

The Declining Health of Canada's Capital Markets:  
It's Time for a New Prescription

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Please check against delivery

Good afternoon and thank you Gordon for that kind introduction. I am pleased to be with you here today, and to see many industry colleagues in the audience and friends at this distinguished head table.

As Gordon indicated, I am speaking to you today in my role as Chair of the Investment Dealers Association of Canada and I'd like to take a moment to describe our role and responsibilities. I am delighted that our President and CEO Joe Oliver and IDA staff have joined us this afternoon and I want to take this opportunity to recognize the good work they do on behalf of the Canadian securities industry and for Canadian investors.

The IDA is the national self-regulatory organization and representative of the Canadian securities industry. Our role is to protect investors and ensure the integrity of the marketplace.

We regulate and represent an industry that employs some 37,000 Canadians and directly touches many people and businesses, either as investors or as issuers of various types of securities. Our 200 Member firms include 6 bank-affiliated full service firms as well as a range of institutionally focussed or retail service firms, full service or discount, each contributing in a significant way to the dynamism of the industry and the health of the Canadian economy.

We regulate the solvency, educational proficiency and sales and business practices of our Member firms and their approximately 16,000 registered employees across Canada. We are committed to ensuring the integrity of the Canadian marketplace with an efficient, responsive and transparent enforcement system. Our rules are designed to protect investors, ensure marketplace integrity and promote efficient capital markets.

Our Member Regulation responsibilities cover virtually the entire securities industry in Canada today, as we have taken on the Member Regulation responsibilities of the Toronto Stock Exchange and CDNX. In addition, the IDA has a 50% ownership of RS Inc, the new equity market regulator.

The IDA represents an industry that has been transformed by globalization and new technologies and by the new demands and needs of the Canadian investing public. We remain unchanged in our commitment to generate capital, create jobs and provide investment opportunities for all Canadians, and that's what I want to talk to you about today.

As investment professionals, our capital markets specialists are partners with Canada's business leaders, working to build a strong economy for our families and our communities. We work with Canadian firms to provide the funds they need to get off the ground or to grow. We work with local businesses, to help them become national ones. Or even multinational ones.

In one sense, what we do is quite simple. We raise capital and then pass it on to public companies that want to expand or make an acquisition. It may be simple but it's essential.

Healthy--- and that means liquid and efficient--- capital markets grow the economy. As a Maclean's article put it:

"The capital markets are the grease of the economy's engines--- without money, things come to a grinding halt. And business goes elsewhere."

How important are liquid, efficient capital markets to Canadian business? Well, access to competitively priced capital is especially crucial in a capital-intensive economy like ours. It made it possible to build our natural resource industries, like forestry and energy and it made it possible to grow Canada into a manufacturing centre.

Canada's capital needs have been growing exponentially to fund expansion of existing operations and new enterprises. During the 1990s, financial requirements for Canadian companies tripled, last year totaling close to \$60 billion in domestic markets. Last year, common equity financings for emerging companies and small companies, in other words venture capital financings, totaled nearly \$5 billion. Merger and acquisition activity totaled almost \$130 billion in 2001, well over the 100 billion mark for the fourth straight year.

This is a trend that will continue. Over the next several years, Canada faces enormous needs for capital. But in the absence of efficient and liquid capital markets, Canadian businesses may be unable to obtain financing at the competitive rates they need.

I want to talk to you today about a disturbing trend to less liquid and less efficient capital markets, a trend that should concern every Canadian investor and every Canadian businessperson. And I want to talk about some of the things that we must do as a country to reverse that trend.

Access to capital – that's the key to an efficient market. It's what narrows the spread between buyers and sellers, producing a price that reflects fair value. It's what attracts companies from around the world to our capital markets. It's what attracts institutional investors, who make our markets even more robust. When markets are illiquid, the result is uncertainty and limited access. Uncertainty about pricing and resale makes investors reluctant to invest, which reduces capital availability and raises its costs.

How are our capital markets at risk today? Why are they becoming less liquid and less efficient? This is not an entirely new development. In fact, it's been happening for quite some time now. However, new factors have exacerbated the situation and accelerated the process.

An increasingly global marketplace makes it increasingly easy for capital to flow outside our borders to maximize return. From 1990 to 1998, portfolio investment flows into Canada -- minus Canadian investment abroad-- averaged an inflow of \$14 billion per year. During the past three years, it has turned into an outflow averaging over \$20 billion per year. A nation of capital importers has become a nation of capital exporters.

It's also easy for the large and well-established Canadian corporations to go beyond our border to raise capital. The trading volume in their securities has followed. Since 1996, the Canadian market share of the 10 most active interlisted stocks declined by 11 % points, to 38%. In fact, twice as many Canadian businesses have listed their shares on foreign stock exchanges as was the case two decades ago.

Last year about 60% of the nearly \$80 billion in debt financing by Canadian business was raised in markets outside Canada. Cross-border equity issues, rare before the Free Trade era, are now almost commonplace. In fact, mergers and acquisitions of American firms by Canadian companies and vice versa have achieved record levels over the past three years. Canada-wide, these transactions had a total value of over \$90 billion last year, remaining over this mark for the fourth consecutive year.

Now by themselves neither of these trends is all bad. In fact, it's a sign of economic health when Canadian companies are able to attract capital in foreign markets. But there is a problem when Canada cannot adequately generate domestic capital to give birth to the next generation of up and comers.

Canadian start-ups find it more difficult to get financing in Canada than their counterparts in the United States. Moreover, they don't have the ability to get attention in the U.S. marketplace. Often they can't even meet the U.S. listing requirements. For example: compared to a Tier-a company listed on CDNX, the NASDAQ requirements are 6 times higher for non-tangible assets and 12 times higher for earnings. That's why, regardless of globalization and the increasing integration of the North America economies, Canada must have its own robust and healthy domestic marketplace.

Unfortunately, a weak Canadian dollar has exacerbated the problem. Since 1991, our dollar has plunged almost 30 per cent in value. It has depreciated in bad times, in good times, when commodity prices were declining, and when commodity prices were rising. Through economic ups and downs, the Canadian dollar has been heading one way -- down.

That has facilitated a spate of foreign acquisitions.

Headlines on the business pages tell the story: MacMillan Bloedel, Westcoast Energy, Gulf Canada, CN Rail, Newbridge, Seagrams. The list goes on. In the last three years,

foreign purchases of Canadian companies totaled \$215 billion. That compares to \$140 billion in Canadian acquisitions of foreign companies.

These newly acquired companies may be strengthened in a number of ways. They may still contribute significantly to the Canadian economy. But invariably, their financing activities follow the head office, particularly if it is located in the world's largest capital market. Over the past two years, 120 Canadian companies have been deleted from our senior equity index, the TSE 300. Now when a company disappears from a US index due to a merger or acquisition, that really doesn't affect the US market's liquidity. There's an ample supply of large cap, liquid US companies to take its place. In Canada, a company that leaves the index is usually replaced by a smaller, less liquid Canadian company.

It's one thing for me to describe the problem. You also have a right to expect me to take on the hard part – offering some solutions.

And you have the right to expect that I won't just pass the buck to government. The private sector has a responsibility too. And that includes the investment industry.

IDA member firms are deploying every strategy they can to provide Canadians with the lowest cost of capital. We're building global platforms, developing alliances, picking our spots. We're using technology to reduce transaction costs. At the IDA, we're working hard to identify and eliminate any unnecessary regulatory costs that make our industry less competitive on the global stage. We're also looking at innovative approaches to helping firms, especially smaller or regional ones, to share costs or services, build common platforms or consortiums, where appropriate. I'd also point to the recent success the IDA and TSX have had in enabling Canadian companies to be more widely traded in the US. This will lower the cost of capital and promote capital formation for Canadian business.

The TSX is introducing innovations that may help Canadian markets recapture some of the trading it has lost to the NYSE and NASDAQ. They have launched a call market that provides twice-a-day anonymous trading of stocks at a half-way point between traditional bid-and-ask prices, a feature that has long been offered in US markets. And the consolidation of the exchanges has had and will have benefits for the efficiency of the marketplace.

These are some of the things the industry is doing. But by itself, it's simply not enough. We also need our governments to act.

The question has become pressing: What can Canadian governments do to reverse the trend and strengthen Canadian dollar markets?

There is no simple answer, no magic bullet to fire. The solution must be multi-faceted. It must include policy initiatives by the federal and provincial governments, their agencies and Crown Corporations.

Ensuring liquid capital markets will require tax reforms that encourage Canadians and foreigners to invest in Canadian companies.

Despite federal and provincial tax cuts, Canadians still carry a bigger tax burden than Americans. Taxes make up about 40 per cent of our GDP. That compares to 32 per cent in the United States. And U.S. taxes will be going down over the next four years.

To make sure that we have growing pools of competitively priced capital, we don't just need tax cuts. We need targeted reforms that will make capital more accessible.

The recent reduction in the capital gain inclusion rate to 50 per cent was a step forward. But economic growth demands further relief – including measures that encourage capital to be held for extended periods. Economic growth demands elimination of capital gains taxes on individual investments in small companies up to a defined lifetime threshold.

Access to capital must include access to venture capital. Over the last 5 years, the Canadian venture capital industry has averaged one-twentieth the size of the US industry and deals have been on average nearly 5 times smaller.

Venture capital is critical to our economic growth. That's why we have to bolster it across the board. We need rollover provisions to allow capital gains taxes to be deferred for reinvested proceeds. That should be extended to limited partnerships and corporations, as well as individuals.

Healthy liquid capital markets also need efficient and effective regulation. Let me say at the outset that the most important thing that regulators can do for our industry is to help us be the best regulated capital markets in the world. That's good public policy and it's good business.

We often hear that there is a tension between the need to protect consumers and the need to preserve market efficiency. The tension is there but it is often overstated. Transparency, integrity and investor protection are not only matters of fairness, they also build investor confidence and the ability to attract domestic and foreign investment.

These two objectives-- investor protection and efficiency--- usually operate in harmony, especially when policy is based on economic and financial data and a rigorous cost-benefit analysis.

In recent years, many measures have been introduced to enhance investor protection. Federal legislative reforms have focussed on consumer protection. Self-funded securities commissions have raised the regulatory bar.

Broader regulation of the debt and equity markets; the creation of new SROs for mutual fund distributors and for secondary equity markets; mutual fund governance and the proposed regulation of advice; conflict of interest rules for small business financing and research analysts, and financial planning legislation, here in Ontario.

Many of these changes have been beneficial and have advanced investor protection. But combined they add significantly to the regulatory burden, serving as a damper on liquidity.

Every regulation costs something to implement. What we need is a new mindset -- one that recognizes that every regulation has a cost, and that ultimately it's the consumer who picks up the cost. As the recently issued British Columbia Securities Commission Concept paper on deregulation so aptly puts it: "we should make new rules only if the benefits clearly outweigh the costs and burdens of compliance, and existing rules should be reviewed regularly to ensure this balance still holds". At the IDA we're doing just that. We have initiated a regulatory streamlining project aimed at eliminating rules that are duplicative or no longer serve a public interest purpose and that impose unnecessary costs of compliance.

What kind of regulatory costs are we talking about? Well, the Canadian Venture Exchange estimates its listed companies now pay an average of \$70,000 per year to comply with regulations. That's double what they paid five years ago. And that's the cost to smaller companies. Companies that represent enormous potential for growth -- growth that must not be nipped in the bud.

That's why I was delighted to see the B.C. Securities Commission Deregulatory Concepts paper make clear its support for reduced and simplified rules to ease the regulatory burden. We are also encouraged that Commission and government task forces have been set up in Alberta and in Ontario where a Working Group comprised of Morley Carscallen, Keith Gray and Gar Pink has been working to identify opportunities to reduce regulatory costs for market participants.

There's also been considerable discussion recently--- and we welcome it-- about regulatory structure, specifically the need for a national regulatory system but it's equally important that we consider not just how we regulate but what we regulate.

That said, the fact remains that Canada needs a modern regulatory structure suited to a fast-paced and increasingly complex global marketplace.

Canada's regulatory structure is fragmented. As several Canadian regulators have pointed out, we're the only advanced industrial country without a national regulator. In a world where capital can move around the world in a nano second, we need to have a clear, consistent voice on the international stage, where global market issues are addressed. In an economy where even **national** borders are becoming less and less of a factor, we need nation-wide consistency.

Obviously, we must take into consideration regional and provincial needs. But we must also defend against market fragmentation.

When companies look at our national smorgasbord of rules, requirements, and costs, what they see is a lot of reasons **not** to issue a prospectus, raise money or list here. Canadian companies look at the maze, and decide it's too much hassle to try to get approvals in so many jurisdictions. It's less expensive to simply list in one or two provinces – and that's unfair for everyone else.

The provincial securities commissions have been trying to move toward a "virtual commission" – a process under which the provinces move in concert. But that's a slow process, and an imperfect one. There's also good work underway on creating a Uniform Securities Act. One set of consistent rules would be a huge improvement. But we need to move farther, faster to ensure a single voice, and a single set of rules across Canada. Our goal must be to make it as easy as possible to raise and invest capital in every part of this country.

We are encouraged that the debate has been joined on the concept of a national-based securities commission under provincial or federal jurisdiction. Work is clearly needed to develop a consensus. I can tell you, however, that if we are still having this debate 5 years from now, it will be too late for Canadian capital markets. We urgently need to find ways to create a harmonized system of securities regulation in this country.

Ladies and gentlemen: robust and efficient capital markets are essential for issuers raising capital. They are vital to investors building a portfolio. They are critical to growing a modern economy. They are crucial to creating jobs. They matter to our quality of life.

And they are indispensable to building and maintaining communities that add up to a country that is greater than the sum of its parts.

Thank you.