

1984

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Citation of this paper:

Courchene, Thomas J.. "A Really Secure Industry or A Real Securities Industry." Centre for the Analysis of National Economic Policy Working Papers, 84-01. London, ON: Department of Economics, University of Western Ontario (1984).

CANEP No. 84-01

A REALLY SECURE INDUSTRY

OR

A REAL SECURITIES INDUSTRY

by

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WORKING PAPER NO. 84-01

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**A Submission
to the
Ontario Securities Commission
in respect of its
SECURITIES INDUSTRY REVIEW**

November 28, 1984

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I: INTRODUCTION AND OVERVIEW

This submission is divided into six substantive sections. Part II is intended primarily as background material in order to make the paper self-contained. Part III focusses on what I consider to be the key issues at stake in the hearings. Included in this section is Joint Securities Industry Committee recommendations with respect to these issues. Part IV presents both sides of the argument as to whether the securities industry has adequate capital. In my view capital is not adequate. But the key point of the section is that capital adequacy, as such, is not the issue. Access to capital is. I do not believe that the role of a regulatory commission is to implement policy on capital access on the basis of some or another notion of capital adequacy. Rather, the policy issue is, or ought to be: allow maximum capital access subject only to any overriding public interest. In other words, the OSC's approach to the Green Line issue ought to be carried over to these hearings, i.e., the presumption that any action is permissible unless it can be demonstrated to be contrary to the public interest.

Part V focusses on the various rationales for regulation and what they might imply with respect to capital access. The analysis begins with some general comments on regulation and its potential for limiting competition. The essential point here is that experience shows that all too frequently regulation serves not the public interest but the interest of those being regulated. In terms of the various rationales for regulation, I argue that disclosure, consumer protection and solvency do not stand in the

way of opening up capital access. Conflict of interest does raise some concerns. However, in this regard, it is important to recognize that attention tends to be riveted only on those potential conflicts of interest that arise between the four pillars. In reality there are substantial conflicts of interest within each of the four pillars and indeed with the securities industry. My overall view on this issue is that functional separation does not require financial separation. If the existing standards of professionalism in the industry are effectively policed then there is no reason why we should place an additional restraint on ownership. Concentration can also give rise to some concerns. The basic issue here is often viewed from precisely the wrong perspective. It is not that the banks are too big; rather, it is that the securities firms are too small! And in large measure this is the result of the maintenance of ownership and investor restrictions over the years. Concentration has in effect come to be a vicious circle of sorts. Because of ownership restrictions the industry is smaller and less capitalized than it would otherwise be. Hence, the industry can then wave the banner of concentration to support the continued maintenance of ownership restrictions. Now is the time to break through all of this and to dramatically increase capital access.

My overall position is that none of these rationales for regulation mitigate against moving toward substantially enhancing capital access and ownership although some of them may have something to say about the selective pace of the process.

The final two rationales for regulation--to encourage competition and efficiency--are dealt with in Section VI, which attempts to make the positive case for enhanced capital access. The analysis focusses on the interests of the investing public and on the needs of enterprise, small and large, and argues that it is difficult to see how these needs can be met without an insurgence of capital. In addition, the underlying thrust of Finance Minister Wilson's budget statement is in the direction of restoring Canada's international competitive position and our ability to penetrate foreign markets. The securities industry's role in this is to ensure that Canadians have access to capital on the best possible terms. To my mind, this means opening up the industry both internally and to outside competition. Somewhat presumptuously, I then suggest that this will also be in the longer term interest of the industry: to strive to be efficient "regional brokers" in an environment which is rapidly moving toward an integrated world capital market is a strategy fraught with danger.

Part VII then focusses on a series of models for regulatory reform ranging from the Medland Committee Approach at one extreme to an unfettered industry at the other. I argue that even though an unfettered market has no chance at all of being the end result of the hearings, it nonetheless is the appropriate starting point for the regulatory authorities. This is so because it will mean that restrictions on the operations of the competitive model will have to be justified as being in the public interest. This places

the burden of proof exactly where it should be--upon those who argue for limiting competition.

The conclusion attempts to lend some general perspective to the paper. Among the points made is that regulatory reform does not occur in a policy vacuum. Rather, at any point in time there is generally one issue that is paramount. This time around the paramount issue is competition. Hence, it is entirely legitimate that there be a lively and even heated public debate as to how one ought to go about ensuring that our securities industry becomes world class, about how one best serves the capital needs of small and medium-sized businesses, about how one tilts the system in order to maximize innovation and competition. However, what is not legitimate at this juncture is for the regulatory process to frustrate the achievement of these goals.

II: MARKET INTERMEDIARIES: CURRENT REGULATORY ENVIRONMENT

The purpose of this section is to provide some background for the range of issues that are to be addressed in the remainder of this paper. (Those familiar with the legal and institutional environment should probably proceed directly to Part III.) The securities market is bifurcated in that there exists both a regulated and a non-regulated sector. I shall deal with each in turn.

A: Regulated Sector

There are approximately 100 securities firms which are registered under the Ontario Securities Commission (OSC) and which are members of the Investment Dealers Association of Canada (IDA) and/or any of the five Canadian stock exchanges. These registered

firms are subject to two general sorts of regulations: registration requirements and ownership restrictions.

1. Registration Requirements

Without resorting to much detail, the Securities Act (Ontario) contains the following general provisions with respect to registration:

- (a) those who trade in securities must register as dealers.
- (b) those whose trading involves the distribution of securities as principal or agent must register as underwriters (actually, registration as a broker-dealer, investment dealer or securities dealer under a) is deemed to be registration as an underwriter,) and
- (c) those who advise as to investing in securities must register as advisers.

In addition to some bonding and capital requirements, registration typically involves adherence to certain "professional" requirements, e.g., satisfaction of education requirements, adherence to know-your-client and suitability-for-investment rules, and adherence to disclosure rules.

2. Ownership Restrictions

There are ownership or capital restrictions with respect to both foreign and domestic investors in the regulated securities market. On the domestic side, no single non-industry investor can hold voting securities carrying more than 10 percent of the voting shares of the firm. In addition at least 40 percent of the directors or partners of a securities firm must be industry members. On the foreign side, non-residents in the aggregate

cannot hold more than 25 percent of any class of securities and no single non-resident investor can own or control more than 10 percent of any class of securities. This is frequently referred to as the 25-10 provision.

B: The Non-Regulated Sector

One of the rationales for regulating the security industry is to protect the investing public from such things as fraud, inadequate disclosure, conflict of interest, etc. However, the regulatory authorities have long recognized that there are certain classes of securities and certain classes of agents where concerns about disclosure, fraud and the like are not likely to loom very important. These have come to be referred to as the "exemptions" under the Act or as the "unregulated" aspect of the securities market.

In general, there are two general types of exemptions. One applies to certain classes of securities where the very nature and quality of the instruments (eg., government bonds) is such that there is really no need for registration requirements in order to protect the investing public. The other type of exemption relates to the nature of the participants themselves. The argument here is that registration on grounds of protection, full disclosure etc., is not needed for trades which involve sophisticated and knowledgeable investors who are quite capable of independent analysis of the merits of any investment.

1. Exempt Trades

In total, the Securities Act provides that no registration is necessary in some 23 specified trades. For

example, there is an exemption for trades involving certain financial institutions and governments. The rationale for granting such an exemption is that the financial institutions are regulated by their own governing statutes and that financial institutions and governments are presumed to have the expertise and sophistication to determine, for themselves, the merits of their investments.

The Securities Act also provides an exemption from registration for trades to companies and persons recognized by the Commission as exempt purchasers. Exempt purchaser status is intended primarily for those institutions with substantial pools of capital and sophisticated investment advisers, such as financial institutions which are not licensed to do business in Ontario and professionally managed pension and mutual funds.

By far the most controversial of the exempt trades relates to what is referred to as private placements. The Securities Act provides an exemption from registration where the purchaser purchases as principal and where the security has an aggregate acquisition cost of not less than \$97,000. The rationale for this exemption is the presumed sophistication of an investor with this amount of money available for investment. The increasing number of "after the fact" announcements of securities issues that appear on the financial pages (referred to as "tombstones") bear witness to the importance of this exemption.

2. Exempt Securities

The second category of exemption relates to certain classes of securities. Registration is not required for trading

in bonds and debentures (direct or guaranteed) by the various levels of government in Canada or foreign countries, various financial institutions and development banks. Short-term negotiable promissory notes or commercial paper in denominations greater than \$50,000 are also exempt. Once again the rationale for these exemptions is one or more of the following: the issuers are regulated in their own right; the nature of the instruments is such that there is no need for the protection afforded by registration; or the purchasers (for commercial paper for example) are thought to be sufficiently sophisticated and knowledgeable to evaluate the investment.

Thus, a considerable portion of the domestic market in securities is unregulated.

3. Cross-National Markets

Finally much of the international trading is also unregulated. Non-resident firms may deal in Canada in exempt securities and they may also deal with exempt institutions in any other securities. Moreover, many Canadians (individuals and institutions) currently have accounts with non-resident securities firms for trading in foreign markets. This activity is also unregulated, at least by the OSC.

C: The Regulatory Interface

There is one further aspect of the securities environment that must be emphasized. This is the fact that, for all intents and purposes, the regulation of the securities industry is the responsibility of the provinces. It has generally been the case that Ontario's rules have had a national influence. However, in

terms of ownership restrictions, and particularly in terms of non-industry ownership restrictions, the Quebec securities commission appears to be taking a far more lenient stance. Indeed, Quebec intends to register financial institutions to carry on any aspect of the securities business provided the institution meets the registration rules and provided it is empowered by its governing legislation to engage in the securities business. The implications of this approach go well beyond the ownership issue, per se. Allowing trust companies and life insurance companies to own or run a securities business is a move in the direction of "financial integration". Most of those who oppose such a policy will not refer to this as financial integration, but rather as an "erosion of the four pillars" (banking, trusts, insurance, and securities).

III: REGULATORY REFORM: THE ISSUES

Even with this brief review of the regulatory and environment it is clear that the status quo gives rise to several far-reaching concerns. While many of these will be aired in due course, it is important for present purposes to highlight one of these issues, particularly since it served as the catalyst for the current OSC hearings on the appropriate regulatory framework for the securities industry. This issue is the following: while the 100 or so registered securities firms are free to operate in the unregulated (exempt) markets, they do so at a considerable disadvantage since their competitors are not bound by either their registration or ownership requirements. In response to this situation Daly Gordon (now Gordon Capital) proposed to set up a

separate corporation (in the form of a joint venture with an off-shore partner) to carry on the "exempt" part of its business, thereby ensuring that, in terms of trading in these exempt areas, the new corporation (Gordon Capital Corporation) could meet the competition on their own turf (the "level playing field") as it were. Even though Daly Gordon insisted that the new corporation would not withdraw capital from its registered business, the IDA and the Toronto Stock Exchange (TSE) vetoed the proposal. Largely as a result, the OSC embarked on an investigation into the structure of the securities market.

While it is unrealistic to attempt to present the full range of concerns that the OSC is considering in these hearings, there are three pivotal and interrelated issues that are at the center of the hearings and that will be the subject of the remainder of this paper:

- 1) the sources and quality of capital that will be available to the domestic securities industry to handle future growth, to innovate and to compete with other providers of financial services;
- 2) whether and to what extent non-resident, institutional or other non-industry participation in the domestic securities industry is necessary or desirable; and
- 3) to the extent that outside participation is permitted, how and to what extent such activities should be regulated by the OSC. (OSC Bulletin, Jan. 29/84 Vol 7; #26/84).

A: The JSIC (Medland) Report

In mid-September of this year the Joint Securities Industry Committee published its Report (henceforth referred to as the Medland Report, after its Chairman, C.E. Medland) which was designed to present the industry's view of the issues and to serve as a catalyst for other submissions. Essentially, the Medland Report argued:

- a) that the capital base of the securities industry is adequate so that no major alteration in ownership restrictions is warranted;
- b) all firms presently carrying on activities in the exempt markets domestically should be required to register with the securities administrators and to comply with the ownership restrictions that are in force with respect to registered securities firms.

In tandem, these recommendations signal a dramatic increase in regulation--indeed a dramatic retrenchment with respect to the status quo.

Nonetheless, I very much welcome the Medland Report. In all my writings in the various areas of public policy I do not think that I have ever seen a document that has served to crystalize the issues in a policy area as effectively as does the Medland Report. From the vantage point of economic analysis the Medland Report rivets attention not only on the perennial issue of regulation-cum-protection vs. competition but as well on whether the ultimate role of regulation is to serve the public interest or the interests of those being regulated. Needless to say, the

thrust of the remainder of the analysis will be to argue that this recommendation for a turning inward of the securities industry is precisely the wrong policy direction, particularly at the very time that there appears to be a growing consensus that Canada must look outward, if not toward free trade then at least freer trade. Most of the analysis in the remainder of the paper will present arguments for "opening up" the securities markets both in terms of access to capital and in terms of restrictions on ownership.

Prior to embarking on this analytical exercise, it is useful to conclude this series of background sections with a brief survey of some of the various arguments and data with respect to the issue of capital adequacy.

IV: IS CAPITAL ADEQUATE?

A: The Medland Approach

As noted above, the Medland Committee takes the position that capital base of the securities industry is adequate. Indeed, it goes further to suggest that there is substantial "excess net free capital", to use their term. What is being measured here is essentially the capital base as required by the registration regulations--in other words, regulatory capital.¹ In their words:

Of the more than \$700 million of capital employed in the industry at the end of the first quarter of 1984, approximately \$200 million was required to provide adequate margins on various types of securities and client accounts [as required by regulation]. After adjustment for all non-active and non-liquid assets (furniture, fixtures, stock exchange seats, etc.) of \$200 million, and after deducting the required \$100 million capital for the volume of existing adjusted liabilities, the industry during the first quarter of 1984 maintained more than \$200 million in excess net free capital for additional activities in underwriting or trading (Medland Report, Appendix II, p. 2).

It is far from clear what one should make of this notion of "excess net free capital". It seems to me that has nothing at all to do with capital adequacy, per se. Rather net free capital must be "positive" under the regulations and this would be the case if the overall capital base of the securities industry was \$700 million or \$7 billion. For example, no one would claim that chartered bank cash reserves are adequate from a policy standpoint

solely on the basis that the banking system at each point in time has some excess reserves--they must have excess reserves under the provisions of the banking legislation.

To be sure, these figures on excess net free capital are only one aspect of the Medland Committee's "demonstration" that capital is adequate. The second part of the argument is that the existing firms in the industry have not made much use of the provisions for an enhanced capital base so that from this vantage point it is difficult to make a case either that capital is inadequate or that the existing ownership restrictions serve to inhibit the growth of the industry. As the Medland Committee notes:

When individual firms are reviewed, only 20 of the 89 firms responding to the survey had acquired equity from non-industry or foreign sources. Only four firms have issued equity publicly. Aside from four firms that are controlled by U.S. parents and the four public firms, only one firm of the 89 had issued more than 10% of its voting securities to non-industry investors. Given the capacity under existing rules to issue up to 25% of voting shares to non-residents and an unlimited aggregate amount of equity to non-industry investors, the firms have significant additional capital available under existing rules. (Medland Committee, Appendix II, p. 3)

This last statement is certainly true--there is unused capital-raising potential under existing rules. I would argue, however, that this fact in isolation can be and is misleading. The concerns associated with this line of reasoning were aired as

early as 1978 and probably well before this. The Barron Report² sought in part to address the issue of why the increased capital-raising flexibility permitted securities firms had not been utilized more fully. Among the answers it provided were the following:

- . the percentage of equity which a securities firm is permitted to sell to a single outside investor is too limited to justify the major adjustments which would be required in obtaining outside investors;
- . the 10 percent limit for single outside investors is too limited to encourage investment by such outsiders;
- . the rules limiting "approved investors" are too limited;
- . the limitations imposed on the transfer of securities by outside investors make investment in securities firms unattractive; and
- . the cyclical nature of the securities business which results in unpredictable levels of profitability from year to year.

Some of these issues will be broached later when the analysis focusses in more detail on the restrictions relating both to ownership and diversification of securities firms. For present purposes, these arguments are intended to serve as a substantive (and in my opinion, persuasive) counter-argument to the Medland Committee conclusion that unutilized capital-raising potential is synonymous with capital adequacy.

B: Capital Adequacy: Some Macro Data

An alternative way of focussing on the issue of capital adequacy is to compare the capital base of the U.S. and Canadian securities industries. Table 1 presents data on Canadian and U.S. securities firms as of March 31, 1977 and Table 2 presents a similar (but expanded) comparison for December 31, 1982. The results are both revealing and sobering. In 1977 Merrill Lynch has a capital base of \$640 million, three times the entire capital of the 94 Canadian securities firms. In 1982 Merrill Lynch's capital base remained roughly three times that of the entire Canadian industry, but by now there were four U.S. securities firms with capital in excess of the aggregate capital base of the Canadian securities firms. As of the end of 1982 the largest Canadian securities firm was Dominion Securities Ames with \$47 million in capital: it ranked 39th on the continent in terms of its capital base.

To be sure, there are certain problems with this comparison. The various regulations with respect to interest rates that apply (or have applied) to U.S. commercial banks as well as the limitations imposed on interstate banking have opened major avenues for innovation and "cross-pillar" activities for U.S. securities firms that are not as available in Canada. Indeed, Merrill Lynch can claim to be the first truly "national" bank in the U.S.

In spite of these factors which limit the implications that can be drawn from Tables 1 and 2, it is clearly evident that the much larger capital base of the U.S. firms affords them the

Table 1

Capitalization of the United States Securities Industry, Ranked by Group and Size of Firm, with Comparative Canadian Data

As of March 31, 1977

In thousands of dollars

U.S. firms	Capital ^a	Canadian firms
1 Merrill Lynch	640,000	
	200,000	All 94
	192,000	60 largest
2 Salomon Brothers	192,000	
	180,000	40 largest
3 Dean Witter Reynolds	176,000	
	157,000	20 largest
4 Bache Halsey Stuart Shields	152,000	
5 E. F. Hutton	150,000	
11 major U.S. regional firms	130,000	
	123,000	10 largest
6 ^b Paine Webber Jackson & Curtis	116,000	
7 Goldman Sachs	100,000	
8 ^b Loeb Rhoades	88,796	
9 First Boston	85,912	
10 Blyth Eastman Dillon	85,527	
11 ^b Shearson Hayden Stone	84,112	
12 Stephens	83,831	
	78,000	5 largest
13 ^b Drexel Burnham Lambert	75,000	
14 Donaldson Lufkin & Jenrette	74,000	
15 White Weld	73,000	
16 Allen	70,605	
17 Kidder Peabody	65,068	
18 Smith Barney Harris Upham	65,068	
19 Becker Warburg Paribas	65,000	
20 ^b Lehman Brothers	58,781	

a. Capital includes equity and subordinated debt.

b. Subsequently grown through merger.

Sources: United States data, *Securities Week* (New York), October 17, 1977;

Canadian data, see note 25 *supra*.

Adopted from J. Peter Williamson, "Canadian Financial Institutions" in *Consumer and Corporate Affairs Canada, Proposals for a Securities Market Law for Canada* Volume II, Table 30, p. 798.

Table 2

50 Largest U.S. Investment Bankers/Brokerages
With Inserted Canadian Data

December 31, 1982

Rank	Name of Firm	Total Capital (\$000)
1.	Merrill Lynch & Co.	\$1,685,277.
2.	Salomon Brothers Holding Co.	1,091,600.
3.	Shearson American Express	836,615
4.	The E.F. Hutton Group	608,061.
	All 98 Canadian Firms	576,990.
	All 79 TSE Member Firms	523,490.
	40 Largest TSE Members	493,550
5.	Goldman, Sachs & Co.	478,000.
6.	Prudential-Bache Securities	443,474.
	20 Largest TSE Members	431,418.
	10 Largest TSE Members	344,797
7.	The First Boston Corp.	341,161
8.	Paine Webber	313,738
9.	Dean Witter Reynolds	300,875
10.	Bear, Stearns & Co.	275,825
11.	Donaldson, Lufkin & Jenrette	249,036
12.	Stephens	248,268
13.	Morgan Stanley & Co.	247,000
14.	Drexel Burnham Lambert	241,307
15.	Warburg Paribas Becker-A.G. Becker	225,840
	5 Largest TSE Members	221,363.
16.	Lehman Brothers Kuhn Loeb	201,599.
17.	Smith Barney	167,800.
18.	Kidder, Peabody & Co.	151,436.
19.	A. G. Edwards & Sons	143,015.
20.	Shelby Cullom Davis & Co.	140,263.
21.	Allen & Co.	130,653.
22.	Thomson McKinnon Securities	126,079.
23.	Spear, Leeds & Kellogg	114,000.
24.	L. F. Rothschild, Unterberg, Towbin	102,633.
25.	The Securities Groups	90,025.
26.	Neuberger & Berman	85,751.
27.	John Nuveen & Co.	81,307.
28.	Oppenheimer & Co.	79,665.
29.	Aubrey G. Lanston & Co.	67,500.

Adopted from J. Peter Williamson, "Discount Brokerage and the Role of Financial Institutions in the Securities Market: A US-Canadian Comparison" (June 1983), Table 1.1.

Table 2 (continued)

30. Alex. Brown & Sons	66,089.
31. McMahan, Bratman, Morgan & Co.	60,700.
32. Bateman Eichler, Hill Richards Group	55,751.
33. Stern Brothers & Co.	55,100.
34. Brown Brothers Harriman & Co.	54,354.
35. Cowen & Co.	54,055.
36. Glickenhau & Co.	49,300.
37. Wertheim & Co., Inc.	49,160.
38. Carl Marks & Co.	48,339.
Dominion Securities Ames	47,130.*
39. Easton & Co.	46,380.
40. Allen & Co. Inc.	46,156.
41. The Ziegler Co.	43,951.
Wood Gundy	43,550.*
42. Prescott, Ball & Turben	39,772.
43. Nomura Securities International	39,766.
44. Dillon, Read & Co.	39,435.
Merrill Lynch Royal Securities	37,545.*
45. Van Kampen Merritt	36,275.
46. Rotan Mosle	35,702.
Richardson Securities of Canada	34,540.*
Burns, Fry	33,915.*
47. William Blair & Co.	33,345.
48. Piper, Jaffray & Hopwood	33,336.
49. M.A. Schapiro & Co.	32,710.
50. Dain Bosworth	32,372.

*1981 Data

Source: Institutional Investor, for U.S. firms (figures in \$U.S.)
TSE for Canadian firms (figures in \$Canadian)

opportunity to develop a range of domestic and international services well beyond those provided by Canadian firms and it also allows our American counterparts a far greater flexibility to innovate quickly if and when opportunities present themselves. These advantages and what they imply for the future of the Canadian industry will be detailed later.

There is a second set of "macro" data that also merits attention. This is the distribution of issues by type of market--private or public (i.e., unregulated or regulated). Table 3 presents 10 years of data on private vs. public placement (i.e. exempt market vs. regulated market placement) of corporate long term debt. While the percentage of public or regulated placement varies from year-to-year, it is evident that the direction over the ten years of data is toward a substantial increase in the proportion of issues that are traded in the private or exempt market. Since regulated firms are free to operate in the private placement market, the figures should not be read as necessarily implying that unregulated market intermediaries are enjoying an increasing share of overall issues. However, the growth of the exempt market is of concern to the regulated sector because they are in competition with firms which are not subject to registration and ownership requirements. These data were part of the underlying rationale for the recommendation of the Medland Committee to the effect that the exempt market should henceforth be subject to the same registration and ownership requirements as the currently regulated sector. As noted above and as will be

Table 3

Corporate Long Term Debt Issues

(by Type of Capital Market)

(\$ Million)

	<u>Private Placement</u>	<u>Public Placement</u>	<u>Total</u>	<u>% Public</u>
1974	717	1,810	2,527	72
75	581	2,478	3,059	81
76	764	1,719	2,483	69
77	1,266	1,876	3,142	60
78	826	1,647	2,479	66
79	949	1,219	2,168	56
80	1,581	1,381	2,962	47
81	2,030	1,161	3,191	36
82	1,154	983	2,137	46
83	1,735	1,167	2,902	40

Source: OSC

spelled out later there are better ways to ensure a "level playing field".

C: Capital Adequacy: Rephrasing the Issue

The emphasis in this section has been on whether the existing capital base of the securities industry is adequate. The Medland Committee has asserted that it is whereas other data can be mustered to argue the opposite. However, the fact that several Canadian securities firms do feel constrained by the ownership restrictions should carry the day on this issue. In my view, therefore, it can be demonstrated that the capital base is inadequate. But adequacy as such is not the issue: it is not the role for a regulatory authority to implement policy on capital access on the basis of some or another notion of capital "adequacy". Rather the policy issue is or ought to be the following: allow "maximum capital access" or "maximum availability of capital" subject only to any overriding public interest.

This refocussing of the issue is not merely a matter of semantics. It is at the heart of the economic approach to regulation since any impediments to capital access qualify as barriers to entry and as such may and likely will serve to emasculate the potential benefits that can accrue from greater competition. These concerns will be dealt with in the next section.

To conclude the present section it is instructive to note that the OSC has in the recent past recognized fully these implications and has appropriately placed the burden of proof on

those who would argue that increased competition is contrary to the public interest. In particular, in the "Green Line" case the OSC phrased the issue as follows:

The Commission determined that the test that it should apply in considering the implications of discount access services should be based on what is perhaps the fundamental principle of any free society: namely the presumption that any action is permissible unless it can be demonstrated to be contrary to the public interest. Thus the question before the Commission was: "Is the offering of discount services by financial institutions prejudicial to the public interest?", rather than "Are such services in the public interest?" The use of this test reflects the Commission's belief that free market forces should generally determine the availability of a service and that the four pillars concept is an exception from this view dictated by particular circumstances.

The Commission was not therefore concerned with protecting one segment of the financial system from competition from another as a matter of principle: Rather it sought to determine whether any breaking down of the separation of the investment banking and commercial banking segments of the system resulting from discount access services would prejudice the healthy functioning of the capital markets in Canada.

In addition, the public interest requires the Commission to determine whether the offering of discount access services by financial institutions would have an adverse impact upon

investor protection so essential to the healthy functioning of our capital markets.³

If the OSC is consistent in its approach to regulation, it will (and should) argue in the present set of hearings that the presumption is that enhanced access to capital "is permissible unless it can be demonstrated that to be contrary to the public interest". Thus, the appropriate issue to be addressed in the current hearings is not whether existing capital is or is not adequate, but rather whether there are arguments to the effect that enhanced access to capital would be contrary to the public interest. This phrasing of the issue places the burden of proof precisely where it ought to be--those that argue that for cartellization, protectionism, or impediments to the operations of capital markets should also bear the burden of proof for their positions.

With this as backdrop, I now turn to some analytical perspectives relating to the interaction among the role of capital availability, the operation of markets, and the rationale for regulation.

V: THE RATIONALE FOR REGULATION: ANALYTICAL NOTES WITH RESPECT TO CAPITAL ACCESS⁴

A: Regulation vs. Competition: General Comments

I begin the analysis with the presumption that it is in the public interest to foster competition across the widest range of economic activity. Since regulation is one of the principal ways in which competition can be restricted, the further presumption is that regulation should be countenanced only when it can be

demonstrated that it is in the public interest. I shall apply these general propositions together with some analytical underpinnings to the securities industry later in this section. For the present, I want to focus on some rather general comments about regulation.⁵

In the last decade or so, it has become recognized that much (but obviously not all) of the so-called "public interest" regulation of enterprise frequently embodies a significant income redistribution component. This finding became popularized as "Stigler's Law"--that regulation tends to be in the interests of those being regulated. In this light the aspects of regulation that are particularly relevant are not only those that bestow a valuable property right on an industry but also those that shelter it from the discipline of the market. In terms of the former, regulation that eliminates price competition or erects barriers to entry will not only tilt the distribution of income toward the industry, it will also shelter the firms from market developments external to the industry. Technological change and innovation arising in the market place cannot impinge directly on behaviour within the industry and as a result they are, at best, substantially delayed and, at worst, inhibited or suppressed. But the income-distributional and market sheltering aspects need not be coincidental. It is this latter aspect of regulation, namely the ability of regulated firms to substitute the regulatory process for the market that may be of especial value to them. Therefore, one of the major roles that the regulatory process can play, and one that those being regulated often want it to play, is

the imposition of due process requirements on any change in the existing set of goods, prices and market structures. This protects existing investments, practices and structures from sudden unexpected reductions in value that might occur if these agents were subject to the discipline of an unfettered market.

Regulation can also serve to preserve the existing market structure within the industry. This is particularly the case when regulation takes the form of limiting access to capital. The large and/or well-established firms typically will benefit at the expense of the small and new.

These observations were not directed at the securities industry, per se, although I would be surprised if most were not pertinent. Rather, they were meant to emphasize the point that much of what passes as "public-interest" regulation may not really be in the public interest. This is what Milton Friedman refers to as the invisible hand in politics (as distinct from the invisible hand in economics): "In the political sphere individuals...who attempt to pursue the public interest as they view it are led by an invisible hand to further private interests which it is no part of their intention to promote."⁶

None of this analysis is meant to suggest that there is no case for regulation. Obviously, there is. The remainder of this section is intended to spell out the nature of this case for regulating the Canadian securities industry and what form this regulation might take. In particular, the emphasis will be directed toward the issue of whether a case can be made to restrict access to capital.

B: The Case for Regulation of the Securities Industry

1. Full Disclosure and Consumer Protection

Two decades ago, the Royal Commission on Banking and Finance (the Porter Commission) noted:

The philosophy of securities regulation in Canada is based on two principles, full disclosure and the prevention of fraud... The first is supported by securities and company legislation and the regulation of stock exchanges, while the second rests on the preventative and punitive powers of the securities laws and the federal Criminal Code as well as those of the by-laws and regulations of the self-regulating associations.⁷

In terms of the mechanisms involved, John Todd, in a recent Ontario Economic Council publication, elaborates:

To enforce the principle of full disclosure, provincial legislation relies on two general methods: registration and investigation. The first ensures that the Ontario Securities Commission (and its counterparts across Canada) has control over those selling securities to the public, and that those persons are properly qualified. Registration applies not only to the brokerage firm itself, but also to the salesmen employed by the firm.

The OSC uses registration to ensure that the rules pertaining to full disclosure are adhered to... The OSC has control over all TSE (Toronto Stock Exchange) bylaws that it considers to affect the public interest.

The OSC is also empowered to investigate any complaint of

wrongdoing. Although it does not have the power to fine or imprison, the OSC can suspend or cancel registration of a broker or brokerage house. The OSC can also order that trading in a particular security can be halted. These decisions are made when the...OSC perceives that the public interest is being harmed.⁸

In somewhat more detail, these concerns are met in terms of the requirements for filing prospectuses, and in terms of the various registration criteria enumerated earlier (bonding, regulatory capital requirements, adherence to know-your-client and suitability rules, educational requirements, etc.).

However, over time the OSC has, in its wisdom, argued that certain types of securities (eg. government securities) are, by their very nature, instruments for which further regulation re fraud etc. would be superfluous. Moreover, certain types of agents are, again by their very nature, sufficiently sophisticated and/or able to appraise the quality of issues on their own so that they need not be subject to the sorts of protection designed for the "average" investor. This led to the "exempt market" or "unregulated sector" referred to in a previous section. Naturally one may quibble about where the line should be drawn in terms, for example, of the size of the maturity issue that qualifies for exempt status, but in general this notion conforms to the principle that regulation is a departure from competition and should only be carried as far as is absolutely necessary.

The Medland Committee's recommendation that the exempt market activities be subject to regulation with respect to both

registration and ownership restrictions is clearly at odds with the above analysis. The burden of proof must rest on the Committee to show that the exempt market transactions (a) are contrary to the public interest and have been over the years, and (b) that registration and ownership restrictions are the way to handle any problems that may exist. The only case that I can see for the Committee's position is that the individual investor may not have access to the full range of financial instruments because he/she is precluded from participating in much of the exempt market. But these concerns can and to some extent are being resolved. For example, McLeod Young Weir, and presumably others as well, are now allowing individual investors to purchase "tranches" of the weekly treasury bill issue. On the equity side, were the recent innovation of "bought sales" to spread, there is no reason why individual investors could not be offered a chance to purchase "tranches" of these equity issues as well (particularly if some of the recommendations that follow are implemented).

What is clear from all of this and what is absolutely critical in my view is that the combined concerns of disclosure and consumer protection have absolutely nothing whatsoever to do with ownership or restrictions thereon. This does not mean that there cannot be arguments for restrictions on ownership, only that they must find their rationale elsewhere.

2. Conflicts of Interest

Marshall (Mickey) Cohen, the Deputy Minister of Finance noted recently that the policy concerns in the financial area are

five-fold--solvency, competition, efficiency, conflicts of interest and concentration. The purpose of this section is to focus on conflicts of interest with later sections dealing with some of the remaining issues.⁹

There is no question that conflicts of interest exist in the financial services area and there is also no doubt that they ought to be of concern to regulators. However, there is also no question but that the conception of the four pillars tends to focus attention on the conflicts of interest that arise from cross-pillar activity, with the implicit assumption that conflicts of interest are negligible within each of the four pillars. This is clearly not the case. The very nature of the securities industry involves a potential conflict of interest between dealers and brokers. The way this potential conflict of interest is handled is through the OSC's registration requirements which ensure professionalism. Thus far, at least, the arguments seem to be that this professionalism can only be maintained if it is also accompanied by ownership restrictions. But some of the existing securities firms are publicly owned, some of them (the grandfathered ones) are foreign and among these at least one is owned by a financial institution. Does the effectiveness of registration and the maintenance of professionalism vary across these firms? If so, the public ought to be informed.

From the Director of Research of the Combines Investigation Act:

Existing regulation to protect against the potential conflicts of interest that may arise from the combined broker

and dealer roles of most securities firms would serve equally well to protect the public interest against parallel potential conflicts that would exist in firms owned by institutional or other investors. If direct regulation adequately controls officers and directors of securities firms, then direct regulation can be expected to also adequately control public owners.

Since direct regulation is considered adequate and is required in any case to protect the public interest and to guard against unprofessional conduct, the use of ownership restrictions seems unnecessary as well as being anti-competitive...

[Therefore] existing registration requirements ensure that professionalism is maintained regardless of where financial ownership lies. Furthermore, even in the absence of limitations on public ownership the Commission [OSC] would continue to exercise its authority under the Act to approve all major investors...in order to ensure that professionalism is not compromised.¹⁰

In short, at least as far as non-industry, non-financial ownership is concerned, I find it difficult to believe that there is something peculiar to Ontario that requires that our securities firms can only be owned in 10% tranches. Does Merrill Lynch lack professionalism? What I do not find difficult to believe is that the conflict-of-interest and professionalism appeals in order to restrict ownership and investment in securities firms are a very

effective way of maximizing industry rents, at the expense of the investing public.

When it comes to relaxing ownership restrictions with respect to investments in securities firms by other financial institutions I can understand that more concerns are likely to be raised. However, most of the above observations still ring true. Protection of the independence of securities firms does not require ownership restrictions since securities firms and other financial institutions such as banks, trust companies and insurance companies are restricted by current legislation from offering their services jointly:

An outright restriction on institutional investment is an appropriate policy if the goal is to maintain the financial separation of the securities industry from other financial industries. It is not appropriate, however, if the goal is to maintain the functional separation of these industries.¹¹

The Medland Committee is somewhat inconsistent with respect to this general issue. It wants to severely limit institutional participation at the ownership end but endorses contractual relationships at the product end (i.e., networking). Taken literally, this would appear to be a move in the direction of institutional separation and functional integration whereas I had thought that institution integration (ownership) but functional separation is more in keeping with the existing approach to financial regulation in Canada and Ontario. In other words, financial separation is not necessary for functional separation (On the more general issue of whether functional separation, i.e.,

preserving the four pillars, is appropriate or possible, my own view is that substantial further financial integration is inevitable. However, this is a separate issue from that currently before the OSC).

As a final comment on outside ownership, the implicit assumption would appear to be these outside owners would lower firms' professional standards without, for example, compensating elsewhere such as lowering the price of services, so that the viability of the firm is put in doubt. This does not attribute much rationality to the outside investor--he is assumed to take those sorts of actions that will undermine the value of his investment.

In summary, I would argue that conflict of interest concerns are not sufficient to argue for ownership restrictions. As an overall assessment of the issue I would like to associate myself with comments by Professor Booth to an earlier set of OSC hearings:

conflicts of interest already exist and are not restricted solely to the question of diversification or public ownership of securities firms. Trust companies, for example, are slowly entering the field of commercial lending and are already in the position of being able to use fiduciary accounts to bail out bad loans. Similarly, securities firms can use their managed funds to bail out a failing new issue. What advocates of market segmentation have to show is why the restrictions on securities firms are justified by conflicts

of interest, when such problems are rampant in other areas of the financial services industry....

[This is particularly so since] failing investor rationality we do have legal rules that can prevent the problems of conflict of interest from arising. Such rules exist, for example, to protect the mutual fund investor from churning by the securities firm. If these rules are efficiently policed there is then no reason why we should add an additional restraint on the ownership of the securities firm.¹²

3. Solvency

In terms of solvency as a rationale for regulation, Mickey Cohen's observations appear fully adequate:

government regulation of financial institutions, in fact, started with the solvency question. At that time, financial institutions were small, often inadequately capitalized, and sometimes lacking in proper experience, expertise and adequate access to emergency sources of funds. Regulations dealt with these problems, often prescribing detailed operating procedures and strictly limiting borrowing and lending powers. Investment rules have included prescribed types of assets and asset ratios, prescribed loan to security ratios, limitations on acceptable security and restrictions on holdings of speculative assets such as common stock. In the last several decades, the solvency question has become relatively inconspicuous. Testimony, I suppose, to the success of the regulations and to the growing sophistication and ability of the major institutions to cope with their

problems. Solvency does remain an important concern, although it clearly no longer has the virtually exclusive claim on policy focus it once had.¹³

I take it as self-evident that the issue of solvency cannot be used as a crutch to restrict ownership.

There is, however, an issue related in part to solvency that is not given much attention either in the Medland Report or in the various submissions to the OSC. Following the U.S. lead, Canadian securities firms are now in the deposit-taking and even the transfer-by-order (chequing) activities. These funds are referred to as "free credit balances" and they now exceed \$1 billion and have exhibited a 48% compound annual growth rate over the 1976-1983 period.¹⁴ The securities firms have no interest in focussing on these deposits since they can be viewed as an intrusion by the industry into the area of banking. Not surprisingly, however, the Canadian Bankers' Association submission to the OSC devotes considerable attention to this deposit-taking activity. Interestingly enough, the CBA's point is not that these activities should cease, but that the deposits should have the protection of some sort of deposit insurance. It is clear that the banks will make this point since the absence of deposit insurance implies that the securities firms can offer a higher rate of interest on these deposits. If the securities dealers were forced to be covered under the Canada Deposit Insurance Corporation fund or to establish a similar fund of their own they would probably have to meet minimum prudential guidelines with respect to capital adequacy, liquidity, and solvency.

However, deposit insurance can be mixed blessing. Presumably depositors with securities firms recognize that their funds are not insured and they also recognize that this means that they are compensated by a higher rate of return. Moreover, the present deposit insurance scheme is problematical in the sense that single-rate insurance for \$60,000 per depositor may entice the insured firms to take undue risks so that there may be a trade-off between depositor safeguards and firm solvency. In effect, what this really means is that there is a need to take a closer look at the operations of Canada Deposit Insurance Corporation. But this is obviously beyond the purview of these hearings.

It is important to recognize, however, that these free credit balances do have some relationship to the overall issue of access to capital. In effect, they have provided securities firms with an escalating source of working capital over the last decade and probably have offset some of the deleterious effects of the ownership restrictions on capital.

In general, my view is that these balances represent a valuable addition to consumer instrument choice and ought to be defended as an essential component of the market intermediary function. I do not think that the OSC should remain silent on this issue in its final report.

Second, it is not obvious that securities firms should be compelled to join a deposit insurance scheme. What is essential, however, is that the general public be fully aware of whether or not these deposits are insured. If the public (by their actions) demands that the deposits be insured, then the securities industry

will be motivated to design a deposit insurance system or to joint the CDIC. In this connection it should be noted that these free credit balances tend in general to be offset by assets that are also of very short maturity (e.g., treasury bills). The risks involved in a "run" on the deposits of a security firm may be substantially less than a run on the deposits of a bank where the offsetting assets typically have a much longer maturity. In other words, there is unlikely to be a "maturity imbalance" in a security firm to the same extent there is in other financial institutions. This will, in turn, influence the type of any deposit insurance scheme that is put in place. Nonetheless, there are implications for the present size of the industry's National Contingency Fund that ought to be aired in the OSC's overall report. Fourth, to the extent that lessening ownership restrictions and/or diversification opportunities for securities firms reduces their risk (as I shall later argue will be the case), this opening up the industry should ease some of the concerns related to these free credit balances.

Finally, and returning to the original thrust of this section, a concern over solvency does not point in the direction of limiting ownership.

4. Concentration

Regulatory authorities ought to be worried about concentration not so much in the sense that it will alter the direction of regulatory reform but rather because it may have implications for the appropriate pace of reform.

It is clear that concentration concerns loom as one of the principal arguments for restricting financial institution ownership of securities firms. The vast difference in size and capital base between, say, the largest five security firms and the largest five chartered banks naturally heightens the concerns over concentration both within the securities industry if the banks take over some securities firms and across the pillars in terms of enhancing the financial scope of the chartered banks. There is no question that if, as a result of easing up on financial institutions ownership, the securities industry came to be dominated by five large firms the commission rates would likely increase and the operational efficiency of the capital markets would be reduced to the detriment of all (except the banks, of course).

Professor Booth addressed this very issue on his submission to the 1982 OSC hearings on institutional ownership and diversification:

The question is, could this [dominant position of the banks] position be maintained? First, we have to maintain collusion between the banks. Certainly, some observers have testified that the Canadian banking industry is monopolistic and collusive and as a result earns monopoly profits. However, their position has historically been protected by legislation restricting the entry of new banks and the barrier to entry posed in having to set up a branch network. If the regulatory bodies do not support legally a monopolistic practice in the securities industry, then the absence of

barriers to entry will cause new firms to enter and the bank's monopoly to weaken over time and with it the operating inefficiencies.

Moreover, the existence of close substitutes to Canadian market intermediaries, namely U.S. market intermediaries, will act as a check on the exercise of monopoly power, even in a highly concentrated Canadian market. The experience after 1975, when U.S. commission rates were negotiated and those in Canada were still fixed, acts as a lesson to those in Canada who would attempt to maintain monopoly prices for market intermediation within Canada.

It is my opinion that even in the very worst case of total control of the securities industry by the chartered banks, that there is enough competition within the banks and between the U.S. and Canadian market intermediaries, that this allied to the lack of barriers to entry would result in competitive prices being charged. However, no-one has conclusively shown that the brokerage industry will be taken over by other financial institutions. This would have been likely before the advent of negotiated commission rates, since it was then in the interest of those financial institutions to circumvent the monopoly prices being charged by the brokerage industry. However, with the increased competition that will result from negotiated commissions, there is almost no reason why a financial institution would want to take over a brokerage firm, since orders will then be executed at marginal cost.¹⁵

The experience from Britain upon the opening up of ownership rules is that to the extent that the banks moved into the brokerage business it was generally through setting up their own companies rather than via the takeover route.

However, there is far too much concern raised about the possibility of the banks moving in. They cannot. The Bank Act will not let them. It is not obvious that the OSC ought to be overly concerned with the banks when focussing on the possibility of opening securities firms up to institutional investment. It seems to me that to treat the banks differently from other financial institutions will be to open up the possibility of a Supreme Court challenge. To give them equal status with respect to other financial institutions will not be to allow them to take advantage of this opportunity unless the federal government eases up on Bank Act restrictions. Under the current sunset clause that will not occur until at least 1990 and, if the last Bank Act revision is an indication of the review process, probably not until 1992 or 1993. So one could be talking of a six to eight year head start before the banks could come on stream. And it is far from clear that even then the federal government would adopt an open cross-pillar policy for the banks. As a matter of fact, it may well be the case that unless the securities industry uses this window of opportunity wisely in terms of responding to the needs of the economy, Ottawa will be more prone to step in and allow the power and influence of the banks to strengthen the domestic securities industry.

The second general point I want to raise with respect to concentration is that it is all too easy to view the issue from the wrong perspective. The accepted perspective is that that banks are too big. I submit that it is far more appropriate to argue that the securities industry is too small. In turn, this is in large measure a result of overly restrictive ownership and investment rules.

Further to this point, it is instructive to quote from one of the major contributors over the years to the analysis of the Canadian securities industry and to the OSC hearings, Professor J. Peter Williamson. As a prelude to the quotation I am interested in, it is important to note that Williamson is on record as arguing for an increase in the access to capital:

The capital needs of the securities industry constitute one aspect of the economics of the industry that will probably call for some decisions before long. There appears to be evidence that the Canadian securities industry would be stronger and certainly less fearful of foreign competition if it were better capitalized. The rules of the self-regulatory organization at present stand in the way of substantially increased capitalization and a regulatory commission may simply have to intervene.¹⁶

This is, of course, the core of my own approach. Earlier in this same article Williamson offered his interpretation of the imposition of the foreign ownership restrictions:

The Securities Industry Ownership Committee of the Ontario Securities Commission referred to the regulation as a

stopgap, to prevent foreign firms from exploiting the undercapitalized Canadian industry until the resident-owned firms could obtain access to new capital. At that stage, the domestically owned firms would presumably not need further protection and the issue of foreign influence would have to be resolved at the federal level.¹⁷

However, in my view, this window of opportunity was not utilized to advantage, largely because of the overall regulatory environment, and the securities industry is free to raise the concentration banner once again against either or both of foreign or institutional ownership. But concentration is rapidly becoming a vicious circle. Because of ownership restrictions the Canadian securities industry remains smaller and less capitalized than it would otherwise be. Hence the industry can continue to fall back on concentration to support the maintenance of limitations on ownership. Now is the time to break through all of this and to move forcefully to allow substantially freer access to capital.

The final point I want to make under the issue of concentration is more in the nature of a query. The chartered banks have a substantial international presence. In an area where the securities markets are rapidly becoming more and more internationalized, there is probably no better partner for off-shore ventures than one of the big five chartered banks (or perhaps one of the new foreign banks). From the existing securities legislation and from the recommendations of the Medland Committee as well I would take it that the securities firms could

engage in such venture off-shore. But not in Canada. There is a certain irony in this. Perhaps it is best left at that.

5. Competition and Efficiency

Mickey Cohen's remaining two rationales for a regulatory presence were those relating to competition and efficiency. In analyzing the four earlier arguments for regulation, my general conclusion was that they did not stand in the way of loosening the shackles on ownership although for some of them one might be able to muster an argument that they might have something to say about the pace of the process. As far as competition and efficiency are concerned, I take it as axiomatic that they are essentially synonymous with opening up capital and investment avenues and, more generally, with subjecting the securities industry to the play of market forces. Rather than focus on these two remaining rationales I shall subsume them in the analysis of the following section which focuses on a rather wide range of arguments to support the proposition that greater access to capital is essential for the future well-being and vitality of the Canadian securities industry and, more importantly, for investing and entrepreneurial Canadian. Since securities regulation is intended to serve the "public interest", much of what the next section is about is that the relevant "public" is the investing and entrepreneurial Canadian and their "interest" is in greater capital access.

VI: THE CASE FOR CAPITAL ACCESS

Various of the submissions have made the case for enhanced capital access on grounds such as the pace of technological

change, the increasing internationalization of markets, and the intensification of competition. While I naturally agree with many or most of these arguments, I want to approach them from a somewhat different vantage point. Accordingly the first part of this section will focus on the need for greater capital access from the vantage point of the individual investor. The second part takes the point of view of the enterprise sector. Somewhat presumptuously, the next section will attempt to argue the case for capital access from the vantage point of the industry.

A: The Demands of Individual Investors

Registered Canadian securities firms are in competition with U.S. firms in the sense that individual investors are free to use their telephone to access an American broker and trade in foreign markets. The information and technological explosion (on the side of provider and user alike) is such that Canadians are progressively going to demand the same sort of services from domestic firms as they know they can get internationally.

One of these services relates to access of state-of-the art technology. For example, as Williamson points out, E.F. Hutton is now offering a "home brokerage" package that individuals can access with their micro computers and which will give them an instant overview of their holdings, their most recent trades, the current prices etc. These services require capital.

As important is the overall range of services offered by brokers. With the growing internationalization of capital markets, an individual will not be served fully unless his/her securities firm has access and expertise in international trading.

It seems to me that except for a few well-established firms, this will require some sort of joint-venturing with off-shore firms. If access to capital is not sufficient for the domestic participants to become significant players on the international scene and if, as a result, they drift in the direction of becoming "regional brokers" in the international setting then one can reasonably predict that individual Canadians will progressively look south for their investment needs.

In short, from the standpoint of the investing Canadian, the present ownership restrictions are hard to support and increasingly so as technology and internationalization increase.

B: The Needs of the Enterprise Sector

Much has been said and written to the effect that Canadian industry is undercapitalized particularly in comparison with U.S. industry. There are, of course, many reasons for this such as the comparative tax treatment of equity and portfolio capital. Nonetheless, part of the solution is to ensure that our capital markets become as efficient as possible. In particular, there is a perception that this is particularly the case for small businesses.

As Mickey Cohen noted recently:

within the broad play of financial markets, our needs are shifting. For example, the Canadian corporate balance sheet is undercapitalized and over leveraged. This remains the case, notwithstanding the extraordinary performance of the new issue equity markets in the last twelve to eighteen months, and this problem is particularly acute for the

medium-sized and smaller businesses where equity capital is often hard to come by and likewise is often hardly sought for. That latter comment is very important and let me repeat it. Small and medium Canadian businesses often do not seek equity capital until it is too late. Hence, in the strictest sense this is not a failure of the financial marketplace. But I put it to you that there are moments when it is important to go where you are invited, and this is one of those moments.¹⁸

Pierre Lortie, of the Montreal Stock Exchange, makes a similar point: equity financing of small and medium-sized companies and the provision of risk capital should be a "key objective in regulatory reform."¹⁹ Catering to these important needs is synonymous with opening up the access to capital.

1. The Concept of "Bought Deals"

In terms of the sorts of innovations that are valuable to Canadian enterprise but that require an insurgence of new capital, one of the best examples is the so-called "bought deal". The Canadian Bankers Association brief comments as follows on bought deals:

The use of "bought deals" is a further example of trends in the securities industry impacting on the capitalization of dealers. It is estimated that between January 1 and July 31, 1984, about \$1.5 billion in "bought deals" have been done, out of a total of about \$6.5 billion in dealer new corporate issues, or about 25%.

This increased reliance on "bought deals" exposes capital to a higher degree of risk. Rather than syndicating and thereby diversifying away some of the risk as in a traditional underwriting, a single dealer assumes it all.

The combined effect of the aforementioned trends toward a changing "business mix" dictates, at a minimum, a review of the capitalization of standards governing the securities industry.²⁰

This point was made with even more force in the CIBC (London) submission:

The international capital markets use almost exclusively today the concept of the "bought deal". This type of business consumes a very large amount of capital and inherently involves substantial risks. One of the reasons why Canadian issuers use the international capital markets so frequently is that they are provided with this type of structure. Once the client has experienced the security and speed of a "bought deal" where he knows precisely, in a volatile market, that he has achieved a desired price, he never really feels comfortable going back to the quasi-agency style of underwriting that is the Canadian domestic norm. Arguably one of the substantive reasons for the failure of the Canadian securities industry to seek a major role in international capital markets has been their inability to generate a sufficient capital base to enable them to perform this role. As such, the Canadian securities industry has had

to be risk-averse and has, therefore, given up this role to foreign banks²¹

Much of the innovation that has occurred in the very recent period in the Canadian securities industry is occurring in the exempt market (whether domestic or off-shore). It would seem patently obvious that the registered dealers would make an important contribution to this innovation if they were allowed to compete in the exempt market without an ownership impediment. This is one aspect of enhanced access to capital. The other and more important aspect is to enhance capital access in the registered market. Not only would this be in the interests of the issuers of either bonds or equity but as well it would be consistent with the on-going policy of the federal government to enhance Canada's ability to penetrate foreign markets. For this to be successful, Canadians must have access to capital at the best possible rates which in turn means removing impediments to competition in the capital markets.

C: Impact on the Industry

The ownership restrictions on regulated sector of the securities industry are such as to lead to the following two observations: (1) firms are at present owned primarily by their employees who suffer from having a substantial part of their wealth tied up with the fortunes of one industry; (2) relatedly, securities firms are at present at a disadvantage relative to financial intermediaries and to foreign and exempt-sector market intermediaries in that they are essentially forced to finance

their growth from the internal resources of their owner-managers.22

I find Professor Booth's analysis of these points difficult to improve upon:

By restricting public ownership of the securities industry to those who are employed in it, you force upon them the holding of an extremely undiversified securities portfolio. Not only is their human capital, or career, tied up with the securities industry, but so too is the bulk of their personal wealth. The basic proposition of finance is that expected return or profit on an investment is a function of their riskiness of that investment. By not allowing diversification of their wealth, through public ownership, it is to be expected that profits within the securities industry are higher than they would be if the investors in that industry could diversify their wealth and thus reduce the risk to which they are exposed. The profits within the industry are increased via higher commission rates or wider bid-ask spreads in the dealer market, both of which reduce the operating efficiency of the Canadian capital markets. Restrictions on public ownership and diversification thus create operational inefficiencies. These can best be reduced by public ownership. The employees and owners of securities firms can thus sell off part of their capital investment in the securities industry and buy shares in unrelated industries. The holding of a diversified personal portfolio will reduce the risk borne by the investors in the securities

Table 4

A Sample of Selected Canadian Borrowers in the Euro Market

Showing Their Principal Lead Managers

<u>Federal Government, Provincial</u>		<u>Currency</u>
Government of Canada	Deutsche Bank	US
Province of British Columbia	Deutsche Bank	US
	Swiss Bank Corporation	Cdn
Ontario Hydro	Deutsche Bank	US
Province of Manitoba	Wood Gundy	US
Province of New Brunswick	Credit Suisse First Boston	US
Province of Newfoundland	Credit Commercial de France	US
Province of Nova Scotia	Union Bank of Switzerland	US
Province of Quebec	Warburg/Credit Suisse First Boston	US
Hydro Quebec	Warburg/Credit Suisse First Boston	US
	Merrill Lynch	Cdn
Province of Saskatchewan	Credit Suisse First Boston	US
EDC	Credit Suisse First Boston	US
	Wood Gundy/Orion	Cdn
FBDB	Wood Gundy	US/Cdn
Farm Credit	Goldman Sachs	US
	Wood Gundy	Cdn
Canadair	Merrill Lynch/Morgan Guaranty/CIBC	US
 <u>Selected Corporates</u>		
Alcan	Morgan Stanley	
	Swiss Bank Corporation	
Bell Canada	Union Bank of Switzerland	
Canadian Pacific	Orion/Swiss Bank/Goldman Sachs	
Gaz Metropolitan	Wood Gundy	
Gulf Canada	Morgan Grenfell	
Hiram Walker	Morgan Guaranty/Warburg	
Hudson's Bay	Morgan Stanley/CIBC	
Imasco	Wood Gundy	
Inco	Morgan Stanley	
Loblaws	Orion	
Pan Canadian Petroleum	Orion	
Royal Trustco	Wood Gundy	
Seagrams	Wood Gundy	
Shell Canada	Morgan Stanley	
Simpson Sears	Wood Gundy	
TransAlta	Merrill Lynch	
Trizec	Merrill Lynch/CIBC	
George Westons	Hambros	
Xerox	Orion	

Source: CIBC (London) submission, op.cit., Appendix A.

industry and thus reduces the required level of profits and the resulting operational inefficiencies.²³

No doubt it is the case that many of the existing securities firms are content with their current state and are not desirous of greater access to capital. No one is suggesting that they ought to take advantage of any regulatory change that eases the capital restrictions. But there obviously are a substantial number of firms who do feel a need for an insurgence of capital in order to play a greater role in the markets for capital, both domestic and international.

In this vein, I was impressed by the CIBC (London) submission which argued that, except for one firm (presumably Wood Gundy), the Canadian securities industry does not have an adequate international presence in terms of marketing domestic securities offshore. Table 4, adapted from the CIBC brief, illustrates this rather persuasively. I draw three implications from this table. First, there is a market that Canadian securities firms can enter if they are given more freedom to operate. Second, the securities affiliates of chartered banks (Orion and CIBC) are likely to increase their role in international placements vis-a-vis registered securities firms or their affiliates unless there is more access to capital for the latter. Third, and most important, unless the registered firms are given more room to manoeuver, I predict that Canadians will eventually demand that companies like Orion and CIBC be allowed to operate freely in the domestic market. The notion, implicit if not explicit, in the Medland Report that one can separate the domestic market from the

international one is, in my view, inherently wrong. Allowing firms the freedom to free-wheel offshore is not the same as ensuring that they can provide the appropriate range of activities to the domestic market. For example, it will become progressively harder to maintain top personnel since the domestic industry will not be able to provide the exciting environment that a full-service international firm will. We are moving toward one integrated world capital market. Turning inward and ignoring this fact may well result in the domestic industry being overwhelmed the Orions and CIBCs of this world.

VII: MODELS OF REGULATORY REFORM

Thus far, the thrust of the analysis has been that it is essential to all concerned to free up the regulated sector of the Canadian securities industry. Were one to adopt such a framework, however, there would still remain the critical issue of converting principle into practice. While I have no expertise at all in the area of institutional design, it nonetheless does seem useful to outline some alternative models of regulatory reform.

Model I: The Medland Approach

- maintain the status quo with respect to registered firms;
- require registration and ownership restrictions for participation in the exempt market.

Comments: Completely inappropriate, in my view, and in the view of all the briefs except the Medland "update".

Model II: The Status Quo

Comments: There would appear to be no support for this, but it would at least ensure some competition and innovation in the exempt market. In this sense it is much preferable to the Medland Approach.

Model III: The Status Quo A La Gordon Capital

- maintain the status quo with respect to the registered market;
- allow registered firms to joint-venture freely in the exempt market so as to compete with the unregulated participants. (For future reference, this provision will be referred to as the "exempt market provision").

Comments: This would appear to be the minimum acceptable reform. However, it is easily dominated, in my view, by the range of models in approach V.

Model IV: Model III Plus Registration Provisions For All

- participants in the exempt market would have to register but would not be subject to any ownership restrictions.

Comments: Several of the briefs from off-shore firms appeared quite willing to register with the OSC, with some provisos, e.g., that it suffice to have an office somewhere in Canada and not necessarily in Ontario.

The potential downside to this approach is that once registration is required for the exempt market it becomes easier at a future

date to convert this in the Medland Approach by insisting upon ownership restrictions. This concern is much alleviated if some version of Model V is adopted which eases up substantially on the restrictions on ownership and investors in the regulated sector.

Model V: Opening Up the Registered Sector

- the "exempt market provision" would still apply;
- ownership restrictions would be eased for the registered market.

Comments: This model is complicated since one has to be concerned with 3 and perhaps 4 types of owners:

1. general public (Canadians)
2. foreign owners
3. financial institutions
4. banks

In terms of the first of these, i.e., the non-industry, non-financial institutions, non-foreign investors, it seems to me that there is no compelling case for any restriction on ownership. In terms of 2, 3, and 4 there may be a case for slowing the pace of any easing. The notion of preserving Canadian ownership may dictate some concern with respect to the options available to foreign owners. Concerns over concentration may provide a case for limitations with respect to financial institutions and banks. And so on.

For example, the specific ownership regulations proposed in the McLeod Young Weir submission would fall within the framework of this approach:

- (a) a bank could own up to 10% of any class of securities of a securities firm, subject to reconsideration at such time as the restrictions in the Bank Act governing the ownership of securities firms by banks are reviewed;
- (b) Canadian financial institutions, other than banks, could, subject to their own governing legislation, own up to 40% of any class of securities of a securities firm provided that no non-residents and no other financial institutions, including banks, owned by securities. Financial institutions would be broadly defined to include banks, insurance, loan and trust corporations, pension funds, credit unions, caisse populaires, other "near banks" and affiliates of any of the foregoing;
- (c) a non-resident could own up to 40% of any class of securities of a securities firm, provided that no other non-resident and no financial institution, including banks, owned any securities;
- (d) any number of financial institutions, including banks, (resident or non-resident) and any number of non-residents, as a group, could own in the aggregate up to 40% of any class of securities of a securities firm, provided that no other non-residents and no other financial institutions owned any securities; and

- (e) any approved shareholder or a group of approved shareholders could own up to 100% of any class of securities of a securities firm provided that they were neither financial institutions nor non-residents. No minimum level of industry ownership would be required; however, the securities commissions and/or the self-regulatory organizations would continue to approve individual shareholders.²⁴

The McLeod Young Weir brief then goes on to argue for some ownership restrictions (with appropriate grandfathering) on the exempt market as well. Basically, these would be more lenient to both foreign and financial institutional investors than is the case for the registered market.

I have one minor comment with respect to this specific proposal. It seems to me that the OSC may run into a constitutional problem if it attempts to treat chartered banks differently than other financial institutions. If for some reason it wants to do so, then it seems to me that the way to go about it would be to take what, at first blush, might appear to be a counter-intuitive route--namely, make the provisions for the banks the same as for other financial institutions, and then make a case aimed at the federal regulatory authorities that the Bank Act legislation should be more restrictive than the OSC provisions.

In general, however, Model V can incorporate a variety of pragmatic approaches to opening up the domestic securities industry to greater competition.

Model VI: The Unfettered Market

- no ownership restrictions;
- registration for all.

Comments: It seems to me that Model VI, like Model I, is a non-starter.

However, I would suggest that the OSC should adopt Model VI as its underlying reference point. As a basic starting point it provides a much better perspective on the economic issues than does Model V. Under V, for example, one would have to justify an easing of ownership as being in the public interest. Under VI, the emphasis would be on justifying a restriction of ownership as being in the public interest. This is where the onus of proof has to lie. The principle adopted by the OSC in phrasing the issue for the Green Line decision is also appropriate here--"the presumption that any action is permissible unless it can be demonstrated to be contrary to the public interest".²⁵ Therefore, even though Model VI is not likely to emerge as a viable end result, it has much to commend it as the starting point for the OSC deliberations.

VIII: CONCLUSION

For a country of some 25 million persons we have a remarkably efficient financial system. Regulators and participants alike can take pride in this accomplishment. However, the nature of the markets for capital is rapidly changing. Technology is a driving force, so is the rapid integration of domestic markets into a global capital market. My underlying approach to this challenge is straightforward: we must aim to be world class. We stand to

be passed by if we choose to become "regional brokers" within an integrated world capital market. The regulatory process must accomodate, not frustrate, those who desire to grow and innovate both domestically and internationally.

The second general point I wish to make is that what is at stake in these hearings is Canada's competitive position in the world economy. The thrust of the recent federal budget statement is that Canada needs to regain its competitive edge and to enhance penetration of foreign markets. Among other things this implies that capital be available as cheaply and as efficiently as possible not only to large firms but to small and medium-sized companies as well. The regulatory authorities should ensure that the Canadian securities industry is positioned so as to facilitate the achievement of this national goal.

Finally, and relatedly, regulatory reform is seldom conducted in a vacuum. In the recent trust company review in Ontario, solvency and investor protection were, not surprisingly, paramount and the resulting white paper reflected this concern. In the present set of hearings, it is clear that competition is paramount. This is not to say that one abandons concern with respect to the other legitimate rationales for regulation. Rather their role is to act as constraints in terms of how far and how fast one can achieve the paramount goal. Consider foreign ownership. One can conceive of situations where this concern ought to get top billing. But this is not one of those situations. In the present case, opening up the industry to more foreign participation will lead to increased innovation, liquidity

and competition in our capital markets. Hence the issue is not one of whether one increases foreign investor access but rather by how much. Likewise investor protection must always be an important goal, but it is not the paramount goal this time around.

The role of regulators is not an enviable one. They have to make delicate trade-offs among competing and legitimate goals. They can never be sure just what course is the right one. Hence, it is entirely appropriate that there be a lively debate as to how one enables our securities industry to be world class, about how one best serves the capital needs of small and medium-sized business, about how one tilts the system in order to maximize innovation and competition. I would submit, however, that what is not appropriate in the present time frame is for the regulatory process to frustrate the achievement of these goals. As the title of my paper suggests, the choice is between a really secure industry and a real securities industry. But reality suggests that there is no choice.

ENDNOTES

1. For example, the conditions of registration as a dealer require:
 - (a) maintenance of minimum net free capital (liquid capital less amounts required to margin fully securities in the firm's and customers' accounts) equal to the sum of the amount deductible under the dealer's bonding or insurance policy plus the greater of:
 - (i) \$25,000 and
 - (ii) an amount equal to the sum of 10 percent of the first \$2,500,000 of adjusted liabilities (total liabilities less very liquid assets), 8 percent of the next \$2,500,000 of adjusted liabilities, 7 percent of the next \$2,500,000 of adjusted liabilities, 6 percent of the next \$2,500,000 of adjusted liabilities and 5 percent of adjusted liabilities in excess of \$10,000,000.
2. Barron Report ("Summary of Recommendations to be Submitted to the Joint Industry Committee on Sources of Capital for, and Ownership of, the Canadian Securities Industry) Calgary, June 17, 1978.
3. Ontario Securities Commission, Report on the Implications for Canadian Capital Markets of the Provision by Financial Institutions of Access to Discount Brokerage Services (Toronto: Dataline Inc.) October 31, 1983, pp. 16-17. Emphasis has been added.
4. Over the past few years there have been some excellent

analytical submissions to the Ontario Securities Commissions. e.g., Final Submission by the Director of Investigation And Research, Combines Investigation Act, To The Ontario Securities Commission on The Matters of Institutional Ownership of, and Diversification by, Securities Dealers, (September 1982) and L.D. Booth, Securities Market Regulation: Institutional Ownership and Diversification (July 12, 1982). I shall make reference to these submissions in what follows. For ease of citation, the former will be referred to as the Combines Submission.

5. The following paragraph is adopted from Thomas J. Courchene, "Towards a Protected Society: The Politicization of Economic Life" Canadian Journal of Economics XIII, No. 4 (November, 1980), pp. 564-5.
6. Milton Friedman, Friedman and Galbraith (Vancouver: The Fraser Institute), 1977, p. 35.
7. Royal Commission on Banking and Finance, Report (Ottawa: Queen's Printer), 1964, p. 345.
8. John Todd, Price Competition in the Canadian Securities Industry: A Test Case of Deregulation (Toronto: Ontario Economic Council), 1983, pp. 15-16.
9. Mickey Cohen, "The Important Role and Future of the Financial Service Industry--A Domestic and International Context" in Institutions in Transition: The Changing Nature of the Financial Services Industry (Toronto: Strategic Planning Forum, Inc.), 1984, p. 6.
10. Initial submission by the Director of Investigation and

Research, Combines Investigation Act, to the Ontario Securities Commission on the Issues of Institutional Ownership of Securities Dealers, Diversification by Securities Dealers and Non-Resident Ownership Restrictions (July, 1982), p. 15.

11. Combines Submission, op.cit., p. 7. Emphasis added.
12. L.D. Booth, op.cit., p. 25.
13. Cohen, op.cit., pp. 6-7.
14. Canadian Bankers Association, "Comments on The Competitive Position of the Securities Industry in Domestic and International Financial Markets" in Submissions to the Ontario Securities Commission in Respect of its Securities Industry Review Volume II, Submission 29, Appendix A.
15. Booth, op.cit., pp. 20-21.
16. Williamson, op.cit., p. 814.
17. Ibid., p. 803-4.
18. Cohen, op.cit., p. 8.
19. Pierre Lortie, "The Re-Regulation of Financial Institutions: The Morning After" mimeo (June 20, 1984), p. 16.
20. Canadian Bankers Association, op.cit., p. 16.
21. CIBC Limited, "A Presentation of CIBC Limited to the Security Industry Policy Review" in Submission to the Ontario Securities Commission... op.cit., Volume II, submission 21, p. 11.
22. These points are adopted from Booth, op.cit., pp. 26 and 30.
23. Ibid., pp. 26-7.
24. McLeod, Young Weir Limited, "Regulation and Its Effect on the

Competitive Position of the Canadian Securities Industry in Domestic and International Financial Matters" in Submissions To the Ontario Securities Commission..., Volume I, submission number 6, pp. 2-3.

25. OSC, op.cit., p. 16.