sometimes do not define a public offering or the responsibilities of relevant authorities in several countries. Prospectuses are analyzed very differently depending on the country. The Lamfalussy

[102] According to Miville M. and A. Bernier (1999, p.4), "The Corporate Bond Market in Canada", Bank of Canada Review. In Europe, the bond market is used more to finance the wholesale business of large financial institutions.

Report also points out the absence of precise European regulation on a great number of issues (such as prospectuses, transborder guarantees, market abuse, investment services), as well as the differences between the legal and tax systems.

Finally, the degree of cooperation at the European level was extremely limited and observation of this situation led to the creation in 1998 of FRESCO (*Forum of European Securities Commissions*) (Lannoo, 2001). In addition, there are no generally accepted guidelines which govern legislation on financial services (Lamfalussy Report).

The challenges facing Europe are therefore of a different type than those facing Canada. However, analysis and the European experience may help our examination and will be discussed here under three headings. Firstly we will study the investment service directive (ISD 93), then its update and finally the main recommendations of the Lamfalussy Report and the reactions it caused.

4.5.2 Competition and harmonization

For Ferrarini (2002, p. 5), *European Securities regulation is the result of an initial attempt at substantially comprehensive harmonization, which was soon converted into a plan of minimum harmonization and mutual recognition. As a result, some regulatory competition between the Member States is allowed, also in compliance with the subsidiarity principle*.[103]

Regulatory competition for securities currently exists in Europe and this market therefore constitutes a preferred laboratory to analyse the effects of competition. However, this competition is mitigated by the adoption of minimal standards which constitute a basis which allows mutual recognition, in theory. However, this system has not functioned properly: few issuers have actually used mutual recognition (the passport) and additional requirements have regularly been imposed under the heading of "general good justification".

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[103] An analysis of the European situation cannot be made without defining the notions of subsidiarity and comitology. The EU is based on the principle of subsidiarity: it only applies where it is indisputable that common action will be more effective than action taken in isolation by one or two countries. Comitology is a community method of indirect administration. Under the treaty establishing the European Community, it is for the Commission to implement legislation at Community level. In practice, each legislative instrument specifies the scope of the implementing powers granted to the Commission and how the Commission is to use them. Frequently, the instrument will also make provision for the Commission to be assisted by a committee in accordance with a procedure known as "comitology". See: Glossary.-Brussels, European Commission, 1999
http://europa.eu.int/scadplus/leg/en/cig/g4000c.htm.

Furthermore, slowness in the progress to a European financial arena has led to the development of an action plan, review of the investment service directive and the creation of a Committee of Wise Men (Lamfalussy Committee). We will quickly review these various elements, studying them from the point of view of regulatory competition.

4.5.3 The investment service directive (ISD 93)

The ISD, known as the European passport directive, has dominated the financial landscape since its adoption in 1993 (Moloney, 2002, p. 355). It is based on European directives respecting the carrying on of business and freedom of location which are the foundation of the European Treaty.

The overall strategy of this directive has been to totally free the investment service market by subjecting suppliers of services solely to the authority of their country of origin. ISD has thus allowed a true passport to be set up which allows a company registered by the authority of its country of origin to offer services in all the countries of the Union without further authorization. A supplier of services remains governed by the rules of his country of origin. The ISD is an application of the principle of mutual recognition developed by the European Court of Justice. This principle has exceptions under the heading of general good justification. Tison (2000) analyses the conditions for exemptions under which a country may have additional requirements and thus contravene the principle of mutual recognition. At the level of all economic activity (outside ISD), the absence of harmonization is one of the causes put forward to derogate from this principle.

This situation also prevails for financial services despite the existence of minimum standards of harmonization which in theory limit recourse to the concept of general good justification. The ISD theoretically allows perfect mutual recognition. However, two areas remain problematic and can give rise to additional requirements: they are the rules of conduct, the oversight of which is up to the countries where the service is rendered (Article 11 (2) ISD) and the regulation of financial products in private law which is not covered by the principle of mutual recognition.

To facilitate use of the passport, the second banking directive and the ISD provide for a notice procedure by which an authority of the host country notifies the supplier of services who requests market access of the specific rules required under the principle of general good justification. However, the commission is looking into the mandatory or discretionary nature of these additional roles and even into pursuing the notice system.

The purpose of the ISD is not to harmonize laws but it uses a minimal harmonization approach. Analysis of issuer behaviour in the framework of the ISD has been conducted by Jackson and Pan (2001). They conclude that market forces determined the way in which companies conducted pan-European offers and not the provisions of the ISD.

Companies have not used the passport, but have conducted international-style offerings, i.e. private placements outside the country of origin where they were in compliance with existing provisions. Rules governing disclosure in this context are not so much affected by regulatory provisions, but by international practices based on American standards. Put in a competitive system, issuers have therefore chosen not to use the lower standards prevailing in several countries of the Union and complied with higher standards and disclosure requirements not required by the regulation in place[104]. We cannot, however, rule out that the quasi-systematic use of general good justification by several countries has limited use of the mutual recognition provisions.

4.5.4 Revision of the ISD and FSAP

The effectiveness of the 1993 ISD[105] has been mitigated by extensive dilution of the ISD's principle of “home country control” whereby a firm can operate EU-wide on the basis of mutual recognition of supervision since numerous provisions of the ISD allow for host country intervention in the interests of the "general good". Article 11 of the Directive provides for host authorities to implement local conduct of business rules in addition to those enforced in the home country of the firm.

Though this may be helpful in terms of protecting retail investors, it is currently applied indiscriminately to inter-professional business which is over-burdened with application of rules designed with the small, household investor in mind. In addition, there has often been wide variation in the interpretation and implementation of the ISD at the national level. Important obstacles to competition have been observed and, for example, use of the passport by issuers has been very limited.

The EC has therefore developed a financial services action plan (FSAP, 1999), the main objective of which is maximum integration of European financial markets, with a 2005 horizon, to optimize the use of capital in the Community. The FSAP contains 43 measures, of which, according to Durance (2002, p. 12), the main ones are the following:

[104] This behaviour is consistent with the *race to the top* argument.
[105] Sections 4.5.4 and 4.5.5 are largely inspired by the European Commission site. http://europa.eu.int/comm/internal_market/fr/finances/mobil/2k-81.htm.

- The integration of “large” markets through universal recognition of prospectuses, the adoption of a common definition of professional investor, use of the same accounting standards, common minimum standards respecting takeover bids, institution of a single market for institutional investors based on the European passport and mutual recognition of retirement plans, life insurance and mutual funds.

- Opening up of retail markets to facilitate remote sale of financial services to customers through information and the application of the legislation of the vendor’s country.

- Reinforcement of prudent surveillance by the definition of a common solvency ratio for banks.

- Authorization of optimal functioning of the European financial market by the reduction of the risk of tax distortion on savings income.

In February 2002, 25 measures had been achieved, including the adoption of uniform accounting standards (IAS, now IFRS) with a 2005 horizon for companies listed on an exchange and their subsidiaries. Several others are still being studied but two new measures have been adopted since then: the proposal on prospectuses (November 2002), and that on market abuse (insider trading and market manipulation, October 2002). The action plan thus involved the revision of the ISD as well as the setting up of a more efficient and, accordingly, more restrictive decision-making model for member States. This analysis of decision structures was the object of the Lamfalussy Report. As Ferrarini mentioned (2002, p. 22), the two steps are inseparable.

4.5.5 Revision of the ISD

The ISD 93 no longer allowed the use of an efficient framework governing transborder investment activity in the European Union. It did not establish clear rules, from which competition between trading systems (stock markets and others) and their integration could take place. Its main deficiencies are the following:

(1) The ISD does not provide for sufficient harmonization to allow effective mutual recognition of consents issued to investment firms. As a result, the efficiency of the passport it introduced has been largely diminished by the exercise of double, and sometimes multiple, oversight of transborder transactions;

(2) The restrictions it contains for investor protection are out of date: the rules of investor protection must be reviewed to require investment companies to actively use new trading opportunities in order to obtain the best possible results for their clients;

(3) The ISD does not cover the full range of services offered to investors (for example, investment advice or new distribution channels) or financial trading;

(4) The directive does not allow for a response to regulatory and competition issues raised by competition between stock exchanges and between them and the new trade execution infrastructure. Competition between the different methods of executing trades constitutes the main regulatory challenge faced by the EC oversight authorities. The few provisions of the ISD respecting regulated markets, as they are excessively limited, do not provide a clear regulatory framework in which these regulated markets and other trading systems can compete to attract liquidity or in which investment firms can execute off-market orders when providing other services to their clients;

(5) The ISD has used an optional approach respecting regulation of market structures, thereby creating a major obstacle to the creation of a competitive and integrated trading infrastructure. From one member State to another, the methods of trade execution are therefore very diverse. Equally fundamental divergences in the regulation of market structures have indirectly caused disparities in national trading agreements, rules governing market operation, the competitive edge which exists between the infrastructure for trade execution and behaviour of market participants. These disparities greatly affect transborder trades and fragment liquidity;

(6) Provisions of the ISD respecting designation of authorities having jurisdiction and their cooperation are insufficient: a condition precedent to the existence of an orderly single market is total and immediate cooperation and the continuous flow of information between the national authorities.

(7) Provisions of the ISD are rigid and out of date: they do not allow for a response to the hot regulatory questions raised by the evolution of market structures, of business transacted in them and of prudent practice. This necessity testifies moreover to the futility of attempting to regulate financial markets by inserting very detailed provisions in unchangeable legislation.

Given that the ISD did not provide for any mechanism to harmonize national approaches to implementation (this absence underlies all the issues examined by the

Lamfalussy Committee), the Commission believed that a new approach was needed to surmount the present difficulties, seize new possibilities offered and meet the legislative challenges caused by the transformation of European securities markets. An essential objective of this revision consisted of endowing the ISD with structural mechanisms of realization.

4.5.6 The Lamfalussy Report

The Lamfalussy Report deals essentially with setting up structures which would allow the ISD to be modernized, and more specifically with setting up minimum standards required for the mutual recognition system to function properly. It does not involve the creation of a European Securities Commission; the two committees set up are essentially joint decision-makers whose powers go further than those of the CSA because they can have their decisions approved by the European parliament. The Lamfalussy Report proposes a decision-making structure which uses four levels based on committees, within the framework of the principle of comitology[106].

Lamfalussy expresses the need for harmonization, which is not total but allows adequate operation of a mutual recognition system. Lannoo (2001) is also clearly in favour of harmonization but sets limits to it. He also criticizes the Lamfalussy Report for not paying sufficient attention to the process of stimulating proper market operation throughout the various institutions and financial intermediaries involved. He writes on page 1: Full harmonisation is not realistic, however, nor is it even desirable since some degree of competition between jurisdictions can do no harm.

This reaction is rather common and several researchers have criticized the Committee for having very clearly defined how to reach a goal, but without defining it. However, the recommendation on structures was clearly the mandate of this committee.

Contrary to what is sometimes argued neither the Lamfalussy Report nor the FSAP provides for the creation of a single securities commission in Europe, as the web site of the European Commission states[107]. This option is only mentioned and the approach of imposed harmonization is seen as an approach of last resort[108]. The sequential steps in the building of a financial Europe can be characterized as follows:

- Step 1: ISD 93 and regulatory competition, limited by the strong prerogatives of States.

[106] Page 12 of the Lamfalussy Report (2001) shows a diagram of the current structure, which includes two committees: the Committee of European Securities Regulators, (CESR) and the European Securities Committee (ESC).
[107] http://europa.eu.int/comm/internal_market/en/finanCEs/mobil/01-213.htm#3.
[108] See on this topic page 52 of the Lamfalussy Report (2001).

- Step 2: updating of ISD 93 and new directives: regulatory competition made possible by the imposition of minimal standards for mutual recognition to become effective.

- Step 3: re-examination in 2004 which may lead, in the case of failure, to the institution of a single set of rules considered by numerous researchers as totally unrealistic. This single commission would require that all countries give up their jurisdiction over securities, which seems highly unlikely.

The role and composition of the two committees set up following publication of the report are defined as follows on the EC website:

> ***The European Securities Committee*** *(ESC) is composed of representatives of Member States, chaired by the European Commission. It may invite experts and observers to participate in its meetings. The Committee will be chaired by the Commission, which will also provide the secretariat.*
>
> *It will be consulted by the Commission when drafting legislative proposals on securities policy issues. In this respect, it will take on the functions of the existing High Level Securities Supervisors Committee established by the Commission on an informal basis in 1985.*
>
> *This Committee may also act as a regulatory committee in the context of work on future legislative proposals conferring implementing powers on the Commission, which must be decided by Co-decision. In its future regulatory capacity, it will vote on draft technical implementing measures that develop basic legislation submitted to it by the Commission.*
>
> ***The Committee of European Securities Regulators (CESR)*** *is composed of high-level representatives of the national public authorities competent in the field of securities. This Committee may invite experts or observers to participate in its meetings. It will set out its own operational arrangements.*
>
> *The CESR will advise the Commission on securities policy issues. After consulting the ESC, the Commission may mandate the CESR to*

prepare draft implementing measures. In so doing, it will act in a transparent manner, fully involving market participants, consumers and end-users on a regular basis.

The CESR will also play an important role for the transposition of community law in the Member States. It will enhance consistent and timely day-to-day implementation of the Community law through reinforced co-operation between national regulators.

4.5.7 The directive on prospectuses

The directive on prospectuses is at level 2[109] with respect to the technical details of the various forms of prospectuses. The direction of the EC is clear.

It is a system of complete mutual recognition. At this time, mutual recognition is only guaranteed when the prospectus includes the elements required by directive 80/390/ECE and the authorities of the host country may request additional information relating to their market specifics, including translation, which involves higher costs. Complete application (on level 4) of a European passport for an issue will imply automatic acceptance of the prospectus in all countries when it has been accepted in the country of origin. The language of drafting is independent of the authority of the country which is contemplated. It must be one recognized by the authority of the country which gives a final receipt in the case of an issue limited to the state of the head office. The prospectus may be drafted in the "usual language of international finance" in the other cases. For shares, the prospectus must be approved by the authority of the country of head office. For debt security, the authority may be other than the country of head office for large issues if criteria of attachment exist. This is the case if the issue is registered in the host country.

The European visa system for prospectuses therefore goes further than the Canadian mutual reliance review system. There is effectively mutual recognition and reciprocal delegation of the power of review except, however, for small-scale issues. It remains to be seen, however, to what extent this system will in fact allow European offers and

[109] There are four levels of directives on securities regulation:

- Level 1: General directives which are limited to principles
- Level 2: Implementation steps developed by the Commission on the advice of an independent committee such as the CESR and approved by a committee of representatives of State members.
- Level 3: Recommendation, rules of conduct or standards issued by the CESR, in areas which are not specifically covered by the regulation.
- Level 4: Setting up of a Community law pursuant to decision of the European Commission.

not *international-style offerings.* This depends on the wishes of countries to use provisions of general good justification. In theory, the quick application of the various directives should limit recourse to these provisions. In effect, a passport system can only function properly if the conditions of authorization are relatively similar in the different jurisdictions. Otherwise, a broker who is refused permission to do business in one jurisdiction could obtain a permit valid for the whole of the Community from a more compliant jurisdiction. FESCO, which became CESR (*Committee of European Securities Regulators*), defined the minimum (not limitative) standards which are based on the principle that individuals who wish to offer financial services must meet high standards of integrity, ability and knowledge.

4.5.8 Control, legal proceedings and competition

The mutual recognition procedure poses significant problems with respect to law enforcement. The responsibility for supervision is divided between the state of origin which is primarily responsible under the ISD and the host state, which keeps important powers of enforcement for investor protection and integrity of the financial system. This problem is handled in two ways. Firstly, the directive sets out a hierarchy of responsibilities and interactions between the authorities of the country of origin and the host country. Secondly, a procedure of close cooperation and information exchange has been set up (Moloney, 2002, p. 409-416). Cooperation between countries and between various financial authorities in the same country is expressly provided for in the directive.

Competition between exchanges is a key element of upgrading the ISD[110]. The Community says [Translation] *With respect to global market efficiency, regulatory provisions directly limit competition between infrastructures which execute trades does not seem to produce, in terms of price, improvements which would justify such strong intervention in market structures to encourage execution on stock markets. A recent analysis of trading prices covering almost all shares traded in the main European stock exchanges has not in any way substantiated the hypothesis that concentration improves market efficiency (as measured by average ranges between actual buy and sell prices)*[111]. There is thus a major difference in this respect between the Canadian and European situations.

[110] The new version of which is available at:
http://europa.eu.int/comm/internal_market/en/finances/mobil/isd/index.htm.
[111] Source: London Economics: 2002

4.6 Conclusion

Research studies and market observation allow us to argue that a regulatory monopoly is not necessarily preferable to regulatory competition, either in company law or securities.

However, it is useful not to systematically oppose the two ideas and a certain form of competition is surely compatible with minimum harmonization. Besides avoiding the high cost of imposing uniform regulation on jurisdictions which do not wish to give up their prerogatives, this pragmatic approach allows for local adjustments and initiatives which may allow local or changing realities to be taken into account. This is the path taken by the European Community.

The European system of mutual recognition allows a certain form of competition but does not lead to the disappearance of local authorities, which several countries are currently strengthening. For example, in France, modernization of regulators has resulted in two new authorities: the *Autorité des marchés financiers* (AMF) and the *Commission de contrôle des assurances, des mutuelles et des institutions de prévoyance* (CCAMIP). For greater efficiency these authorities result from the merger of existing bodies. The AMF, in particular, is the result of the merger of the *Commission des opérations de bourse* (COB), created in 1967, the *Conseil des marchés financiers* (CMF), created in 1996, and the *Conseil de discipline de la gestion financière*, created in 1988. Its mission will be to protect savings invested in financial products, investor information and proper market operation.

Europe seems to have adopted a position which reconciles a form of regulatory competition since certain jurisdictions may apply minimum standards and others may require more. However, the minimal harmonization imposed prohibits the second group from refusing to allow intermediaries or companies located in the least stringent jurisdiction access to its market. Regulatory competition is therefore balanced by minimal standards, which limit the possibilities of a race to the bottom. This approach to harmonization for securities reflects a model of reciprocity and not convergence.

The reciprocity approach is based on the concept of respect for standards and regulations of other jurisdictions. To the extent that two or more jurisdictions have relatively similar principles in common, it is possible for them to accept, within the context of bilateral or multilateral agreements, that an entity which meets the requirements of the jurisdiction of origin also meets the requirements of the other jurisdictions. This mechanism can be set up based on minimum standards.

For Warren (1990), the manner in which the EC has partially harmonized company and securities law to allow reciprocal recognition is an example of this pragmatic approach. This approach is applicable between jurisdictions which display, from the outset, similarities in terms of regulation. It has however been put in place in a European Community which is very diverse in terms of securities regulation and the role and responsibility of commissions[112].

Commonality requires the development of a body of equivalent or uniform rules which apply in all jurisdictions. In the securities field, these rules should include accounting and disclosure principles, insider trading, market manipulation, conflicts of interest and fraud (Warren, 1990, p. 191). The agreement in force between Canada and the United States (MJDS) is a reciprocal recognition system based on the establishment of substantially equivalent standards (Warren, 1990). As we will see in the following sections, this treaty operates almost unilaterally because shares of Canadian companies are traded on the American market whereas trades in Canada of American shares are extremely rare. Commonality does not necessarily require the disappearance of local jurisdictions. It seems however essential, in a non-homogenous body such as the EC, to maintain a degree of regulatory competition.

According to Niemeyer (2001):

> *Thus, harmonization may very well improve the competition between different markets and agents. However, given the differences in legal system and regulatory tradition, harmonization is difficult. Furthermore, it may not even be desirable. First, individuals are likely to demand certain proximity in the regulation and supervision of securities markets. If this proximity is reduced, their confidence in the appropriateness and impartiality of the regulation and supervision may be hurt.*
>
> *Second, a far-reaching harmonization would reduce a healthy competition between different regulatory regimes. If the harmonized regulations are not open enough, they could easily curtail the development of new services and techniques. In the present non-harmonized regulatory situation, there are possibilities to compare how different regulatory structures handle different problems. There are therefore also possibilities to learn and over time improve the regulatory framework. In a fully harmonized world, this will be more difficult. As the pace of change in the markets increases, the need for*

[112] See Warren, 90, p 195 on the absence of regulation and CESR, 2002.

> *regulatory change also increases. There is a clear risk that a fully harmonized regulatory system would be less flexible.*

The issue of an adequate model of reciprocal delegation was debated at the 8th law symposium at Queen's University in 2001. Maykut (2001) presented this model as a reasonable and viable alternative to centralization proposals. For Maykut, this model recognizes *and makes the most of the political and constitutional realities of our country*. Maykut shows that the delegation of powers to securities commissions is in accordance with the Canadian constitution and points to the example of the MJDS, where a real delegation of power exists between the Canadian and American authorities. She presents inter-provincial delegation as a natural progression from the MRRS. She observes that this mutual recognition is at any rate becoming required between national jurisdictions because trades are becoming more and more frequently transborder. For the author, a condition precedent of setting up such a system is uniformity of legislation. The European experience shows, however, that uniformity is not an essential condition.

Minimal harmonization is certainly required, but perfect uniformity is neither an absolute condition nor probably a desirable situation. It would eliminate possibilities of innovation which are one of the advantages of regulatory competition.

Anand (2001) opposes this proposal with the following arguments. Reciprocal delegation cannot be put in place without harmonization of provincial regulations. Anand then writes that "*uniformity can only be achieved with a national regulator in place*". Two observations can be made. Firstly, a system of delegation can function without regulatory uniformity. Minimal harmonization is required, as the European example shows. Secondly, this harmonization may occur without a central authority even if it requires the creation of structures and mechanisms which bridge divergences between regulations of various jurisdictions. The Lamfalussy Report recommends onerous structures and a complex process which respond to the significant differences separating the regulations of European countries. The CSA already exists in Canada and its recent proposal for regulatory uniformity shows that harmonization may be attained without a national commission.

PART 5

5- The Canadian and American Financial Systems: Competition and Regulation

The debate on the centralization of securities regulation in Canada has recently been reopened in the name of improved efficiency and reduction of costs for issuers and investors. Because of the fragmentation of securities regulation, Canada suffers from a net disadvantage compared to other jurisdictions, which limits development of its market. This argument was put forward in the following manner by the Ontario Teacher's Pension Plan Board which, in its comments submitted to the Ontario Securities Act Five Year Review Committee[113] (Five Year Committee), wrote:

> *The Provinces need to recognize that Canada is suffering as a destination for business and capital because they refuse to give up jurisdiction to a first class regulatory regime that is administered and enforced by a first class regulator.*

Centralization of securities authorities in Canada constitutes the first recommendation of the Five Year Committee and the Ontario Securities Commission.

The American situation is often put forward as an example of regulatory centralization and its implementation within a federal state. For example, the Five Year Committee writes (p. 6):

> *Canada competes with other jurisdictions around the world for capital and for investment opportunities. Our regulatory regime must be part of our competitive advantage. This requires that our regulators be able to operate efficiently and that our regulatory requirements not be more onerous than those existing in other jurisdictions (particularly the United States), except as may be required to satisfy our public policy objectives.*

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[113] OSC. *Five Year Review Committee Final Report*, *Reviewing the Securities Act (Ontario)*, 2003 http://www.osc.gov.on.ca.

Various participants recommend total harmonization with the American system[114]. The IDA, in its answer to the Five Year Committee, proposes that *Canadian regulatory Policy must, in general terms, be congruent with the SEC standards, and in some case recognize US standards to ease the regulatory burden for Canadian Companies*. Such statements suggest that American securities regulation is a model for centralization and efficiency. They also suggest that the American model could be transferred to Canada. These two statements require careful analysis which we will discuss here from the viewpoint of concentration and competition.

Market participants agree that a dynamic and innovative market is essential to maintain and develop the securities industry in Canada. In theory, innovation and dynamism go hand-in-hand with competition. In the United States, competition between stock markets grew in the 1900's and played a decisive role in reducing transaction costs and stimulating innovation. In Canada, to the contrary, the financial system has become progressively concentrated and the six large banks, in addition to controlling most banking activity, control two-thirds of brokerage firms through their subsidiaries. Dealers, through the IDA and the TSX Group inc., the single remaining market group, play an important regulatory role. The principal dealers own one of the Canadian alternative trading systems. The level of concentration in the Canadian financial market has therefore become extreme. An eventual merger between the principal banks, often mentioned, will increase this concentration. The Canadian situation is therefore totally different from that which exists in the United States. This concentration is in part the result of a wish to improve the competitive position of the Canadian securities market faced with an attractive and very dynamic American market. However, proposals respecting the regulatory structure in Canada cannot ignore this reality and the transposition of an American model, although very different from what is generally said, cannot take place without significant adjustments.

We will begin by analysing the evolution of the American financial system and its regulation. In the second part we will study the evolution of the Canadian financial system and its current structure. This exercise will give us a better understanding of the enormous differences which separate these two systems and reveal the fact that, in many areas affecting the financial world, American regulation is very broadly decentralized and competitive.

The introduction of the dimension of competition into the debate surrounding securities regulation in Canada is essential for several reasons. Firstly, market

[114] For example, Romano, of Stikeman Elliott, wrote in his answer to the Five Year Committee (p. 2) (…) *we need both to move towards harmonization with the U.S. system and avoid unneeded complexity*.

participants all wish for a dynamic and innovative market; these two characteristics are generally the hallmark of competitive markets. Secondly, several theoreticians of regulation maintain and demonstrate that regulation does not always have a public interest orientation, namely the correction of market dysfunctions and consumer protection. Private interest theories see the regulatory process as a competition between interest groups where the best organized and structured groups are able to capture the benefits of regulation to the detriment of less organized groups[115]. Becker (1983) shows that the most highly concentrated sectors are more likely than others to impose their priorities. Capture theory defends an extreme situation where the regulatory process is subservient to the needs of an industry. Mechanisms which may lead to such situations are the differences in levels of expertise, transfers of human resources from the sector to the regulatory organization and *vice versa* (the revolving door process) and the infiltration of organizations by upper-level industry staff. Here again, capture is more likely when concentration is great. Furthermore, it has become impossible to deal with securities regulation without dealing with the banking sector, which owns the main brokerage firms in Canada. In addition to dominating the banking field, the large Canadian institutions also dominate securities. The main objective of this study is therefore to illustrate the process of concentration of the Canadian financial sector while, however, going beyond the narrow framework of financial corporations. These play a growing and important role with regulatory organizations and this role must be examined. A parallel with the American situation will be drawn.

American securities regulation is more complex than it initially seems, despite recent changes giving broader powers at the federal level. It is therefore important to understand the main characteristics of American financial regulation. It is also useful to assess the current regulatory systems in Canada. This is the second objective of this Part.

In the third section we will discuss the issues relating to the American and Canadian situations in terms of regulation of the financial sectors. In the United States, the SEC may be considered a regulatory monopoly with respect to important securities, in the face of a competitive and fragmented industry. In Canada, provincial securities regulation creates a form of regulatory competition in the face of a very heavily concentrated industry. The establishment of a national commission will lead to the setting up of a regulatory monopoly. Authorization of the mergers of banks, which own the main brokerage firms, and the growing concentration in this sector, seems to be leading Canada to oligopoly. According to the forecasts of regulatory theoreticians, a situation where a regulatory monopoly governs an oligopoly is

[115] The works involving this area are too numerous to be reviewed. Kroszner and Straham (2000) and Heinemann and Schüler (2002) present summaries of them in the section on financial regulation.

potentially dangerous. This cannot be ignored in the present discussion surrounding the restructuring of securities regulation in Canada.

5.1 The American system: market competition, regulatory monopoly

The level of competition in American securities markets is significant and grew rapidly during the 1990's. The United States General Accounting Office states that in March 2002, the SEC oversaw nine exchanges, the over-the-counter market and seventy alternative trading systems as well as twelve clearing houses[116]. The existence of several exchanges stimulated competition, but the growth of alternative trading systems or ATS was the major element in the reduction of transaction costs (Benhamou and Serval, 1999). This growth was moreover stimulated by the slowness of American exchanges to adopt efficient trading platforms, as several European countries have done. Several analyses have shown important differences between the cost of trading on the NYSE and on NASDAQ (Huang and Stoll, 1996; Chung *et al*, 1999). These observations, unfavourable to NASDAQ, lead to regulatory intervention to change the behaviour of market makers. However, it appears clear that the development of ATS played a major role in the overall reduction of transaction costs and improvement of the quality of services.

In the United States, the stock market has become progressively more competitive, the number of institutions offering trading services has grown, and transaction costs have decreased. It does not appear that this evolution took place to the detriment of liquidity or the quality of information, in particular because of the existence of data consolidation systems. The regulation of this large collection of institutions and organizations is entrusted to the SEC, which has intervened several times to stimulate competition. It has also promoted the emergence of ATS, despite the fact that setting up these systems fragments trades and potentially harms liquidity. Faced with such fragmentation, a single regulatory body might be best. However, American regulation is not totally centralized and it is, moreover, opposed and sometimes even connected with the recent setbacks of several large corporations.

5.1.1 Regulation of the securities industry in the United States

[116] United States General Accounting Office, *SEC Operations: Increased Workload Creates Challenges*, March 5, 2002, http://www.gao.gov/new.items/d02302.pdf.

The securities industry in the United States is one of the most regulated[117]. Its regulation is, moreover, an effort shared between federal and local decision-makers (at the level of each State) and self-regulatory organizations. For example, in the State of Tennessee[118], the *Securities Division* is responsible for the administration of the *Tennessee Securities Act of 1980*. This division registers brokers, handles public complaints involving trades in securities and authorizes new share issues. The Division acknowledges, however, that it only looks after around 15% of all share issues taking place in the State. Issuers who have registered their securities on a national exchange benefit from an exemption under either the *National Securities Markets Improvement Act* of 1996 (NSMIA) or the SEC provisions. Local commissions therefore in fact manage the issuances of small businesses[119].

By using one of the 5 regional SCOR (*Small Capital Offering Regulation*) programs or certain types of direct federal investment (Regulations A, D and *Intrastate*), start-up businesses may raise capital more easily and less onerously than conducting a traditional initial public offering (IPO). They then register with one or more States in which their shares will be sold, and not with the SEC (under an SEC exemption). They thereby avoid the traditional investors for start-ups who are gluttons in terms of percentage of voting rights (venture capital companies and angel investors) and their alternative, bank financing. Compared to an IPO, the amounts raised are less (between $1 and 20 million), and disclosure requirements are reduced.

An issue may be sold by the business or by a commissioned sales agent, and use mass methods of communication. The Internet represents an ideal media for businesses conducting initial direct offerings (direct public offering or DPO) authorized to promote their securities themselves[120]. The gross proceeds of the issue must be put in trust with an independent bank until a predefined minimum amount is reached. This method of financing has the disadvantage, however, of an illiquid secondary market because of restrictions on the sale of shares and the fact that these shares are not

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[117] http://www.sia.com/career/html/regulation.html. This industry is governed in particular by the following statutes: *the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940 (together with the amendments of 1970 and 1975), the Securities Investor Protection Act of 1970, the Securities Acts Amendments of 1975, the Insider Trading and Securities Fraud Enforcement Act of 1988, the Securities Enforcement Remedies Act of 1990, the Private Securities Litigation Reform Act of 1995, the National Securities Markets Improvement Act of 1996 (amending the Securities Act of 1933, the Securities Exchange Act of 1934 and the Investment Company Act of 1940), the Securities Litigation Uniform Standards Act of 1998 and the Sarbanes-Oxley Act of 2002.*

[118] http://www.state.tn.us/commerce/securdiv.html.

[119] Issuances of securities *not covered*, within the meaning of the *National Securities Markets Improvement Act* of 1996.

[120] Shares of DPO may be sold to participants in the business(clients, salaries, employees, etc.) and, since 1995, the SEC has authorized the issue of a prospectus via the Internet.

traded on a stock exchange. To address this issue, in 1995 the SEC authorized the Pacific Stock Exchange to publicly list securities subject to SCOR regulation and Regulation A[121]. Since January 13, 1998, securities listed on Tier 1 of that exchange are "covered securities" within the meaning of the NSMIA of 1996 and come under the jurisdiction of the SEC. A great majority of businesses use this type of issue as a private placement, however, and investors hold the shares until the business is sold, is listed on an exchange, or redeems its own shares. The SB-1 and SB-2 legislation is distinguished from other types of issues by small businesses in that it corresponds to initial public offerings reserved for start-up companies. Businesses must therefore register with the SEC but the procedure is simplified.

Regulation of the securities industry in the United States takes into account the realities of a very fragmented market. In particular, financing of small business is overseen at the local level and use of simplified procedures is allowed. Small issues represent the vast majority of Canadian issues. In particular, the program of start-up capital partnerships (or "capital pools") allowed 868 issues between 1991 and 2000, mainly in the western provinces. This represents 46% of the 1,891 IPOs in this period. In total, during this period, 1,217 issues raised an amount less than or equal to $1 million, and 1,491 raised less than CDN$5 million. Less than 10% of issues raised gross proceeds greater than US$20 million. Almost 90% of Canadian IPO's would have met local American regulation and could have taken advantage of "not covered securities" status. The image of centralized regulation applied throughout the United States should therefore be qualified, particularly when talking about small issues.

5.1.2 Criticisms of centralized regulation

The American regulatory system is the object of criticism which cannot be ignored. It may be grouped into three sub-headings. For several observers, the centralizing influence is one of the factors contributing to the multiplication of accounting and financial scandals. For other authors, the centralized system eliminates regulatory competition and impairs the ability for rapid adaptation of regulation to market evolution. Finally, American securities regulation is considered onerous and costly.

5.1.2.1 The accounting and financial scandals argument

As mentioned in section 3.4, the wish of the American federal government to impose a uniform securities law seems to have had indirect negative effects. These interventions are seen by certain researchers as direct, although partial, causes of

[121] On the minimum conditions of registration http://www2.Inc.com/search/1897-print.html.

recent financial scandals. The exclusion of the States from lawsuits for securities having national scope eliminated several lawsuits and does not seem to have allowed uniformity of decisions. However, this effect was reinforced by the inaction and lack of means of the central regulatory body, the SEC. Based on the American example, it does not seem that the Enron affair can be a very solid argument to require uniform securities legislation in Canada.

5.1.2.2 The regulatory competition argument

Regulatory competition is the situation under which, in a given area, economic agents may choose the regulatory system which governs them. Such a system prevails in the United States in the field of company law, where Delaware offers what appears to be the most attractive company law. Such a regulatory structure allows differences to exist between jurisdictions and may generate a race to the bottom. However, this does not seem to happen. In fact, in a properly functioning economy, businesses which opt for a less strict system tell investors that they present additional risk and thus see their cost of capital grow accordingly.

Regulatory competition may lead to a situation which seems sub-optimal because of inter-jurisdictional differences. However, it presents two major advantages. Firstly, the regulated businesses, intermediaries or investors may indicate their preferences by changing jurisdiction. The needs of those regulated are therefore taken into account more than in the classic (top-down) approach, where the agents, if they are heavily structured and organized, have more influence on the development of the laws governing them. Secondly, competition between jurisdictions allows more rapid reaction to changes in the economic environment, which are particularly rapid in the financial sector. Romano (2002, p. 13) describes as follows the advantages of regulatory competition in the field of securities:

> *Regulatory competition, moreover, offers a distinctive advantage over a single regulator for securities law. It better aligns the incentives of issuers, and of regulators, with the interests of investors, and will thereby lead to the promulgation of rules that investors most prefer. That is so because issuers will be drawn to the regime preferred by investors to lower their cost of capital, and regulators will be able to discern the efficacy of their regulatory choices by the flow of firms into and out of jurisdictions.*

An analysis of regulatory competition was conducted in Part 4 of this report and will not be repeated here. However, it was important to show that regulatory uniformity is not the only means available and that competition between authorities, widely practiced in the United States, has significant advantages.

5.1.2.3 American regulatory costs

It is difficult to maintain that an alignment of the Canadian regulatory system with that of the United States would reduce costs for Canadian businesses. American regulation is onerous, costly and complex. Gagné *et al* (2002) observe that American regulation of businesses and consumers comprises 130,000 pages in the federal register and 4,000 new regulations are added each year. In banking, Pattisson (1994) notes that institutions face 200,000 pages of banking laws, standards and regulations, of which 4,000 change each year. He writes (p. 2) that *the regulatory structure is disproportionately thick*. *In securities*, *the US System is much more costly for market participants than the Canadian system. By US standards, most of our market participants are small and cannot afford the cost of a US style designed for its much bigger markets and players* (answer to the OSC preliminary report (2002) by the BCSC). In fact, the minimum standards to maintain listing on the NASDAQ require capitalization greater than US$50 million, or around CDN$75 million. Only 590 Canadian businesses meet these criteria, representing 14% of officially listed corporations[122].

Corporations whose securities constitute the TSX 60 index have characteristics quite similar to those whose securities trade on the NYSE (average capitalisation of US$5 billion as opposed to $3.6 billion for NYSE stocks).

5.1.3 The American banking sector

According to Weelock and Wilson (2002), there were 14,483 banks in the United States at the end of 1984. At the end of 1999, only 8,563 remained because of bankruptcies (1,312), but especially because of a large wave of mergers after the removal of legal barriers. Consolidation activity accelerated between 1997 and 1999 (Hughes *et al*, 2002). At the end of 1999 we saw the lifting of the *Glass Steagall Act*, which kept the activities of deposit, insurance and brokerage institutions independent[123], resulting in new consolidation in the industry. However, there nonetheless remained slightly more than 8,000 American banks at the end of 2001 (Olson, 2002).

[122] *Going Public and Listing on the US Securities Markets*, Nasdaq, 2000 p. 56. The estimate assumes capitalization equal to shareholders' equity.
[123] *Goodbye Glass-Steagall, Hello Big Mergers -- and Big Fees?* Business Week, 29/09/1999.

The American banking system is unique in several ways: it includes a large number of banks and is governed by a multiplicity of regulatory organizations with overlapping authority as well as banking laws which differ from State to State. For example, the Financial Institutions Division of the Ohio Department of Commerce[124] authorizes the creation of new deposit institutions (*banks, credit unions, savings and loans, and savings banks*), approves the restructuring of institutions already registered and checks compliance of institutions with State statutes and regulations. The *Federal Reserve System*, the American central bank, is decentralized in the sense that its authority is divided between twelve regional banks governed by a common board composed of seven governors appointed for fourteen years by the President of the United States. According to Olson (2002), the American banking system is characterized by its duality, in the sense that it has developed jointly at the federal level and local level:

> *We have nationally chartered banks supervised by the federal government and state-chartered banks supervised by both state and federal regulators. (...) Now that interstate banking is a reality, I submit that the dual banking system remains an important factor underlying the strength and flexibility of our financial system. As Chairman Greenspan has reminded us in the past, the freedom of banks to choose their regulator is the key to the protection of banks from the potential for unreasonable regulatory behaviour. (...) But I believe that the ability of banks to choose their regulator has fostered both the continued competitiveness of the industry and vitality of the economic activity it finances.*

5.1.4 Conclusion

The United States practices strong regulatory competition or a two-level (local and national) system in several areas, such as company law and banking. In the area of securities, regulation of local issuers remains with the States. The progressive encroachment of the federal government, particularly in terms of lawsuits, is criticized and alternative models of regulation based on competition have been proposed. Finally, the American financial landscape includes a large number of institutions and markets. It is fundamentally different from Canadian financial markets.

[124] http://www.com.state.oh.us/odoc/dfi/dfiabout.htm.

5.2 The Canadian market: regulatory competition and market oligopoly

The Canadian financial system is traditionally an oligopoly (Bordo *et al,* 1993). In 1987, a timely amendment to the ten-year reform of the 1980 banking legislation allowed banks to acquire brokerage firms. This amendment promoted increased concentration in the sector. Bill C-8, which came into force in October 2001, authorized institutions other than deposit institutions (such as life insurers, money market mutual fund managers and stock brokers) to become members in the Canadian Payments Association. This statute also set up a procedure for reviewing proposed mergers of large financial institutions, which includes a review of their effect on the public[125]. According to the International Monetary Fund (2003, p. 22)[126]:

> The financial sector reforms of 2001 appear to have been implemented effectively. The new consumer protection agency is up and running, a framework for bank mergers has been established, and measures had been taken to encourage entry in the payments and banking systems, including by branches of foreign banks. The officials noted that, while some applications by new banks were close to approval, there had been relatively modest interest by potential entrants, possibly reflecting the dominant role of the existing major banks and the fact that the reforms were relatively new.

This statute, intended to promote competition through the introduction of foreign players, therefore seems to have had little effect for the moment. The several large Canadian banks presently own the large brokerage firms and their already significant influence in the only Canadian stock market should grow[127]. Brokers, through the IDA, are co-owners with the TSX Group Inc. of Market Regulation Services Inc. (RS Inc.). The large brokerage firms play a key role in the fixed income market and are shareholders of one of the Canadian ATS (Candeal.ca Inc.).

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125 According to Roy, J. (2003), *Vers une théorie des systèmes financiers*, March 21, 2003, HEC, Montreal.

126 IMF Country Report No. 03/33, February 2003.

127 The concentration in the insurance field is also high. At the end of 1999, the five main companies represented more than 54% of the Canadian market in terms of premiums and 57% of Canadian general assets. They were Great West, Clarica, Manulife, Sun Life and Canada Life. (See http://www.fin.gc.ca). This concentration grew again at the end of 2002, with the merger of Sun Life and Clarica, implemented on December 31, 2002. Manulife also launched a hostile take-over bid for Canada Life on December 9, 2002, but the board of directors of Canada Life announced on Monday, February 17, 2003 that Great West had agreed to purchase all its common shares for $7.3 billion cash. Before these transactions, the life insurance sector was already more concentrated in Canada than in all other countries studied by the Group of Ten (Group of Ten, 2001). The five largest companies controlled 73.1% of assets in the sector. The ratio of concentration was 25.2 in the United States at the time.

5.2.1 Canadian banks and the brokerage industry

Canadian banking activity is spread between nine national banks and fifty subsidiaries of foreign banks. The six large Canadian banks control approximately 90% of total banking assets and offer a wide range of financial services.

They are:

- The Royal Bank of Canada (RBC, and RBC Financial Group),
- The Canadian Imperial Bank of Commerce (CIBC, owner in particular of CIBC Wood Gundy and CIBC Trust),
- The Bank of Montreal (BMO of which the subsidiaries of BMO Financial Group include Nestbitt Burns and the Harris Bank of Chicago),
- The Bank of Nova Scotia (which owns Scotia Capital),
- The Toronto-Dominion Bank, which owns TD Waterhouse Canada Inc. and TD Securities Inc.,
- The National Bank of Canada (which owns National Bank Financial, as a result of the merger of Levesque Beaubien Inc. and First Marathon Inc.).

Table 11 shows various indicators of Canadian market concentration. For the Task Force on the Future of Canadian Financial Services (MacKay letter), Canada was the developed country with the most concentrated banking sector in 1997. The method used by the Royal Bank gives a ratio of Canadian concentration of 46% as opposed to 81% for the MacKay letter, so Canada is surpassed by Switzerland and the Netherlands. However, the study by the Bank for International Settlements confirms the MacKay letter data and also shows strong growth in the concentration, which increased from 60.2 to 77.1% from 1990 to 1997. Such an increase is not seen in any other country. Only the United States saw growth in the same direction but the concentration index was only 11.3% in 1990. Canada, along with the Netherlands, seems to be the OECD country where the banking sector is the most concentrated. Despite this already high concentration, the largest banks have tried several times to merge. According to Cookey *et al* (2001, p. 1), in 1998 these attempts lead to new legislation on mergers for financial institutions.

In 1987, the federal and provincial governments amended legislation so that banks, trust companies and foreign brokerage firms could own brokerage firms. This leads to a profound reorganization of ownership in the securities industry. The large Canadian banks acquired leading brokerage firms or created their own firms.

According to the IDA[128], at the end of 2002 the Canadian securities industry included 200 brokerage firms (as opposed to less than 119 at the beginning of 1990). Three broad types of brokerage firms coexist, namely the integrated brokerage firms (78% of business in the sector), institutional brokerage (9%) and retail brokerage[129] (12%). In 2001, the seven main integrated firms, including the brokerage subsidiaries of the six large Canadian banks and a large American brokerage firm (Merrill Lynch), had more than 70% of the business in the industry. They are:

- BMO Nesbitt Burns, owned by the Bank of Montreal,
- CIBC World Markets, owned by CIBC,
- National Bank Financial, part of the National Bank of Canada,
- RBC Dominion Securities, owned by the Royal Bank of Canada,
- Scotia Capital Inc., owned by the Bank of Nova Scotia,
- TD Securities, owned by TD Bank Financial Group,

[128] Merrill Lynch, Strategis web site, at business trends and profitability in the Canadian securities industry, July to September 2002, see also: http://www.fin.gc.ca/tocf/2002/cansec_f.html.
[129] Integrated brokerage firms serve the institutional and retail markets. Institutional brokerage firms also work with pension funds, insurance companies, mutual funds, banks and trust companies. Retail brokerage firms offer products and services to retail investors.

- Merrill Lynch, which had captured a significant share of the Canadian retail market, withdrew from the retail market. CIBC purchased the Canadian retail brokerage business of Merrill Lynch at the end of 2001 and its securities and mutual fund services in 2002.

At the end of 2001, all the large integrated brokerage firms in Canada belonged to the banks, of which six represent more than 90% of total banking assets in 2002. These institutions are heavily involved in the holding of exchanges and various self-regulatory organizations.

Table 11: Ratio of concentration in the Canadian banking sector according to various studies

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

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

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

5.2.2 The Canadian Exchange or the TSX Group Inc.

The restructuring of Canadian exchanges was carried out quickly. The Alberta and Vancouver exchanges merged in 1999, soon to be joined by the Winnipeg Exchange (2000), to form the CDNX (*Canadian Venture Exchange*)[130]. This restructuring was motivated by the goal of cost savings and the wish to make it easier for small businesses to access the TSE. The CDNX is therefore the national junior exchange. In May 2001, CDNX shareholders accepted a buyout offer from the TSE, which was approved by the Alberta, British Columbia and Ontario securities commissions in July 2001. The CDNX became a subsidiary operating separately but owned by the TSE, soon using the TSE infrastructure. In October 2001, small-cap stocks of the Montreal Exchange were transferred to the CDNX[131], which opened an office in Montreal. The Montreal Exchange specializes in derivatives.

On April 3, 2000, the Toronto Stock Exchange was demutualized and continued under the name Toronto Stock Exchange Inc., and the broker members of the Exchange became shareholders of the new entity. On July 10, 2002, the Toronto Stock Exchange Inc. was renamed TSX Inc. and the CDNX was renamed the TSX Venture Exchange Inc. On August 31, 2002, no person owned more than 10% of the Group TSX Inc.[132]. The TSX Group Inc. owns about ninety brokerage firms[133]. Following the initial offering of the TSX Group inc., the TSX Group inc. has four operating subsidiaries: TSX Inc, the TSX Venture Exchange inc., TSX Markets (trades) and TSX Datalink (data). In addition, TSX Inc. holds 18% of CDS (The Canadian Depository for Securities Limited), 50% of the shares of RS Inc. and a 40% interest in Candeal.ca Inc.

5.2.3 Clearing houses

CDS is the only Canadian entity offering deposit and clearing services for securities other than derivatives[134]. CDS is a private corporation owned by the large Canadian banks, the IDA and the TSX Group Inc.[135]. A Canada-wide organization for the deposit, clearing and settlement of securities, the CDS offers electronic clearing services which allow participants to declare, confirm and settle securities transactions. The institution is governed at the federal level by the Bank of Canada

[130] See Boisvert and Gaa (2002) for an analysis of the reasons for, consequences and methods of this restructuring.
[131] A first transfer of certain classes of small-cap stocks took place in November 1999. Large-cap stocks were transferred to the TSE on December 6, 1999.
[132] TSX Group prospectus, p. 48.
[133] http://www.ledevoir.com/2002/09/12/8967.html.
[134] http://www.banqueducanada.ca/fr/paiement/other-f.html.
[135] The Montreal Exchange transferred the shares it held in CDS to the Toronto Exchange, in accordance with a memorandum of understanding dated March 15, 1999, between the exchanges.

under the *Payment Clearing and Settlement Act*. At the provincial level, the activities of the CDS are governed by the Ontario and Quebec securities commissions[136].

The Canadian Derivatives Clearing Corporation (CDCC), a private business corporation[137], issues options, futures and options on interest rate futures and on shares and clears them. These contracts are traded on the Montreal Exchange. Since the beginning of 1999, the CDCC has provided clearing, settlement and administrative services to the Winnipeg Commodity Exchange and the WCE Clearing Corporation. The CDCC is recognized as a self-regulatory organization in Quebec. It is subject to the joint supervision of the Quebec and Ontario securities commissions. Under an agreement between the exchanges, all derivatives for interest rates and listed shares are traded on the Montreal Exchange. The Montreal Exchange Inc. is now the sole shareholder of CDCC[138].

5.2.4 Alternative trading systems in Canada

According to certain participants, the Toronto Stock Exchange has for a long time been afraid of competition by alternative trading systems (ATS), and succeeded in preventing their introduction in Canada. The Teachers Pension Board Plan, in its brief to the CSA respecting ATS, wrote on November 24, 1999:

> *We expect the Toronto Stock Exchange (TSE) to propose that they be the consolidator and regulator of ATS. The fear we have with this proposal, is that the TSE has resisted change and been steadfast in its opposition to ATS and Crossing Networks (...). If Canada is to regain some of the trading volume that is has lost to the U.S. we will need flexibility and innovativeness. The TSE has rarely shown these attributes.*

During the fall of 2001, the Canadian securities commissions finally adopted national standards on ATS[139]. National Instrument 21-101 defines an alternative trading system as a marketplace that does not act as a self-regulatory organization or list

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[136] The CDS also collaborates, when necessary, with the Alberta and British Columbia securities commissions.
[137] The Canadian Derivatives Clearing Corporation has been in existence since 1975, but has only been a private corporation since the beginning of 2001 http://www.cdcc.ca/accueil_fr.php/.
[138] The Board of Directors of CDCC is composed of the President of Montreal Exchange Inc., one member firm representative, one public director, and CDCC's Senior Vice-President and Chief Clearing Officer.
[139] National Instruments 21-101 "Marketplace Operation" and 23-101 "Trading Rules" set up a regulatory framework applicable to all Canadian markets, exchanges and ATS.

securities for trading, which allows a significant reduction in fixed transaction costs. ATS are the Canadian equivalent of the American electronic crossing networks. Following this legislative reform, three alternative trading systems for fixed income trades emerged in Canada[140], namely, Bloomberg Tradebook Company Canada, CollectiveBid System Inc.[141] and Candeal.ca Inc.[142].

Bloomberg Tradebook Company Canada is a wholly-owned subsidiary of Bloomberg Canada LLC. CollectiveBid System Inc. is a private business founded in 1999 in Toronto. It provides services to Merrill Lynch, JP Morgan Securities Canada, Laurentian Bank Securities and HSBC Bank Canada. Candeal.ca Inc. combines quotes and updates the prices offered by the six major brokers on a screen showing the best quotes in real time, which allows institutional clients to have access to a more liquid and more transparent market. Candeal.ca Inc. is owned by the TSE Group and brokers[143]. Despite a favourable regulatory framework, market conditions have not been conducive to the growth of ATS in Canada. Their number and trading volume are still low.

5.3 Regulatory monopoly and market competition in Canada

The provincial regulatory securities commissions delegate part of their powers to self-regulatory organizations, which regulate their members and supervise intermediation in the Canadian market. Canadian exchanges are self-regulating for members and markets. The regulation of members consists of registering representatives of participants, ensuring that participants and their representatives meet professional standards for qualification, minimum capital, internal organization and handling of clients' complaints. Market regulation governs participant activity[144].

The disappearance of the Western exchanges and the redefinition of the role of the Montreal Exchange have profoundly affected the traditional situation. Self-regulation of members has become the prerogative of the IDA[145] and market self-regulation is currently the responsibility of RS Inc., owned by the IDA and the TSX Group Inc.[146].

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[140] Several ATS such as Instinet Canada Inc. or Versus Technologies Inc., associated with E-Trade, operate in the field of variable income securities.
[141] http://www.collectivebid.com/.
[142] http://www.candeal.ca/en_h/index.asp.
[143] BMO Nesbitt Burns, Basis100 Inc., CIBC World Markets. Inc., MoneyLine Telerate, National Bank Financial Inc., RBC Dominion, Securities Inc., Scotia Capital Inc. and TD Securities Inc. http://www.finextra.com/fullstory.asp?id=6110.
[144] Over-the-counter trades are governed by member regulation.
[145] Except in Quebec, where the Montreal Exchange governs brokers.
[146] The Montreal Exchange is not covered by RS Inc.

Self-regulation, which was previously entrusted to each Canadian exchange, is now more or less under the aegis of a single institution.

5.3.1 Market regulation

For ATS, governed by two instruments in December 2001, to function, a new generation of self-regulating organizations must be created. These providers of regulatory service, recognized by securities authorities, supervise markets and may impose disciplinary measures. Each ATS must be governed by a supplier of regulatory services which is [Translation] *an organization recognized and supervised by the securities commissions to offer regulatory services to marketplaces, exchanges or ATS, which sign an agreement to such effect*[147].

The TSX Inc. has thus made a subsidiary of its regulatory division, which has become RS Inc. RS Inc. is recognized as an SRO by the Ontario, Quebec, Alberta, Manitoba and British Columbia securities commissions.

RS Inc. provides regulatory services to the TSX Inc. and the TSX Venture Exchange Inc. The regulatory mission of RS Inc. is to *develop, administer and enforce the Universal Market Integrity Rules (UMIR") and other marketplace requirements applicable to trading in the Canadian securities market in a neutral, cost effective, service oriented and responsive manner*[148]. RS Inc. manages requirements for business and exchange trading and oversees compliance of members with these requirements. The only other self-regulatory organization for a market is the Montreal Exchange[149].

RS Inc. is owned 50% by TSX Inc. and 50% by the IDA[150]. The present board of directors of RS Inc. includes eleven directors, five of whom are appointed by the two shareholders, five independents (including at least one representative of an ATS) and the President. RS Inc. is a monopolistic not-for-profit business corporation "independent" of its two shareholders. When an ATS wishes to be established, it must come to an agreement with RS Inc. or an exchange, this last option being somewhat theoretical as ATS compete with exchanges. RS Inc. has become a de facto monopoly for market self-regulation.

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[147] CVMQ 2001-2002 Annual Report, French version.
[148] The RS Inc. web site gives access to the UMIR, see http://www.regulationservices.com/.
[149] In the mutual fund industry, the *Mutual Fund Dealers Association of Canada* is recognized as a self-regulatory organization by the Ontario, British Columbia, Saskatchewan and Alberta securities commissions.
[150] http://www.regulationservices.com/whatsNew/. It is expected that any new market will be offered an interest in RS Inc.

5.3.2 Member regulation

Brokers trading on one of the exchanges must be members of a self-regulatory organization, which governs the broker-client relationship, and sets out rules of ethics and minimal capital requirements to ensure investor protection. In Canada, this self-regulation of members is the mission of the IDA and the Montreal Exchange, the evolution and effect of which we will look at in turn.

The traditional role of the IDA is to represent the national securities industry. Following the process of demutualization, and the abandonment by the Toronto Exchange of member regulation in 1996, the IDA also became an SRO.

Its mission is to protect investors and enhance the efficiency and competitiveness of the Canadian capital markets. The regulation of members consists of[151]:

- Registering members, which implies verifying compliance with high professional standards and minimum professional qualifications;
- Checking financial compliance, i.e. the existence of minimum capital;
- Checking sales compliance, to ensure member firms have effective procedures to process and analyse the investment needs and risk tolerances of clients;
- Managing complaints received against a member firm or one of its registered employees, and impose penalties where applicable;

To do business in Canada, a dealer must be a member of an SRO. Everywhere in Canada except in Quebec, the IDA is a monopoly because it is the only recognized SRO[152].

Under section 351 of the Quebec *Securities Act*, which states that SRO's existing at the time of the coming into force of the Act may continue their activities (a grandfather clause), the CVMQ has allowed the IDA to carry on its activities in Quebec. In October 2001, the Montreal Exchange specialized in derivatives trading and this redefinition of its role lead to a decrease in the number of its approved

[151] http://www.ida.ca/About/roles_en.asp.
[152] Note that dealers with a restricted practice must be registered with the Mutual Fund Dealers Association of Canada.

participants, which currently number 74, only 17 of which are exclusive[153]. The IDA today includes more than 190 stock brokers, effectively making it the sole self-regulatory organization for members of the securities industry in Canada[154].

5.3.3 Who regulates?

The presence of many representatives of the regulated industries in the regulatory organization is not abnormal. It results from the asymmetry of information between the organizations and the regulated businesses.

As Laffont and Tirole (1991) indicate, the clear answer to the problem of regulatory capture would be to reduce the share taken by representatives of the regulated sector or sectors in the regulatory process[155]. It is therefore interesting to estimate the relative importance of participants in the respective sectors directly concerned with regulations in the composition of boards of directors of Canadian regulatory organizations. Table 12 sets out the composition of these boards, taken from annual reports and information available on the web sites of these organizations. Twenty seven percent (27%) of the directors of self-regulatory organizations come from a deposit institution or related organization. Twenty two percent (22%) come from a Canadian bank or related institution. Five percent (5%) come from a Quebec deposit institution or related institution. In total, the securities industry and banking institutions dominate the board of directors of Canadian SRO's. Issuers hold 10 of the 124 positions, representing 8% of the total and the investors supposedly protected by these bodies are not present. The financial services industry is therefore able to significantly influence Canadian regulatory organizations, of which they control the boards of directors.

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[153] Following the demutualization process, Montreal Exchange Inc. was recognized as an SRO on November 24, 2000.

[154] The *Act respecting the Agence nationale d'encadrement du secteur financier* (AANESF, S.Q. 2002, c. 45) sets up a new mechanism of general application to recognize SRO's. Existing SRO's will have to be recognized again as SRO's, within six months of the coming into force of the new section (see transitory provisions 740 and 741 of the AANESF).

[155] However, Laffont and Tirole (1991) observe that this reduction can be sub-optimal if it reduces the knowledge of the regulator in the area regulated.

Table 12: Breakdown of boards of directors of self-regulatory organizations and other key organizations in the Canadian securities industry

The organizations studied are: the Investment Dealers Association of Canada (IDA), the Investment Funds Institute of Canada (IFIC), The Canadian Depository for Securities Limited (CDS), the Canadian Derivatives Clearing Corporation (CDCC), the Canadian Capital Markets Association (CCMA), the Montreal Exchange, Market Regulation Services Inc. (RS Inc.), the Toronto Exchange (TSX) and the Mutual Fund Dealers Association (MFDA).

Self-Regulatory Organizations and Others

Composition of Boards of Directors

Category of employer	Number of persons sitting on One board	Two boards	Three boards	Four boards	Number of directors
Insurance	3				3
Attorney	3	1			1
Bank	3	1			4
Bank (dealer subsidiary of one)	13	4			17
Bank (trust subsidiary of one)	2				2
Bank (mutual fund subsidiary of one)	4				4
Foreign bank (mutual fund subsidiary of one)	1				1
Quebec bank	1	1			2
Quebec bank (dealer subsidiary of one)	1				1
Savings union	1				1
Quebec saving union	1				1
Quebec savings union (trust subsidiary of one)	1				1
Quebec savings union (dealer subsidiary of one)	1				1
Venture capital	2				2
Advisor	3				3
Consultant	3				3
Dealer	16	1			17
Issuer	10				10
Trust	1				1
Manager	8				8
Government of Canada	1				1
Government of Quebec	1				1
Not stated	6				6
Media	1				1
SRO	1	1	2	2	6
SRO (itself)	2				2
Mutual fund	20	2			22
University	2				2
Total	109	11	2	2	124

Table created from annual reports and web sites.

5.3.4 Conclusion

The Canadian financial sector is therefore highly concentrated. 8,000 American banks correspond to nine Canadian banks. Seventy trading systems for securities operating in the United States are served by twelve clearing services. Canada has only one exchange group, two clearing agencies, one regulatory service and a few ATS, which are mostly under the direct or indirect control of the large banks and their related brokerages. To our knowledge, no developed country presents such a high level of banking, financial and self-regulatory concentration. The financial aspect is governed by the provincial securities commissions. The centralization proposals for regulation of securities responsibilities will, faced with such a group, lead to a single securities commission.

5.4 Findings and implications

The analysis of the Canadian and American situations for securities regulation leads to three important findings for public policy in Canada. Firstly, the American regulatory framework is complex, has not proven its effectiveness and is not transferable to Canada. Secondly, the structures of the industries regulated in the two countries are totally different. Finally, the risks of significant influence by the industry on the regulatory framework or even regulatory capture are high in Canada.

We have put forward the fundamental differences which exist between market organizations and securities regulation in Canada and the United States. The American banking and securities markets include a very large number of participants, which strongly compete with each other. The situation is totally different in Canada, where activity is highly concentrated. A regulatory response must take this major difference into account.

The United States enjoys regulatory competition in the field of company law. In the banking sector, a dual system has been set up which also allows a certain form of competition. Securities regulation is segmented, as small issuers are governed locally. The transfer of the American regulatory system to Canada is therefore difficult to conceive. On the basis of a standard established at the level of gross proceeds of issue, a Canadian SEC would be responsible for less than ten percent of initial offerings.

In the securities area in particular, the United States is considered to have onerous, costly and strict regulation. This regulation applies, for securities, to a business world very different from that in Canada. The SEC is considered as being inefficient, slow and lacking resources. The United States therefore does not provide a model for regulatory centralization in the various areas related to the financial sector. Moreover, centralization would harm the capacity for adaptation by the regulatory system. Centralization, in particular for legal actions in the securities industry, is widely condemned and related to a series of market scandals.

The centralization the American government would like to have has not brought about perfect uniformity and the laws and regulations have been applied unequally. For several authors, limitations on the right of legal actions by the States for the benefit of national lawsuits alone have had very negative effects.

The main argument opposing the adoption in Canada of a regulatory framework based on that of the United States relates, however, to the structure of the industries regulated. The Canadian financial sector is already extremely concentrated and this trend is continuing. There is strong pressure to permit the merger of a few existing banks and mergers continue in the related field of insurance. Exchanges have been restructured and the dealers association plays a very important role at different levels, including regulation. Representatives of the financial industry constitute the majority of members of SRO's and key institutions in the financial sector. It seems that the sole competitive element remaining in the entire Canadian financial system is the regulatory aspect and is the result of provincial jurisdiction over securities. The proposed single commission would lead to the regulation of an oligopoly by a regulatory monopoly in a sector where the industry already dominates the regulatory organizations. Unless the capture theory of regulatory organizations does not apply in Canada, the eventual elimination of the single element of competition must therefore be considered with extreme care.

As Coleman pointed out in 1992, a model similar in certain respects to that taken by the European Community could, by instituting mutual recognition, improve the current system while preserving a certain level of regulatory competition which seems essential, given the concentration of institutions and markets.

PART 6

6- GROWTH OF THE CANADIAN SECURITIES MARKET: FINDINGS AND CHALLENGES

In his letter to the Deputy Prime Minister and Minister of Finance of Canada, MacKay (2002) writes: *Vibrant and fair capital markets and their key components (including the securities regulatory apparatus) are essential to the health of Canada's economy and to the success of Canadian-based companies*. The development of a dynamic, liquid and efficient equity market is an important condition to the economic development of a country.[156] It allows companies to obtain financing at the lowest possible cost, thereby improving their competitiveness. In Canada, the stock market has undergone major upheavals and, according to the promoters of regulatory centralization for securities, regulatory decentralization and multiple securities commissions hurt its development. MacKay established a direct link between the regulatory situation and the securities market in Canada. However, there is relatively little empirical data and, as Harris observes (2002): *the debate in Canada typically has not been informed by robust empirical analysis and suffers from a lack of empirical data on the central issues in respect of Canadian securities regulation*. Several authors have a relatively optimistic view of the Canadian market. For example, Boisvert and Gaa mention (2002): *in Canada, the number of shares on the Toronto Stock Exchange has doubled in the last five years, while the dollar value of trading has increased three-fold*. Jenkinson and Ljungqvist (2002) place Canada among countries where the increase in stock exchange listings was the highest from 1981 to 1998, far ahead of the United States, Japan, and the United Kingdom.

This relatively optimistic vision is contrary to alarmist statements that the Canadian stock market is heavily penalized by its regulatory structure. An analysis of the evolution of this market is therefore in order.

The goal of this study is to contribute to a better understanding of the reality and issues in Canadian securities markets. We seek firstly to characterize the evolution of the Canadian securities market since 1990. Curiously, it is a difficult task, as available data is generally incomplete or contradictory. It is also distorted by the restructuring of the exchanges in 1999. This characterization will be done according to the main aspects that allow us to describe a stock market and its evolution, and by using the main markets of OECD countries as a point of reference. In the second stage, we will analyze the competitive position of the Canadian market based on the evolution of trades for interlisted stocks. Finally, we will discuss the known factors

[156] This is the classic view as expressed for example by Bekaert and Harvey (1998), with respect to developing economies. Given growing market integration and foreign market financing possibilities, it is unclear whether this argument is still as important in developed economies in the 2000's.

to assist, or instead limit, the development of modern markets and try to determine the importance of these factors in Canada. In particular, we will attempt to determine to what extent regulatory elements can interfere in this respect. In conclusion, we will look at the real challenges affecting a market very much subject to American competition, which debates centered solely on regulatory structure tend to obscure.

6.1 Canadian market development

6.1.1 Measurements of stock market development

The number of listed corporations or securities, total capitalization and trade volume are classic indicators of the level of development of a stock market. Each of these variables, however, captures only a single aspect of complex reality: the number of securities may hide considerable differences in size and capitalization gives little information if the securities are rarely traded. Moreover, the evolution of these different quantities over a given period provides more information than the level, especially when the evolution is compared to that of other markets.

Finally, because of market globalization, the capacity of a market to attract corporations already listed elsewhere and to keep the trading of domestic securities has become an important factor. Accordingly, we find three groups of indicators: 1) capitalization levels, trade volume and number of listed corporations, 2) the evolution of these levels during the period 1990 to 2002 and 3) the evolution and size of trades in Canada of securities of foreign corporations and foreign trades of Canadian interlisted securities.

Each of the measures of market size must be subject to analysis and adjustments. The number of listed corporations must be considered in relation to listed but not operating corporations and the study of the distribution of the size of companies, in particular due to the existence of capital pools, which allow initial offerings of $500,000 and less—tiny compared to international standards. Total capitalization is an indicator that suffers also from several types of gaps. Its variation may have two origins. It may be related to the growth of issued capital through initial or secondary offerings net of redemptions. It is an important indicator, often clouded by the effect of variations of market indices, which is the second factor explaining the variation. Capitalization amounts issued by the exchanges therefore combine two effects which it is crucial to distinguish. Trading volume is also an important indicator, but the effect of the variation of the index must also be distinguished from the real increase in activity. As with capitalization, the Canadian variation will be compared to that of other developed countries.

Most data available for Canada, which mainly comes from the stock exchanges, is subject to several problems, which it is useful to note:

- Inactive companies: not numerous on most markets, represent more than 20% of the corporations listed in Canada;

- Foreign corporations, whose capitalization is enormous compared to the size of the Canadian market, were taken into account in the capitalization of several exchanges. Several disappeared from the lists, and accordingly from the calculation of total capitalization, without being specifically mentioned, during the 1990's. This is the case for IBM, which disappeared as a listed security in Canada in 1995. The TSX showed a total capitalization of $1,300 billion in 2001, but $264 billion was associated with foreign securities, which are almost never traded on this market;

- Securities traded on several exchanges, mostly banks, showed in the capitalization of each exchange until the restructuring in 1999. It is incorrect to calculate total Canadian capitalization by adding the capitalization of the four exchanges which were active before the restructuring. Restructuring therefore causes an apparent lowering of capitalization and of the number of companies, which is simply a return to normal;

- Capitalization of fixed income securities. The CDNX includes in its capitalization a significant amount as capitalization of debt instruments[157];

- Securities interlisted in the United States: several Canadian securities are almost exclusively traded in the United States.

Moreover, the restructuring of the Canadian exchanges greatly influenced data and its evolution. The Alberta and Vancouver Exchanges merged in 1999, soon joined by the Winnipeg Exchange (2002) to form the CDNX[158], which is now the Canadian Venture Exchange. In May 2001, the CDNX became a subsidiary operating separately but owned by the TSE, whose infrastructure it was to soon use. In October 2001, small capitalization securities of the Montreal Exchange were transferred to the

[157] CDNX Monthly Review, December 2000, p. 5.
[158] See Boisvert and Gaa (2002) for an analysis of the reasons, consequences and methods of restructuring.

CDNX, which opened an office in Montreal[159], and the Montreal Exchange specialized in derivatives. It is therefore difficult to have a clear image of the evolution of the Canadian securities market. However, such an image is necessary to assess and guide public policy in this strategic sector of the economy.

6.1.2 Number and characteristics of public corporations

The overall evolution of the number of securities officially listed in Canada is greatly influenced by the exchange restructuring. In addition, the Canadian market is made up of a number of small companies with a high mortality rate, which makes it an atypical market compared to the stereotype of markets of developed countries.

6.1.2.1 A very small-cap market

Table 13 gives a breakdown of corporations listed in Canada, according to their net book value in 2001[160]. Around 21% of listed Canadian corporations in 2002 were not operating. These corporations reported no assets or no longer send information to SEDAR. Most listed corporations are very small: 67% of operating corporations have shareholder equity of less than $10 million. More than 70% of companies whose net book value is less than $10 million come from British Columbia or Alberta. Finally, on the sole basis of shareholder equity, only 415 companies could be listed on the NYSE, and approximately 590 on NASDAQ[161].

The relative importance of small-cap securities must be taken into consideration when studying methods of organizing and regulating markets. Small-cap securities are generally rarely traded, which creates liquidity problems. Low liquidity causes higher trading costs and, according to several authors, is inversely related to the market risk premium[162]. Both factors directly influence the cost of capital for businesses. Moreover, the small size of many issuers requires more flexible and restrained regulation.

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[159] The transfer covered 108 corporations. A first transfer of certain classes of small-cap securities took place in November 1999. Large-cap securities were transferred on December 6, 1999. http://www.newswire.ca/releases/September2001/27/c1721.html.

[160] Since capitalization cannot be calculated for around 25% of securities which are not regularly traded or have been suspended, book values have been used.

[161] By keeping capitalization equivalent to equity, the threshold to maintain listing on the NASDAQ is US$50 million or approximately CDN$75 million and on the NYSE is US$100 million or CDN$155 million. Securities, however, must comply with other criteria respecting shareholding and revenues.

[162] See Swan (2002) for an analysis of this relationship and a review of the different studies on this subject.

Table 13: Distribution of shareholder equity for corporations listed on the Canadian market for the end of November 2002

Province of incorporation	In millions ($) < 10	>=10 and <50	>= 50 and < 100	>= 100 and < 1000	>= 1000	Total Operating	Non Operating	Total
British Columbia	965	104	30	44	32	1175	222	1397
Alberta	569	123	36	53	21	802	270	1072
Ontario	327	142	64	130	28	691	177	868
Québec	150	61	22	52	19	304	54	358
Yukon	75	13	5	1		94	30	124
Foreign	45	11	3	13	8	80	92	172
Manitoba	17	3	1	7	5	33	12	45
Nova Scotia	6	6	3	4	5	24	14	38
New Brunswick	9	6	2		3	20	5	25
Saskatchewan	7	5		2	2	16	3	19
Newfoundland	2			6		8		8
Northwest Territories	3					3		3
Prince Edward Island	1		1			2		2
Total	2176	474	167	312	123	3252	879	4131

Source: *Cancorp Financials*. The place of incorporation of corporations with a Canadian charter has been estimated from the city of their head office. A non-operating corporation is a corporation which reports no assets or did not file financial statements after 2000.

During the period preceding the exchange restructuring, the number of corporations listed in Alberta regularly increased from 1990 (742) to 1998 (1,035), especially because of capital pools, representing total growth of 39.5% (Table 14). In Vancouver, the situation is reversed: the number of listings went from 2,104 to 1,384, a 34% decrease. The Montreal Exchange saw a smaller decrease (11.9%), dropping from 657 in 1990 to 579 in 1998. The Toronto Stock Exchange, on the other hand, showed regular growth and the number of listed corporations increased by 20% (from 1,193 to 1,433). Taking all exchanges together, there was a decrease in the total number of listed companies in the Canadian marketplace from 4,696 in 1990 to 4,431 in 1998, representing a 5.6% decrease, which seems to be specifically related to the disappearance of several companies in British Columbia.

6.1.2.2 The disruptive effects of restructuring

On November 22, 1999, the trading of certain classes of shares of small-cap corporations was transferred from the Montreal Exchange to the CDNX[163]. On December 6, 56 large-cap corporations (64 securities) on the Montreal Exchange were transferred to the Toronto Exchange and interlisted securities are henceforth only traded on the TSE. The number of corporations listed in Montreal went from 532 on November 30, 1999 (759 securities) to 129 on December 31, 1999 (140 securities), a decrease of 403 listed corporations (619 securities). The transfer covered over $1,000 billion[164] of capitalization; however, they were essentially securities already traded in Toronto, and the transfer had little effect on the capitalization of that exchange[165]. The transfer seemed to be an opportunity to de-list around 400 securities which probably did not meet the criteria of either of the two original exchanges.[166] In October 2001, all remaining small-cap securities were transferred from the Montreal Exchange to the CDNX. These activities make it difficult to follow the evolution of the market.

6.1.2.3 Creation and disappearance of listed corporations

During the period studied, the number of listed corporations decreased overall by 808, dropping from 4,696 to 3,888. Between 1991 and 2000 there were 1,891 initial public offerings (IPO) of companies other than mutual funds, trusts or limited partnerships, of which 1,217 issues raised amounts less than $1 million, mainly within capital pools (868 issues). The net decrease in the number of businesses therefore translates into a significant "death rate", which may result from mergers, going private, or delisting[167].

[163] Annual report of the Montreal Exchange, 1999, p.12. There were 532 listed corporations left in Montreal on November 30, 1999, as compared to 579 on December 31, 1998, and 47 were therefore transferred. In total, 1,384 corporations from Vancouver, 1 035 from Alberta and 47 from Montreal, or 2,466 corporations, were therefore transferred The CDNX gained 2,358 corporations. The 108 securities that disappeared probably did not meet the CDNX listing requirements.

[164] Estimated based on the difference in stock market capitalization as at November 30, 1999 ($1,005.873 billion) and on December 31, 1999 ($0.684 billion), according to the 1999 annual report of the Montreal Stock Exchange.

[165] 91 companies were listed both on the Montreal and Toronto Exchange, three of which were also listed in Vancouver. One company was listed in Toronto and Vancouver. No foreign interlisted company was listed on more than one Canadian Exchange.

[166] An increase of 403 securities on the Toronto Exchange (more companies transferred from Vancouver and Alberta to Toronto) was observed, but the increase was only 23 securities from 1998 to 1999.

[167] For December 1998 only, there were 25 de-listings on the TSE (TSE Review, December 1998), and four in Montreal

The Canadian market is therefore characterized by the presence of a large number of new businesses (an average of 189 IPO's per year), generally small-cap, but also by a significant death rate among listed corporations. There are thus more initial Canadian offerings, but their gross proceeds are less than in other countries: in Canada, there are around 189 IPO's per year, as opposed to 47 in France, 80 in United Kingdom and 43 in Germany according to Ljungqvist and Wilhelm (2002)[168]. On average, initial offerings raised \$131 million in Germany, \$74 million in France and \$93 million in United Kingdom. In Canada, the average amount initially raised by an IPO is \$31 million if we exclude capital pools, \$17 million if we count all issues and close to \$2.5 million, if we leave out five privatizations and five demutualizations which raised a third of the total gross proceeds during the period.

Table 14: Annual distribution of the number of listed corporations on the Alberta, Vancouver, Montreal, Toronto and CDNX exchanges between 1990 and 2001

Year	Vancouver	Alberta	Montreal	Toronto	CDNX	Total
1990	2104	742	657	1193		4696
1991	1905	690	609	1138		4342
1992	1738	614	584	1119		4055
1993	1642	672	573	1193		4080
1994	1599	755	575	1251		4180
1995	1515	797	558	1258		4128
1996	1495	874	555	1323		4247
1997	1429	999	577	1420		4425
1998	1384	1035	579	1433		4431
1999			129	1456	2358	3943
2000			128	1398	2598	4124
2001			118	1316	2688	4122
2002			80	1304	2504	3888

Sources: Montreal Stock Exchange: Rapport d'activité au 31 décembre 2002, http://www.m-x.ca/f_stat_fr/0212_stats_fr.pdf, Revue mensuelle, 1999-2001; Statistiques, Recherche et information sur le marché (1991), Statistiques, faits saillants: Négociations, inscriptions, membres (1992, 1993); Revue boursière et répertoire des sociétés (1994, 1995, 1996, 1997 and 1998). Toronto Stock Exchange Review, Alberta Stock Exchange Review, Vancouver Stock Exchange Review, and CDNX monthly Review. ftp://ftp.cdnx.com/Publications/CDNXReviews/.

[168] Authors also count 4,541 IPO's in the United States, representing 412 per year, for an average amount of approximately \$93 million.

6.1.2.4 Canada and other countries

The United States represents the largest exchange in the world, with over 7,500 companies in 2000 (Table 15). Canada is in second place if we use S&P data, for a very significant change in the number of listed corporations from 1999 to 2000 (the number triples), as compared to Germany (the number doubles) or France (a 40% increase). The strong Canadian growth is, however, due to a different basis of measurement; the S&P takes into account only companies listed on the Toronto Exchange in 1990, but includes those of the CDNX in 2000. If data provided by the Toronto Exchange is used for the entire period (Panel B of Table 15), the variation in the number of listed companies is only 12.49%, when corrected for the 56 corporations transferred from Montreal to Toronto. This evolution is similar to that of the United States and the United Kingdom.

Table 15: Distribution of countries sampled according to the number of listed corporations at the end of 1990 and 2000 and distribution of the number of listed corporations at the end of 1990 and 2000

Panel A Initial distribution

	2000		1990		Variation
	Rank	Number	Rank	Number	in %
United States	1	7,524	1	6,599	14
Canada	2	3,977	4	1,144	248
Japan	3	2,561	2	2,071	23.7
United Kingdom	4	1,904	3	1,701	11.93
Germany	5	1,022	7	413	147
France	7	808	5	578	39.8

Panel B Corrected distribution to take account of stock exchange restructuring

	2000		1990		Variation
	Rank	Number	Rank	Number	In%
United States	1	7,524	1	6,599	14
Japan	2	2,561	2	2,071	23,7
United Kingdom	3	1,904	3	1,701	11.93
Canada TSE	4	1,398	4	1,193	17.18 (12.49)
Germany	5	1,022	8	413	147
France	7	808	6	578	39.8

Sources: Standard & Poors, Emerging Stock Market Fact Book, New-York, 2000, 2001, and TSE Review, 1993 and 2001, Five Year Statistical Summary.

6.2 Capitalization Growth

Table 16 shows capitalization growth in Canadian markets. Total capitalization of the Montreal and Toronto Exchanges in 1998 was $1,664.57 billion ($830.37 and $834.20 billion). Following incorporation into the TSX of securities already listed in Montreal and Vancouver, on December 31, 1999 the Toronto capitalization should be (if new issues are omitted) $2,159 billion, taking into account the 29.72% variation in the SP/TSX index. However, capitalization in Toronto was $1,145.30 billion at the time. The difference simply results from no longer double counting interlisted securities. Canadian capitalization data prior to 1999 is therefore the only data allowing analysis and comparisons.

Figure 1 shows that the gross cumulative growth in capitalization of the Toronto Stock Exchange is very high. This growth reflects, however, mainly the variation of the market index during the period. However, real growth in Canadian market capitalization, corrected for fluctuations in the index, is only 4.2% annually, and it drops to 4% when growth from restructuring is eliminated. This growth represents net creation of capitalization. It almost corresponds to growth in the GDP calculated during this period by the OECD, namely 3.2% annually.[169]

Real Canadian capitalization growth is therefore slow and not very different from that of the economy. Statements referring to dynamic growth in Canadian exchanges should thus be given serious qualification, especially since capitalization data is not systematically related to data on activity, because of the phenomenon of interlisting. Moreover, the growth of the Canadian market should be compared to that of the main developed markets. They saw strong increases in the last decade. In terms of market capitalization, Canada is among the top six countries between 1990 and 2000 (Table 17), and we have used the five other countries as a basis of comparison.

[169] http://www1.oecd.org/publications/e-book/0102071E.PDF.

Table 16 : Growth of Canadian market capitalization between 1990 and 2002. Amounts are expressed in billions of Canadian $ as at December 31st each year.

	Vancouver	Montreal			Toronto			CDNX
	Total	Total	Canadian Companies	Non-interlisted Canadian Companies[2]	Total	Canadian Companies	Canadian companies (corrected data)[3]	Total
1990	2.95	373.04	251.83	44.37	703.30	280.70	280.70	
1991	3.59	395.10	278.32	57.18	703.50	308.00	308.00	
1992	4.13	367.29	272.69	37.91	703.10	308.90	308.90	
1993	7.32	495.71	356.17	26.17	862.10	432.30	432.30	
1994	6.24	448.40	365.89	12.69	803.70	441.90	441.90	
1995	7.29	502.07	417.27	19.21	978.70	499.70	499.70	
1996	14.71	638.98	539.64	17.46	1,176.70	666.50	666.50	
1997	9.47	750.85	636.44	16.74	1,270.30	812.30	812.30	
1998	6.83	910.03	830.37	198.88[4]	1,350.30	834.20	834.20	
1999	6.74	0.68			1,498.20	1,145.30	1,142.75	16.65[1]
2000		1.09			1,433.90	1,156.70	1,154.04	14.87
2001					1,246.70	982.10	978.75	10.59
2002					909.02	897.90	897.90	11.12

Sources: Statistiques, recherche et information sur le marché, Bourse de Montréal (1990 et 1991), Statistiques, faits saillants: Négociations, inscriptions, membres, Bourse de Montréal (1992 et 1993), Revue boursière et répertoire des sociétés, Bourse de Montréal (1994 à 1998), Revue mensuelle de la Bourse de Montréal (1999 à 2001), Toronto Stock Exchange Review, Alberta Stock Exchange Review and Vancouver Stock Exchange Review, and CDNX Monthly Review (ftp://ftp.cdnx.com/Publications/CDNXReviews/).

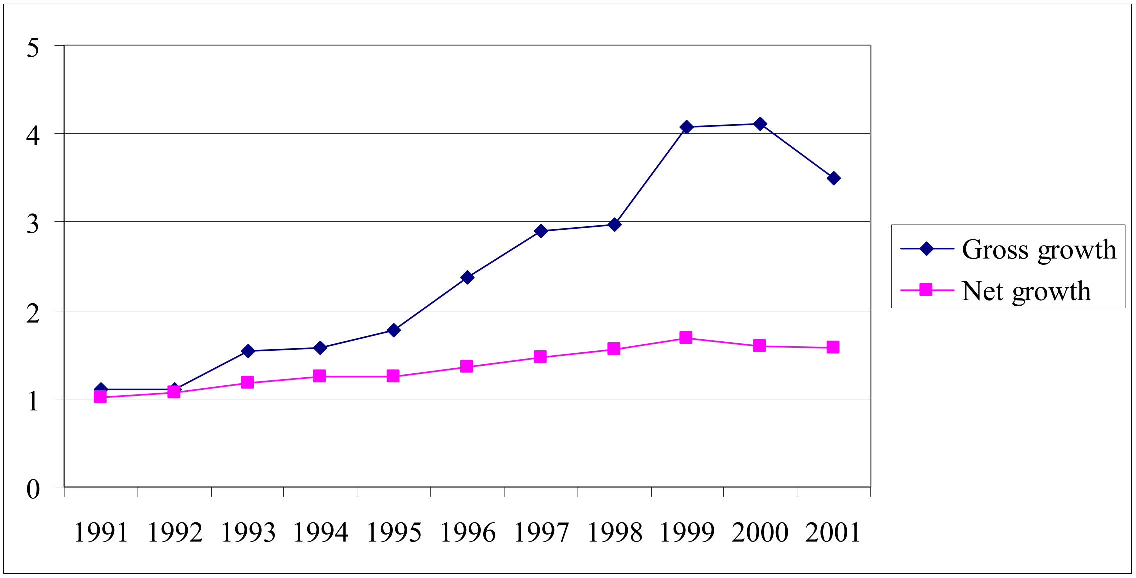
[1]CDNX capitalization excludes capitalization of companies interlisted on other Canadian exchanges, but includes capitalization of debt instruments. For 2000 and 2001, the table shows corrected capitalization. Respectively out of $107 and $137 billion of capitalization reported for 2000 and 2001, only $14.87 and $10.59 billion correspond to share capitalization. Information is unavailable for 1999.

[2]To eliminate the effect of double counting from interlisting, we have estimated the amount of Canadian interlisted share capitalization from interlisted companies in Canada in 1998, and from capitalization for these securities for each year from 1990 -1998.

[3]This is the corrected (decreased) capitalization for Canadian companies for the transfer of non-interlisted companies from Montreal for 1999, 2000, 20001.

[4]Data for 1998 is in accordance with values given by the Exchange, but is still inexplicable. The enormous growth of domestic capitalization in 1998 may be related to the fact that the Exchange counted that year total capitalization of companies for which it listed derivatives. Total capitalization of non-interlisted securities transferred to Toronto in 1999 is $2.55 billion, and cannot explain the lowering of capitalization by $1.98 billion from 1998 to 1999.

Figure 1: Cumulative Canadian market capitalization on the Toronto Stock Exchange between 1991 and 2001. Net growth is gross growth adjusted for end-of-year SP/TSX index fluctuations.



Source: TSE Review and Datastream.

Table 17: Ranking of the first 6 countries at the end of 1990 and 2000 by market capitalization, distribution of market capitalization in billions of US$, according to S&P data. Panel A shows gross data, panel B shows data net of index fluctuations.

Panel A	Variation (%)	2000 Rank	2000 Capitalization	1990 Rank	1990 Capitalization
United States	393.76	1	15,104	1	3,059
Japan	8.19	2	3,157	2	2,918
United Kingdom	203.53	3	2,577	3	849
France	360.83	4	1,447	5	314
Germany	257.75	5	1,270	4	355
Canada S&P	247.93	6	842	6	242
Canada corrected	218.60	7	771	6	242

Panel B	Variation (%)	2000 Net Capitalization	1990 Net Capitalization
United States	23.50	3,778	3,059
Japan	-29.34	2,062	2,918
United Kingdom	51.83	1,289	849
France	62.10	509	314
Germany	52.39	541	355
Canada S&P	26.86	307	242
Canada corrected	16.12	281	242

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

In 1990, Canadian market capitalization consisted, according to S&P, in capitalization of listed companies on the Toronto Stock Exchange only, expressed in US dollars. In 2000, it was the capitalization of Canadian companies listed on the Toronto Stock Exchange and on the CDNX in US dollars. Capitalization of the CDNX includes capitalization of debt instruments for an amount of CDN$97 billion. This is an unusual practice, and share capitalization is only $14.8 billion. Total Canadian capitalization was thus artificially inflated in 2000. As data was only available on the international level, we are only using TSE capitalization for Canada in 1990 and 2000, but we are using S&P data for other countries. Canadian market capitalization more than tripled in the last decade, increasing from US$242 billion at the end of 1990 to US$771 billion in 2000. Canada ranks behind France, Germany and Switzerland[170] in 2000. Market capitalization for Germany tripled in ten years[171], whereas that of Japan stagnated. If these variations are corrected to neutralize variations in the market index (Panel B of Table 17), the net Canadian capitalization increase is, however, much lower than that of other countries (with the exception of Japan). The net Canadian capital created is 16% in ten years, as opposed to 62% in France, 52% in the United Kingdom and Germany, and 24% in the United States.

6.3 Growth of trade volume

On the basis of data from Levesque, Beaubien and Geoffrion Inc., Shearmur (2001, p. 223) shows extremely rapid growth in the value of trades on Canadian stock exchanges between 1976 and 1998. Table 18 shows, over the last decade, a breakdown of this growth essentially related to the growth of the Toronto market. Total volume of trades between 1990 and 1998 in $ grew slightly on the Alberta Exchange, whereas it decreased in Vancouver. It grew strongly on the Montreal and Toronto Exchanges. Average annual growth is around 24.5%. As the average annual return on capital from the index in this period is around 7%, real growth is around 17.7%.

Growth in the value of trades is, however, a worldwide phenomenon, stimulated by technological change and the unusual returns several markets experienced during the 1990's. A comparison with other developed markets must therefore be made. It is presented in Table 19, for 1990 and 2000[172]. The United States holds first place with a value for trades of around $32,000 billion in 2000, followed far behind by Japan ($2,700 billion), then by the United Kingdom with $1,800 billion. France and Germany follow with around $1,000 billion each.

The relative position of the Canadian market is deteriorating: it was in 9th position in 2000, with US$635 billion, whereas it was in 6th position ten years earlier. The Canadian stock market was surpassed by that of Spain, Italy, and the Netherlands. The value of trades rose from $71 to $635 billion between 1990 and 2000, but this increase is less than that of France, Spain, Italy and the Netherlands, which explains the drop in the Canadian ranking. In net terms, volume growth of Canadian trades is much less than that of the United States, but approximately the same as that of France

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170 Switzerland has a capitalization of $792 billion. Canada was in seventh position in 2000, whether we include capitalization of shares on the CDNX or not (for a total US$781 billion).

171 In France and Germany, significant privatizations between 1995 and 1997 explain a large part of the increase in capitalization.

172 For 1990 S&P reports the volume on the Toronto, Montreal and Vancouver Exchanges, and for 2000 the volume on the Toronto and CDNX Exchanges, and it does not appear useful to correct this data.

and the United Kingdom. Although the value of Canadian trades was 4.05% of the American volume in 1990, it represented 1.99% in 2000, and this decrease can be only partially explained by the differences between the market index returns in the two countries, which is around 3% during this period. Canada is thus progressively losing strength to other markets and in particular to the American market, the volume of which increased eighteen-fold.[173]

Table 18: Growth of gross trading volume expressed in billions of Canadian $ on various Canadian stock markets

	Vancouver	Alberta	Montreal	Toronto	CDNX
1990	4.06	0.62	15.40	64.01	
1991	3.47	0.57	18.33	67.75	
1992	3.57	0.98	21.06	76.16	
1993	6.78	2.14	30.35	147.06	
1994	5.78	2.23	32.44	181.91	
1995	6.42	3.37	38.59	207.67	
1996	12.00	5.97	50.17	301.30	
1997	8.67	3.87	61.91	423.17	
1998	3.79	1.78	55.65	493.21	
1999			0.46	529.00	1.15
2000			1.00	944.25	15.98
2001				712.52	3.61
2002				637.70	3.23

Sources: Revue mensuelle de la Bourse de Montréal, Toronto Stock Exchange Review, Alberta Stock Exchange Review and Vancouver Stock Exchange Review.

[173] It is, however, possible that the American volume is overestimated, in particular by double counting NASDAQ trades (Dyl and Anderson, 2002).

Table 19: Ranking of countries sampled and trading volume in billions of US $ at the end of 1990 and 2000. Panel A shows gross data. Panel B shows data net of index fluctuations.

Panel A	Variation (%)	2000 Rank	2000 Volume	1990 Rank	1990 Volume
United States	1,719.65	1	31,862	1	1 751
Japan	68.16	2	2,694	2	1 602
United Kingdom	557.71	3	1,835	4	279
France	825.64	4	1,083	5	117
Germany	Na	5	1,069*	3	502
Canada	794.37	9	635	6	71

Panel B	Variation (%)	2000 Net Volume	1990 Net Volume
United States	355.11	7969	1 751
Japan	9.80	1759	1 602
United Kingdom	229.03	918	279
France	225.64	381	117
Germany	Na	455*	502
Canada	225.35	231	71

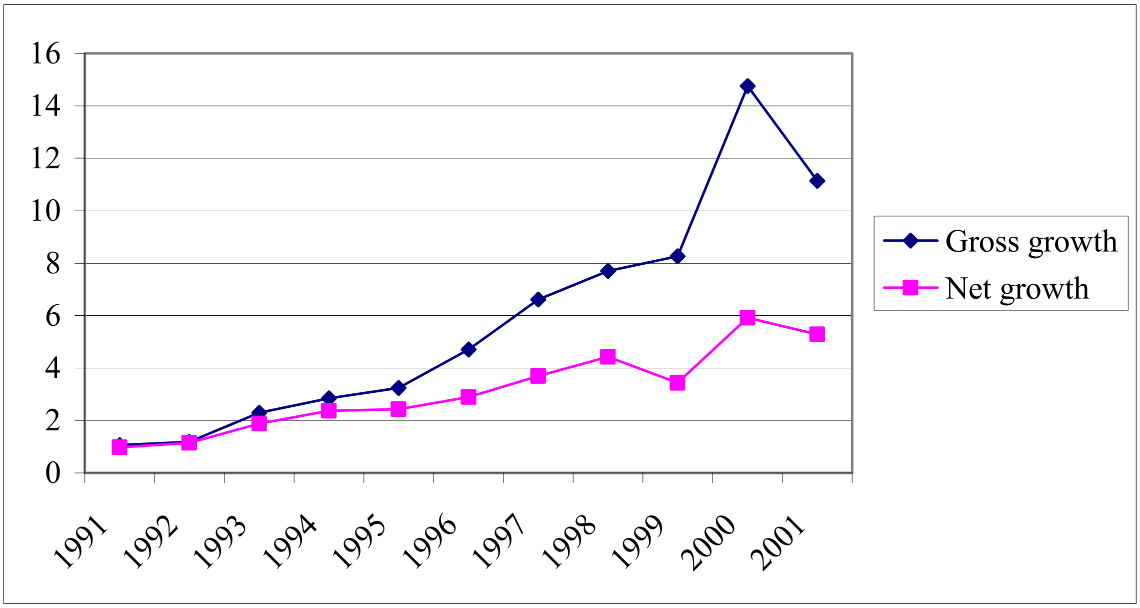
Sources: Standard & Poors, Emerging Stock Market Fact Book, New York, 2000, 2001, and stock market index by country from Datastream.

*Data for Germany is not comparable between 1990 and 2000. The method of recording volume was changed in 1997 to eliminate partial double counting of trades (Emerging Market Fact Book 2001, p. 37).

As with capitalization, the strong increase shown reflects two cumulative effects: a net growth of volume, representing actual volume for new trades, and a price effect related to variation in the index. We have decreased volume growth to roughly take into account index changes in the price of SP/TSX securities at the end of the year. Figure 3 shows that most of the strong increase in volume on the Toronto Stock Exchange comes from the increase in the index. Variations in the volume therefore result to a great extent from the increase in the average value of securities during the period.

Stock market growth is fuelled by internal factors, namely demand for capital from local companies and demand for securities from local investors. This growth may also be triggered by the issue of securities by corporations or, on the contrary, weakened by the transfer to other markets of trading in local securities.

Figure 2: Cumulative growth in trading volume on the Toronto Exchange between 1991 and 2001. Net growth is gross growth adjusted for fluctuations in the SP/TSX composite index



Source: TSE Review and Datastream.

6.4 The Canadian stock market in relation to the American market

Given competition by exchanges to keep domestic corporations and attract foreign securities, it is important to analyze activities of interlisted foreign securities and securities of Canadian corporations, traded mainly in the United States.

6.4.1 The attraction of the Canadian stock market

Table 20 is made up of tables of interlisted foreign securities from the Toronto Stock Exchange Review. They are mainly securities of American corporations.

The value of (worldwide) trades of interlisted foreign securities increased from 1990 to 1998, reflecting the existence of several large-cap securities, such as General Motors, Sony and Phillips Petroleum. The value traded decreased considerably in 1999, mainly because of the withdrawal of Mobil Corp and Citicorp from the Canadian market. The number of interlisted foreign securities decreased sharply from 54 in 1990 to 18 in 2002. However, the worldwide volume of trades executed for securities listed in Canada is insignificant, as these trades were conducted on other markets. The percentage volume of trades carried out in Canada is consistently less than 1%. In 2001, 23 corporations[174] were listed both on an American (or foreign) stock exchange and on a Canadian stock exchange. But only one of these 23 securities is more than 50% traded in Canada, and it was a very small-cap security (Gold Reserve Inc), which disappeared in 2002. For fifteen of the securities, Canadian volume represents less than 0.02% of total trading volume, and for seventeen of them Canadian volume represented less than 1% of total trading volume. The presence of foreign corporations on the Canadian market is symbolic—more than 99.9% of the value of trades for these securities is outside the Canadian market.

For comparison, interlisted foreign securities represent around 10% of trading volume on the NYSE (Boisvert and Gaa, 2002, p. 23) and more than 900 foreign securities are listed on the NYSE and NASDAQ. The Swiss market has 150 listings of foreign securities, London reports 448 and Luxembourg 208, according to data from the World Federation of Stock Exchanges (WFE). Canadian markets thus trade practically no foreign securities any more[175].

[174] The number of securities does not always correspond exactly to the number of different interlisted companies, as the same business may list several different securities. In 2001, however, all listed securities are issued by different corporations.

[175] The situation seems different, however, on the derivatives market. The Montreal Exchange reports an increase of 35% in 2002, as opposed to 9% in 2001, of its market share for interlisted Canadian options traded in the American market (April 23, 2003 ME press release).

Table 20: Annual distribution of the number and value traded of foreign and American interlisted securities and the breakdown of trades between Canada and other countries.

Yearly	# of securities	Value traded in millions of $	Securities of which the value traded is < 100 Millions $		>=$1,000 million		Traded in Canada[1] Total in %	# < 1%	# > 50%	Traded elsewhere[1] in %
			#	%	#	%				
1990	54	212,379	15	27.78	29	53.70	0.00	47	0	100.00
1991	57	218,813	14	24.56	29	50.88	0.20	48	1	99.80
1992	63	251,522	21	33.33	27	42.86	0.10	49	6	99.90
1993	62	326,617	20	32.26	29	46.77	0.20	46	4	99.80
1994	56	297,547	14	25.00	31	55.36	0.10	42	3	99.90
1995	47	282,585	13	27.66	25	53.19	0.10	35	5	99.90
1996	47	316,994	15	31.91	19	40.43	0.20	34	6	99.80
1997	35	369,691	8	22.86	20	57.14	0.10	26	2	99.80
1998	32	452,385	8	25.00	19	59.38	0.00	26	2	100.00
1999	24	203,057[2]	7	29.17	14	58.33	0.60	17	2	99.40
2000	23	186,971[2]	7	30.43	11	47.83	0.70	17	2	99.30
2001	23	180,345[2]	4	17.39	12	52.18	0.10	19	1	99.90
2002	18	176,192	5	27.78	9	50.00	0.10	14	0	99.90

Sources: Toronto Stock Exchange Review, December 1990 to December 2002.

[1] The percentage of value traded is based on capitalization.

[2] The total value traded reported by the TSE Review for 1999, 2000 and 2001 is respectively 189,934, 168,771 and 170,011 and does not correspond to the total value traded for each interlisted security (reported in this table).

[3] Certain securities did not trade: in 1990, Coleco Ind and Stan West J, 1993, British Tel instl, in 1996, Owens Corning (2 securities) and, in 1997, Tenneco Inc.

6.4.2 The attraction of the American market for Canadian stock exchanges

Table 21 shows significant growth in the number of interlisted Canadian securities over the past decade. The number went from 143 in 1990 to 237 in 2000, a 65% increase. The trading value also grew considerably: from \$69 billion in 1990 to \$1,280 billion ten years later. In 2001, the trading value decreased to \$805 billion, mainly because of the loss of value of Nortel Networks (a \$353 billion decrease) and BCE Inc. (a \$75 billion decrease). The percentage of trading volume which took place outside Canada sharply increased from 1998 to 2000, a year in which only 46% of trades of interlisted securities was made in Canada. The TSX seemed to regain ground and in 2002 the Canadian share exceeded 60%. This variation seemed in large part associated with the crash of technological stocks which, following their large dip, were abandoned by American investors. Nortel represented \$508.3 billion of trades in 2000, of which 65.7% took place in the United States. Trades rose to \$41.9 billion in 2002, of which 51.2% were in the United States. BCE dropped from \$96.8 billion and 25.5% of U.S. trades to \$25.5 billion and 12.6%. Corel went from \$9.1 billion and 88.5% of U.S. trades to \$194 million and 58.1%. These three stocks together represent a decrease in trading volume in the United States of around \$350 billion. We will have to wait several years to experience a significant and sustainable realignment of the proportion of interlisted stocks traded in Canada.

The proportion of stocks traded mainly on foreign exchanges went from 40 companies out of 143 in 1990, or 28%, to 36% in 2001 and 37.1% in 2002. This does not include Canadian companies directly listed on an American exchange (without being interlisted). There were thirty-five of them in 2001 according to the final prospectus of the TSX Group inc. (p. 18). We calculated that Canada is still the main market (where most trading takes place) for 67% of interlisted companies whose annual trading volume is less than \$120 million. However, in 2000 91 Canadian stocks had a trading volume of over \$1 billion. 85 of them were interlisted. In 2001 the corresponding figures were 83 and 75 respectively. Heavily traded Canadian stocks are thus almost all interlisted. We then calculated as follows the proportion of heavily traded interlisted stocks, for which the main market was the United States. In 2000 this proportion was 32%. In 2001 it was 36%. In 2002, it reached 38%. More than one-third[176] of heavily traded Canadian stocks are now traded more in the United States than in Canada. The Canadian stock market does not seem to attract trading in foreign stocks. On the other hand, the U.S. market captures a significant portion of the trading of large interlisted Canadian companies. This is a very worrisome situation, given the importance of a stock market for a country.

[176] Around 90% of heavily traded stocks are interlisted, and 38% of them are mainly traded in the United States. In relation to the number of large-capitalizations, 33.4% of stocks are now mainly traded outside of Canada, and this proportion is growing.

Table 21: Annual distribution by number and value traded of Canadian stocks traded in the United States and geographical breakdown of trades

Yearly	# of securities[2]	Value traded in millions of $	Securities of which the value traded is < $100 million		>= $1,000 million		Traded elsewhere[1]			%
			#	%	#	%	Total in %	# < 1%	# > 50%	Traded in Canada[1]
1990	143	68,540	93	65.03	16	11.19	45.3	8	40	54.7
1991	139	59,115	91	65.47	16	11.51	39.6	6	35	40
1992	137	68,019	79	57.66	16	11.68	40.2	7	30	59.8
1993	157	149,760	70	44.59	29	18.47	54.1	12	46	45.9
1994	172	199,014	83	48.26	35	20.35	50.7	15	57	49.3
1995	200	249,886	85	42.50	48	24.00	45.3	27	74	54.7
1996	222	334,304	74	33.33	66	29.73	42.2	20	81	57.8
1997	243	411,477	85	34.98	69	28.40	35.4	24	85	64.6
1998	244	490,663	92	37.70	75	30.74	34.8	19	93	65.2
1999	222	566,331	88	39.64	69	31.08	42.1	18	74	57.9
2000	237	1,280,983	71	29.96	85	35.86	54.1	32	89	46
2001	213	805,399	79	37.08	75	35.22	46.7	19	77	53.3
2002	194	665,373	55	28.35	73	37.63	38.8	6	73	61.2

Source: Toronto Stock Exchange Review, December 1990 to December 2002.

[1] The percentage of trading value is based on capitalization.

[2] Certain securities show zero trading value: in 1990, Fahnestock II, in 1994, Currage inc. and U. Dominion, in 1995, Curragh Inc., in 1996, STN inc., in 1997, Trizec Hahn and Moores Retail, and in 1998 Rea Gold and Tee-Com.

The number of Canadian securities listed in Canada is significantly lower than that reported in other studies (Houston and Jones, 1999, Table 2). These authors base their estimates on lists of the American stock exchanges and therefore include securities listed on any of the Canadian stock exchanges in addition to those which are only listed on American stock exchanges. Our estimates only cover interlisted securities traded on the Toronto Stock Exchange. The difference is around 35 securities.

6.5 Competitive advantages of stock markets

There are two sub-categories of works respecting stock market development. The first includes texts devoted to developing countries and refers to factors such as privatization, opening of markets and a legal system ensuring investor protection (La Porta *et al*, 1997; Black, 2001). However, as Black has noted, markets such as those of the United States and the United Kingdom have already reached this level of development and we will deal mainly with the second sub-category of works which deal with competition and comparative advantages between developed markets. These works attempt to answer the following question: What factors lead investors and issuers to prefer one market over another? These factors may be put into three groups, respectively related to the quality of markets (and information), applications for registration and various other factors we will group under the heading of marketing.

6.5.1 Market quality

For Halpern (2000), the main requirement for markets to operate is information, which leads to a bias in favour of domestic stocks, as well as risk capital, stock exchange development and governance, initial offerings and the dynamics of intermediaries. Wells (2000) recognizes the growing competition between stock exchanges and relates their competitive advantage to the mechanism of discovering prices, which is associated with the various components of market quality. In particular, for Wells, the aspect which will guide stock market growth is the demand by institutions for block trades, which few exchanges adequately support.

Theoretical models developed to explain the growth of trading volume in interlisted securities (Chowdhry and Nanda, 1991) show the emergence of a dominant market in accordance with the *winner take most* rule. These models distinguish *liquidity traders* from *informed traders.* Liquidity traders trade without any specific base of information and are attracted to the market where trading costs are lower and create liquidity. *Informed traders* base their trading on analysis and information. Essentially, they are institutional investors, who maximize their return by trading in the most liquid market. Accordingly, even if the total trading volume increases when a stock is listed on a secondary market[177], the trading volume in the country of origin may increase or, on the contrary, sharply drop depending on whether or not the country has a dominant market position. The Canadian market is apparently not a dominant market for foreign stocks (except one in 2001), and it is progressively

[177] Foerster and Karolyi (1993) observed a 62% increase in the total trading value of Canadian securities in the three months following their listing on an American exchange. This increase is especially noticeable on the American market, but the value traded on the Canadian market also increased by 26%.

losing its role as the principal market for high-volume Canadian stocks (with the exception of banks, probably because of rules governing the holding of these institutions). It is possible that this phenomenon will grow, to the extent that, according to Eun and Sabherwal (2003, p. 1), *attracting non-US listing is now a top priority of the US stock exchanges.* This tendency of moving trades to American stock exchanges is not specific to Canada. Pagano *et al*, (2002, p. 1) shows that *in 1986-1997, many European companies listed abroad, mainly on U.S. exchanges, while the number of US companies listed in Europe decreased.* The authors state that *the listing of EU companies in the United States went from 53 in 1986 to 207 in 1997, while in the same interval, their listing within Europe went from 267 to 309.* In addition, interlisting of Canadian corporations has been facilitated since November 1, 1998, by the implementation of the MJDS which allows Canadian corporations to list their stocks in the United States, under easier criteria than what exists for other non-American corporations[178]. However, as Pagano *et al* (2002, p. 2657) point out: *of course, if exchanges compete for new listings by adjusting their regulatory standards, this motive for cross-listing may diminish over time.*

Models predict that the transfer of trading will continue to gravitate to the country offering the most favourable trading conditions. For investors who must trade large blocks of shares, the various components of trading costs are an essential element in the choice of trading location. Foerster and Karolyi (1998) analyzed the evolution of ranges following the decision of Canadian corporations to list their stocks on the American market. They measured both the *posted bid-ask spread* and the effective spread[179], and took into account the different factors influencing the ranges, such as price level, size and volume of trades. The two measures of the range showed a significant drop following listing of stocks on an American market, but this decrease especially affected stocks for which the transfer of trading to the United States is the greatest. This decrease is measured on the Canadian market and shows that the Canadian market adjusts to a more competitive environment as soon as the stocks are widely traded on a competitive market. Trading costs may thus be lower on the American market than the Canadian market, and interlisting may reduce these costs even on the Canadian market. There is little evidence, however, as cost measurement is difficult. Costs depend on volume and liquidity, size of trade, price of stocks. Cleary *et al* (2002) showed the great sensitivity of trading costs to various factors; they cite and criticize the study of Elkins (1998), who compares the impact cost of

[178] The MJDS is a joint initiative of the CSA and the SEC. See National Instrument 71-101: The multi-jurisdictional disclosure system at http://www.cvmq.com/upload/fichier_pdf/norme/71-101ang.pdf.

[179] The *effective spread* is the difference (in absolute value) between the price of the trade and the middle of the range.

institutional trading on the NYSE (0.18%), the NASDAQ (0.35%) and the TSE (0.29%), and noted significantly higher trading costs[180].

Kryzanowski and Rubalcava (2002) analyze the range and length of holding Canadian interlisted shares. Their results s*uggest that the TSE has consistently lost its share of executed order flow (share turnover) relative to the U.S. primary trade venue, and that this loss is associated with increased relative trade costs in the TSE*. Doukas and Swidler (2000) observe an abnormally positive return for Canadian companies interlisted in the United States, which results in a reduction in the cost of capital. According to this work and that of Foerster and Karolyi (1993 and 1998), the transfer of trading to the United States lead to increased volume, a lower cost of capital and decreased trading costs, when they were directed towards the NYSE.

Mittoo (1997) shows, before 1991, that the growth of trading volume after interlisting is greater for VSE securities than for those which were listed on the TSE. This difference may be related to the less stringent requirements of the VSE. By meeting American standards, companies listed on the VSE improved their disclosure. Their regulatory environment became more similar to that of the TSE, which seemed to have attracted greater interest from investors[181].

In a recent study, Mittoo (2002) confirms that Canadian companies have always been attracted by the American stock market. Between 1991 and 1998, 108 Canadian companies were listed in the United States[182]. The abnormally positive return seen on listing in the United States is not as great as that reported in previous studies, and it is positively related to increased liquidity. The trading volume increases by 40% after 6 months. Most of this increase is captured by the American market. However, the effects of interlisting are different depending on the companies. Mittoo observes that decreased trading costs are only noticeable for securities of which the trading volume increases after the transaction, and it does not exist for natural resource companies. The listing effect in the United States on trading costs is therefore lower than that

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[180] The measuring of impact costs is difficult because it involves comparing the price of a trade to what would have been in the absence of the trade. This unobservable price is estimated using different models, that chosen by Elkins/McSherry Co tend to underestimate the price effect. In addition, several studies cited were conducted during the period where the tick was different in the United States and in Canada. The lower increments in Canada, because of decimalization, might have temporarily lowered the trading costs measured.

[181] This observation is important for proponents of the overall lessening of the regulatory burden. According to the explanation put forward in this study, the lowering of standards could reduce liquidity and encourage more companies to interlist.

[182] Houston and Jones (1999) found 149 new listings during the same period. The difference is probably due to the fact that Mittoo considers securities listed in Canada whereas Houston and Jones also include companies which are not listed in Canada.

reported previously by Foerster and Karolyi (1998). The long-term performance of recently listed securities in the United States is significantly negative. This may be related to the fact that Canadian companies list in the United States after a period of strong stock market performance. Overall, this activity seems to have a positive effect on short-term prices, increased liquidity and lowering of trading costs which is not as great as that mentioned above.

Although differences between levels of trading costs are relatively weak (Smith *et al* 2000) and sometimes slightly lower in Canada due to more frequent use of upstairs trading and although the advantages of interlisting seem to be decreasing, the US market continues to attract Canadian companies. This evolution has not been checked by the steps taken by the TSE in response to competition from American stock markets. According to Mittoo (2002), the TSE adopted decimalization in April 1996 for securities trading at $5 and up and implemented the minimum quotation increment reduction (MQIR) for two classes of shares. However, the NASDAQ and the NYSE reacted quickly by adopting similar measures. Several studies show that the spread decreased in Toronto following decimalization. Liquidity gains related to interlisting seem to have also decreased, which could correspond to a lesser advantage in the US market. However, it still exists.

Trading costs, however, are only one aspect of the problem. Trades are the basis of the mechanism to determine price, through which information shown by orders comes together in the market price. For economists, the ideal way to determine price is a public auction. However, stock exchanges are not transparent auction mechanisms and must meet several challenges. According to the Wells (2000), the main ones are the following:

- Access: who can have access to the order book?
- Liquidity: what measures are taken to ensure sufficient liquidity?
- Protection of order priority;
- Block trades must have a minimal impact on price, and all trading;
- Best possible trade, which relates to the problem of trading costs;

- Transparency, which gives all participants information simultaneously;

- Fragmentation of orders and price centralization.

We will not review here the Canadian situation respecting each of these factors, a study which is largely outside the scope of our report. Order fragmentation and price centralization is, however, a major factor related to the information argument. Order fragmentation has been invoked to justify restructuring the Canadian stock exchanges and to restrict the activity of alternative trading systems. A fragmented system has little liquidity and requires setting up a centralized data system.

The problem of fragmentation is crucial in a small market, where 80% of trading volume comes from institutional investors[183]. They must be able to dispose of their position quickly, without excessive market reaction. Fragmentation results in Canada from the splitting into two relatively equal parts trading in the most active stocks between Canada and the United States. It also results from internal trades, which happen when a broker combines orders of his own clients. Upstairs trading is allowed by TSX rules, but it is greatly restricted by the NYSE (Smith *et al*, 2000). This practice covers most trading by institutional investors (54% in 1997, according to Smith *et al)*. A broker does not place an order in the stock market, and does not reveal the trade immediately, which may have an important information effect on price. Upstairs trading favours institutional investors and is used both by dealers with an unrestricted practice and by specialized systems such as Instinet. Canadian brokers, however, are required to report internal trading volume, which is counted in trading volume. We therefore estimate that less than 30% of trading value in Canadian stocks is conducted in the conventional Canadian market (the estimate is indicated in Schedule 3).

The best operating structure for markets is an extremely complex problem, and we have mentioned it here only to point out the challenges to the Canadian market. Upstairs trading is developing quickly, but is creating a transparency problem and impairs information quality, a key element of market quality.

It may help to keep part of the trading, which would perhaps move more rapidly to the United States, but this growth seems inevitable and gives businesses various advantages. Finally, only 30% of total trading value in securities of Canadian corporations is now done in the regular Toronto market. This is a major challenge,

[183] http://www.osc.gov.on.ca/en/About/News/Speeches/davidbrown_presentcreation_19990412.html.

absent from the list of problems raised by MacKay (2002), probably because it had little to do with regulation.

6.5.2 The registration effect

The effect of transferring trading to major markets is not a phenomenon specific to Canada. As Coffee writes (2002b), *during the 1990's, the phenomenon of cross-listing by issuers on international exchanges accelerated, with the consequence in the case of some emerging markets that trading followed, draining the original market of its liquidity. (..) A superior explanation is "bonding": issuers migrate to U.S. exchanges in particular because by voluntarily subjecting themselves to the U.S.'s higher disclosure standards and greater threat of enforcement (both by public and private means), they partially compensate for weak protection of minority investors under their own jurisdiction's law and also credibly signal their intention to make fuller disclosure, thereby achieving a higher market valuation and a lower cost of capital*. This effect is described by researchers as *piggybacking* (Licht, 2001; Coffee, 1999; Black, 2001). Businesses seek to increase their market value by complying with more strict disclosure and governance standards than those prevailing in their country of origin (Pagano *et al*, 2002). The American market would be particularly attractive for this[184]. Businesses thus seek to be registered in the United States to benefit from higher prices in their national market. However, as Black and Licht indicate, this strategy can only work if local institutions are adequately structured and understood by investors.

Euronext has understood this problem well and offers market segments where disclosure requirements are aligned with international standards, i.e. American ones. [Translation] *The creation of the NextEconomy and NextPrime segments meets the needs of investors seeking greater transparency and liquidity. (...) For investors, these two segments constitute an additional, quality-based criterion for selecting companies, as choosing a company that is a member of one of the segments ensures them a high level of financial transparency consistent with the most exacting international standards* [185].

Several studies have observed positive effects following registration in the United States of non-American corporations. Once again, there is a difficult problem for the Canadian stock exchange: for example, should criteria for disclosure and governance

[184] See Coffee, (1999 note 7) for a list of provisions respecting governance in the United States, established before the events of 2000 and 2001 lead to an analysis of and probably an increase in these governance rules.
[185] See the provisions at: http://www.euronext.com/fr/markets_prices/list/new_segments/description/.

be tightened to align them with American requirements for disclosure and governance or, on the contrary, should they be softened to meet a more local dimension?[186]

6.5.3 Marketing aspects

These are related to the sale of securities, but also to that of products and services. Trading securities on a segmented market may provide investors with profits from diversification and lower the cost of capital. There is much empirical evidence indicating that Canadian and American markets are progressively integrating, but that they are still partly segmented. (Foerster and Karolyi, 1998).

However, all profits from diversification which can be obtained between two more or less correlated markets are likely to be minimal. Licht (2001) maintains that corporations may seek to be listed on larger markets to have access to a larger base of potential investors and to offer those investors greater liquidity. Works which equate growth in price and trading volume following interlisting confirm this hypothesis. Lang *et al* (2002) show that securities listed on a market other than their market of origin get increased interest from financial analysts, improved quality of their forecasts and a higher price for their securities. In Canada, the progressive reduction in the size of the conventional market to the benefit of the United States and the upstairs market could lead more companies to interlist.

In addition, companies tend to follow their economic activity: a company with high sales in the United States would be likely to issue in the United States since investors know its products and would be more inclined to buy shares in the company.

The studies of Mittoo (1992) and Houston and Jones (1999, 2000) discuss the perceptions Canadian business executives have of the advantages, costs and net benefits of listing on American stock exchanges. These authors confirm that the perceived advantages are increased trading volume, stock following by financial analysts, reputation and advantages facing competition. The main obstacles are reconciliation of financial statements with American accounting principles and the additional disclosure requirements related to these principles. The SEC requirements only appear to be a minor concern. However, Houston and Jones show that the MJDS only had a minimal effect on the perceived and actual costs of interlisting, and write that this agreement did not lead to the hoped-for results.

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[186] This question is currently the subject of discussion. In an article in the *Globe and Mail* (*Like it or not, TSX must match U.S. standards*, May 17, 2003), Eric Reguly strongly opposes the position taken by the Chairman of the TSX and writes that: *If Canada and its stock markets want to play seriously in the integrated North American market, they have to live up to the new standard*.

6.6 Summary and implications in terms of policies

We have shown that the Canadian securities market is growing slowly and that large trades are moving increasingly to the United States. The proportion of trades of foreign securities conducted in Canada has become insignificant and it is becoming difficult to consider these stocks in the Canadian capitalization.

On the other hand, since the beginning of the 1990's a growing number of Canadian securities trade in the United States and, for these interlisted securities, around half of the trades are done outside Canada. A large number of Canadian corporations (thirty-five), no longer trade in Canada. The only dynamic element of the market is the high rate of creation of new companies, but this creation is associated with a high mortality, which leaves the total number of listed corporations unchanged. Our conclusion approximates that of Gaa *et al*, (2002, p 31) who write: *the results of the study (of national markets) suggest that the direction of change is towards a single global market through the interlinkage of national equity markets. Domestic intermediated markets would be undermined by this development, since the standardized products traded on those markets could be traded more efficiently and at lower cost on the global matching market. The domestic intermediated market would continue to exist, since there will always be relatively illiquid products and agents desired to trade them*.

Certain recent writings associate the difficulties of the Canadian market with regulatory factors and in particular with provincial jurisdictions, which would increase operating costs. However, the main challenges before the Canadian stock market do not seem to be of this nature. The progression of trades to the United States, the smaller and smaller portion of trades carried out on the *downstairs market*, and the total lack of attraction to Canada by foreign securities appear very problematic. It seems to us, however, difficult to associate these with regulation.

Galper (1999) defines three business models for stock exchanges in the 2000's. A global exchange (GEX) *dominates an economically linked community of several financial jurisdictions. It has the largest market capitalization in that community and the greatest trading volume and liquidity of any of its direct competitors. It trades both highly visible international securities and derivative products (...) It draws its clientele from a pool of both domestic and global investors.* The TSX at least partially meets the criteria of a GEX, but more those of a regional market (REX), defined as follows: *the Regional Exchange dominates its local economy. It has the greatest concentration of regional listings available and is the chief expert in these listings. By virtue of its intense national concentration, its index becomes a barometer of the health of the publicly quoted part of the regional economy. It may trade securities* *and derivative products. It draws its clientele primarily from regional investors, with a smaller share of international investors interested in benefiting from the available expertise and opportunities*.

The TSX Venture Exchange is clearly what Schulman (1999) defines as a *Small and Medium Business Market* (SMB), a category in which the NASDAQ also falls. To the extent that Canada has less than 600 corporations capable of being listed and traded on the NASDAQ, the TSX should also be put into this category. This seems especially true since trading of the best capitalized securities is progressively moving to the American market. The implications are significant in terms of development and regulatory strategy. According to the World Federation of Stock Exchanges, the main element to consider for SMB exchanges is location: *an exchange provides a real estate function for companies in the sense that it is where companies locate their stock listings and it is where customers (investors) come to buy and sell that stock. Therefore, to enhance the profile of an SMB market, exchanges should create attractive SMB market communities with financial influence, recognized value, and uniquely beneficial services* (Schulman, 1999, p. 14). Since the several large-cap securities are moving to the American stock exchanges, it seems inevitable that the Canadian exchange will become increasingly an exchange of medium and small businesses according to international standards.

The stakes are high and cannot be ignored in the debate taking place in Canada. The aspects of location, adaptation to different regional and sector factors, the framework of small-cap securities, the switch from risk capital to public financing and the survival of new issues will become major factors. Moreover, the reduction of real or perceived advantages from the transfer of trading to the United States should become a subject of study and careful thought. It seems strange that these issues have until now not been apparent in the debate taking place on regulatory revision.

7- CONCLUSION

The main argument put forward by promoters of securities centralization in Canada is that participants face thirteen securities commissions, causing additional costs and hurting Canadian market competitiveness. In Part One we have shown that four provinces monopolize almost all issues, listed companies, population and economic activity in Canada. Most issuers therefore only deal with one securities commission. We also pointed out the initiatives taken by Canadian securities authorities to set up several important measures to limit problems caused by multiple jurisdictions. They are the memorandums of understanding respecting the mutual reliance review system and oversight of exchanges, national instruments, registration of representatives and the blueprint for uniform securities legislation.

According to the promoters of centralization of securities regulation, there are serious problems of efficiency in terms of excessive costs and delays resulting from compliance with statutes and regulations. Part Two shows that there is little evidence supporting this point of view. On the contrary, empirical evidence is convergent, and it all shows that the initial offering process is less costly in Canada. These studies do not specifically show the additional costs related to regulation. Issuers and investors are subject to various forms of cost, of which regulation is a small component. These studies show, however, that the present structure does not create a comparative advantage over the American situation.

A certain number of arguments are regularly put forward to justify revision of the Canadian model of securities regulation. More specifically, they are the insignificance of Canada internationally, jurisdictional conflicts, accounting manipulation, and the ineffectiveness of harmonization efforts. We show in Part Three that Canada is active on the international level and that Canadian securities authorities have set up a number of mechanisms based on the principle of cooperation.

We have analyzed the American situation in terms of regulation and central authority. Finally, we have shown the homogeneity of the Canadian securities market, in terms of company characteristics and provincial initiatives. Given these different elements, it is difficult to maintain that strict uniform regulation and a single securities commission are best.

Promoters of securities centralization maintain that a single authority would regulate the sector best, at a lower cost, and that completely unified regulation would be preferable to the present situation. This view is the opposite of a market approach, regulatory competition, which prevails in particular in American company law. In Part 4 we analyzed the management model of regulation and its application in different contexts. We conducted an in-depth examination of the European situation, which combines regulatory competition for securities and minimum standards. Finally, we put in perspective and analyzed the various forms and alternatives to regulatory competition. It appears that regulatory monopoly is not necessarily preferable to regulatory competition, and that some competition is compatible with minimal harmonization.

The debate over centralization of securities regulation in Canada has recently been relaunched in the name of improved efficiency and reduced costs for issuers and investors. The American situation is often put forward as an example of regulatory centralization and its operation in a federal State. In Part 5 we have shown the significant differences separating the two markets. The American financial market is very fragmented, both in banking and securities. Regulatory centralization may be best in such a case, although a number of researchers dispute this. Regulatory monopoly is however only apparent: it does not exist for banking or company law, and is only partial for securities, where the States keep a significant role in local small-cap financings. These local issues essentially correspond to financing in Canada. On the contrary, the Canadian financial system is highly concentrated; a half-dozen institutions essentially control the financing and intermediary business. Nothing therefore would lead us to believe that the American securities regulatory model is transferable to Canada

According to promoters of securities centralization, regulatory decentralization and multiple securities commissions hurt development of the Canadian stock market. However, there is little information respecting the evolution of this market. We have discussed this evolution over the last decade and shown the special characteristics of the Canadian market. It is distinguished from other developed markets by the presence of very many undercapitalized companies and by the high incorporation and mortality rate of companies. Canada has little attraction for foreign corporations and there is a very clear movement in the trading of the largest Canadian companies to the United States. To understand the reasons for this situation, we have examined the factors causing investors to prefer one market over another. Our study has shown that the Canadian securities market is facing important challenges. They are strategic positioning in terms of market quality, the registration effect, and corporate visibility. Revision of the present regulatory structure is probably not a central element in the challenge put by this situation in terms of public policy. It seem strange that these aspects have so far been absent from the debate over the revision of the Canadian securities regulatory framework.

Schedule 1: National Instruments and other Canadian Texts on Securities

Procedures and related topics

- National Policy 11-201: Delivery of Documents by Electronic Means
- National Policy 12-201: Mutual Reliance Review System for Exemptive Relief Applications
- National Instrument 13-101: System for Electronic Document Analysis and Retrieval (SEDAR)
- National Instrument 14-101: Definitions

Capital market - certain participants

- National Instrument 21-101: Marketplace Operation
- Companion Policy 21-101: Marketplace Operation
- National Instrument 23-101: Trading Rules
- Companion Policy 23-101: Trading Rules

Registration and related topics

- National Instrument 32-101: Small Securityholder Selling and Purchase Arrangements
- National Instrument 33-102: Regulation of Certain Registrant Activities
- Companion Policy 33-102: Regulation of Certain Registrant Activities
- National Instrument 33-105: Underwriting Conflicts
- Companion Policy 33-105: Underwriting Conflicts
- National Policy 34-201: Breach of Requirements of Other Jurisdictions
- National Instrument 35-101: Conditional Exemption from Registration for United States Broker-Dealers and Agents
- Companion Policy 35-101 Conditional Exemption from Registration for United States Broker-Dealers and Agents
- Le mécanisme de traitement des plaintes et de règlement des différends
- Les acquisitions fermes - (*Bought Deals*)
- CSA Notice 33-305: Sale of Insurance Products by Dually Employed Salespersons
- CSA Notice 33-401: Canadian Capital Markets Association - T + 1 White Paper

Distribution of securities

- National Policy No. 2-B: Guide for Engineers and Geologists Submitting Oil and Gas Reports to Canadian Securities Administrators
- National Policy No. 15: Conditions Precedent to Acceptance of Scholarship or Educational Plan Prospectuses
- National Policy No. 21: National Advertising - Warnings
- National Policy No. 22: Use of Information and Opinion Re Mining and Oil Properties by Registrants and Others
- National Policy No. 42: Advertising of Securities on Radio or Television
- National Instrument 43-101: Standards of Disclosure for Mineral Projects
- Companion Policy 43-101: Standards of Disclosure for Mineral Projects
- National Policy 43-201: Mutual Reliance Review System for Prospectuses and Annual Information Forms
- National Instrument 44-101: Short Form Prospectus Distributions
- Companion Policy 44-101: Short Form Prospectus Distributions
- Companion Policy 44-102: Shelf Distributions
- Companion Policy 44-102: Shelf Distributions
- National Instrument 44-103: Post-Receipt Pricing
- Companion Policy 44-103: Post-Receipt Pricing
- National Instrument 45-101: Rights Offerings
- National Policy 46-201: Escrow for Initial Public Offerings
- National Policy 47-201: Trading Securities Using the Internet and Other Electronic Means
- Policy Statement Q-28: General Prospectus Requirements
- Policy Statement 41-601Q: Capital Pool Companies

Continuous disclosure

- National Policy 51-201: Disclosure Standards
- National Policy No. 3: Unacceptable Auditors
- National Policy No. 14: Acceptability of Currencies in Material Filed with Securities Regulatory Authorities
- National Policy No. 27: Canadian Generally Accepted Accounting Principles
- National Policy No. 31: Change of Auditor of a Reporting Issuer
- National Policy No. 41: Shareholder Communication
- National Policy No. 48: Future-Oriented Financial Information
- National Policy No. 50: Reservations in an Auditor's Report
- National Policy No. 51: Changes in the Ending Date of a Financial Year and in Reporting Status

- National Instrument 55-101: Exemption from Certain Insider Reporting Requirements
- Companion Policy 55-101: Exemption from Certain Insider Reporting Requirements
- National Instrument 55-102: System for Electronic Disclosure by Insiders (SEDI)
- Companion Policy 55-102: System for Electronic Disclosure by Insiders (Sedi)

Public offerings and specific transactions

- National Instrument 62-101: Control Block Distribution Issues
- National Instrument 62-102: Disclosure of Outstanding Share Data
- National Instrument 62-103: The Early Warning System and Related Take-Over Bid and Insider Reporting Issues
- National Policy 62-201: Bids Made Only in Certain Jurisdictions
- National Policy 62-202: Take-Over Bids - Defensive Tactics
- Policy Statement Q-27: Protection of Minority Securityholders in the Course of Certain Transactions

Trading in securities outside a jurisdiction

- National Instrument 71-101: The Multijurisdictional Disclosure System
- Companion Policy 71-101: The Multijurisdictional Disclosure System

Mutual funds

- National Policy No. 29: Mutual Funds Investing in Mortgages
- National Instrument 81-101: Mutual Fund Prospectus Disclosure
- Companion Policy 81-101: Mutual Fund Prospectus Disclosure
- National Instrument 81-102: Mutual Funds
- Companion Policy 81-102: Mutual Funds
- National Instrument 81-105: Mutual Fund Sales Practices
- Companion Policy 81-105 to National Instrument 81-105: Mutual Fund Sales Practices
- Regulation 81-104 Respecting Commodity Pools

Source: CVMQ, http://www.cvmq.com/fr/regl/normes_ins.asp

Schedule 2: Indicators of direct costs in different jurisdictions

Estimates of direct costs of securities regulation differ depending on the work. The causes of the differences are the following:

- Difference between expenses of the commissions and amounts collected: the net surplus of amounts collected by securities commissions represented approximately $30.71 million in Canada in 2002. In this study, we are using expenses to estimate direct costs. The collection of fees over and above expenses is not unique to Canada. In 2000, in the United States, fees collected at the federal level were US$2.1 billion and SEC expenses were US$377 million. The Texas State Securities Board incurred expenses of US$3.8 million for the 2001-2002 fiscal year, but collected fees of US$103.6 million, which is greater than the costs of all Canadian commissions combined. For purposes of comparison, surpluses were not taken into account.
- Inclusion or exclusion of small commissions. The published data generally covers 4 or 6 of the largest commissions.
- Inclusion or exclusion of the Bureau des services financiers (BSF). Since 2002 the cost of the BSF has been included in the calculation of direct costs. That was not the case for the previous fiscal years.

For 2000, the expenses of the four main commissions were $90 million. For the year 2001, according to annual reports of the commissions, they were $104.09 million.

For 2002, we used the FSA study[187], which allowed us to make certain comparisons between countries. The calculated cost including the BSF is £56.8 million, or $133 million. The increase from 2001 can be explained in part by taking into account the BSF, the expenses of which are estimated at $9.6 million, and two commissions not accounted for in 2001.

Table A2 shows the main FSA data for Australia, Canada, the United Kingdom and the United States. Panel A of Table A2 gives the FSA data, in £. Panel B shows the main securities expressed in Canadian dollars. Panel 3 shows the calculation of the direct cost per million dollars of capitalization and of the cost per registered company. However, the FSA warns about this type of comparison because of measurement difficulties. In particular, all comparisons with the United States are false because data relating to this country does not take into account State securities regulatory organizations[188]. The estimates should be handled carefully.

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[187] In 2002, the FSA significantly adjusted its estimate of direct costs in 2001, which was £117 million, or $260 million, and seemed to relate to all financial regulation.

[188] For example, the Colorado Division of Securities reported expenses of US$2.717 million for fiscal year 2002-2003. The Texas State Securities Board incurred expenses of US$3.8 million for fiscal year 2001-2002. http://www.ssb.state.tx.us/agencyinfo/02arsup.pdf

Table A2 Indicators of Costs in Different Jurisdictions

	Australia	Canada	UK	US
Panel 1: FSA Data, millions of £				
Securities firms and fund management firms - prudential supervision	73.8	55.4	18.0	821.1
Supervision of and standards for exchanges / clearing and settlement systems / market service providers			4.0	
Supervision of, and standards for conduct on capital markets		1.4	4.0	149.0
Standard for / approval of listings of securities			11.0	7.2
Total cost of securities regulation	73.8	56.8	37.0	977.3
Market capitalization (domestic stocks, billions of £)	251.8	389.5	1,013.6	6,889.1
Panel 2: Data expressed in Canadian $				
Total cost of securities regulation (millions of Can $)	173.4	133.5	87	2,296.7
Number of listed stocks	1,410	3,967	2,332	7,074
Market capitalization (billions of Can $)	591.7	915.3	2,382	16,189.4
Panel 3: Estimates of the relative cost of regulation				
$ / millions of capitalization	293.1	145.8	36.5	141.9
$ K / Listed securities	123.0	33.6	37.3	324.7
% of Capitalization	0.029	0.015	0.004	0.014

Sources: FSA, Indicators of the costs of regulation in different jurisdictions, http://www.fsa.gov.uk/pubs/annual/ar02_03/ar02_03app8.pdf
Bank of Canada (exchange rates)

http://mutualfunds.about.com/gi/dynamic/offsite.htm?site=http://www.dora.state.co.us/securities

Schedule 3: Estimate of Proportion of Value of Trading in Canadian Securities on the Regular Toronto Market in 2001

Total value of Canadian trades on the TSE, in billions of $	712.52
U.S. portion of value of interlisted Canadian trades[1], in billions of $	376.12
Total value of trading in Canadian securities, in billions of $	1,088.64
Value of trading on upstairs market (estimate)[2], in billions of $	384.76
Value of trading on regular or *downstairs* market, in billions of $	327.76
Proportion of value of trading in Canadian securities on the regular Toronto market	30.10%

Source: TSE Review 2001.

[1] Total value of trading of interlisted Canadian companies multiplied by the proportion of trades conducted outside the Canadian market: 805.40 x 46.7%.

[2] Total value of Canadian trades on the TSE multiplied by the estimate of the proportion of trades going through the upstairs market: 54% of volume. The estimate is from Smith *et al* (2000), p.5 and it is probably an underestimate since the data dates back to 1997.

Abbreviations

AMEX	American Stock Exchange	AMEX	Bourse AMEX
ATS	Alternative Trading System	SNP	Système de négociation parallèle
BCSC	British Columbia Securities Commission	CVCB	Com. Des valeurs de Colombie-Britannique
BDC	Business Development Bank of Canada	BDC	Banque de développement du Canada
CDCC	Canadian Securities Clearing Corporation	CCCPD	Corporation canadienne de compensation des produits dérivés
CDNX	Canadian Venture Exchange	CDNX	Devenu TSX croissance
CDS	Canadian Depository for Securities	CDS	Caisse canadienne de dépôt de valeurs limitée
CESR	Committee for European Securities Regulation	CESR	Committee for European Securities Regulation
CPC	capital pool company	SCD	Société de capital de démarrage
CSRS	Canadian Securities Regulatory System	CRVM	Centralisation de la réglementation des valeurs mobilières
CSA	Canadian Securities Administrators	ACVM	Autorités canadiennes en valeurs mobilières
EC	European Community	CE	Communauté européenne
EDGAR	Electronic Data Gathering, Analysis, and Retrieval System	EDGAR	Electronic Data Gathering, Analysis, and Retrieval system
FASB	Financial Accounting Standards Board (US)	FASB	Financial Accounting Standards Board (US)
FESCO	Forum of European Securities Commissions	FESCO	Devenu CESR
FSA	Financial Services Authority (U.K.)	FSA	Autorité des services financiers du Royaume Uni
FSCO	Financial Services Commission of Ontario	FSCO	Commission des services financiers de l'Ontario
FSTQ	Solidarity Fund QFL	FSTQ	Fonds de solidarité des travailleurs du Québec
GAAP	Generally Accepted Accounting Principles	PCGR	Principe comptable généralement reconnu
GAO	United States General Accounting Office	GAO	Bureau du vérificateur général (USA)
IAS	International Accounting Standards, now the IFRS	IFRS	International Financial Reporting Standards
IASB	International Accounting Standards Board	IASB	International Accounting Standards Board
IDA	Investment Dealers Association of Canada	ACCOVAM	Association canadienne des courtiers en valeurs mobilières

IDS	Integrated Disclosure System	RII	Régime d'information intégré
IJC	Interjurisdictional Competition	IJC	Concurrence interjuridictionnelle
IOSCO	International Organization of Securities Commissions	OICV	Organisation internationale des commissions de valeur
IPO	Initial Public Offering	PAPE	Premier appel public à l'épargne
ISD	Investment Service Directive	DSI	Directive européenne sur les services d'investissement
ME	Montreal Exchange	BDM	Bourse de Montréal
MF	Mutual fund	OPC	Organisme de placement collectif
MFDA	Mutual Fund Dealers Association	MFDA	Mutual Fund Dealers Association
MJDS	Multi-Jurisdictional Disclosure System	MJDS	Multi-Jurisdictional Disclosure System
MOU	Memorandum of Understanding	MOU	Protocole d'entente
NASDAQ	National Association of Securities Dealers Automated Quotations	NASDAQ	Bourse NASDAQ
NRB	Net Regulatory Burden	NRB	Fardeau réglementaire net (Levich, 93)
NSMIA	National Securities Market Improvement Act	NSMIA	National Securities Market Improvement act
NYSE	New York Stock Exchange	NYSE	Bourse de New York
OSC	Ontario Securities Commission	CVMO	Commission des valeurs mobilières de l'Ontario
OTC	Over-the-Counter	OTC	Marché au comptoir ou hors cote
PAC	Programme d'aide à la capitalisation	PAC	Programme d'aide à la capitalisation
FSAP	financial services action plan	PASF	Plan d'action sur les services financiers
PSLRA	Private Securities Litigation Reform Act	PSLRA	Private Securities Litigation Reform Act
CVMQ	Commission des valeurs mobilières du Québec	CVMQ	Commission des valeurs mobilières du Québec
QSSP	Québec Stock Savings Plan	REAQ	Régime d'épargne-actions du Québec
MRRS	Mutual Reliance Review System	REC	Régime d'examen concerté
RS	Market Regulatory Services Inc.	SRM	Service de réglementation des marchés Inc.
RSS	Registration Streamlining System	RSS	Système d'enregistrement des représentants
SAB	Statement of Accounting Board	SAB	Norme comptable américaine émise par l'Accounting Board
SCOR	Small Capital Offering Regulation	SCOR	Small Capital Offering Regulation
SEC	Securities and Exchange Commission	SEC	Commission des opérations de bourse américaine
SEDAR	System for Electronic Document Analysis and Retrieval	SEDAR	Système électronique de données, d'analyse et de recherche
SEDI	System for Electronic Disclosure by Insiders	SEDI	Système électronique de déclaration des initiés
SLUSA	Securities Litigation Uniform Standard Act	SLUSA	Securities Litigation Uniform Standard Act
SPE	Special Purpose Entities	SPE	Entité à vocation particulière

SPEQ	Société de placement dans l’entreprise québécoise	SPEQ	Société de placement dans l’entreprise québécoise
SRO	Self-Regulatory Organization	OAR	Organismes d’auto-réglementation
TSX	Toronto Stock Exchange, formerly TSE	TSX	Bourse de Toronto
TSX venture	TSX Venture Exchange, formerly CDNX	TSX croissance	Bourse de croissance TSX, anciennement CDNX
UMIR	Universal Market Integrity Rules	RUIM	Règles universelles d’intégrité du marché
USL	Uniform securities legislation	USL	Projet d’uniformisation de la législation en valeurs mobilières
VC	Venture capitalist	SCR	Société de capital de risque
WFE	World Federation of Exchanges	WFE	Fédération mondiale des Bourses

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