Information

Canada's Financial Services Sector

January 2005

Canada's Securities Industry

Overview

- The Canadian securities industry plays a key role in Canada's financial services sector. It enables businesses and governments to raise debt and equity capital and allows investors to trade with confidence in open and fair capital markets.
- Canada's securities industry grew significantly during the 1990s and by the end of 2003 included an all-time high of 207 firms employing over 37,000 people across Canada.
- The industry is regulated at the provincial and territorial level. In addition, self-regulatory organizations such as the exchanges, the Investment Dealers Association of Canada and Market Regulation Services Inc. also play an important regulatory role.
- Currently the securities regulatory framework in Canada is under review. In December 2003 the Wise Persons' Committee presented its report recommending that the federal and provincial governments collaborate to establish a single securities regulator in Canada. The federal government continues to work with the provinces towards the development of a single securities regulator to promote greater efficiency in Canada's capital markets.
- The industry is made up of integrated, institutional and retail firms. In 2003 the integrated firms, which represent mainly the securities dealer affiliates of the six largest domestic banks, generated 73 per cent of the industry's revenues.
- After declining for two consecutive years, revenues increased to $10.6 billion in 2003. Total net profit increased by 18 per cent over the previous year while return on equity averaged 18 per cent, the same as in 2002.
- Canada's major exchanges reached an agreement in 1999 to restructure along lines of market specialization, with the Toronto Stock Exchange becoming the sole exchange for the trading of senior equities, the Montreal Exchange assuming responsibility for the trading of derivatives, and the Canadian Venture Exchange (CDNX), created through a merger of the Vancouver and Alberta (and later Winnipeg) stock exchanges, handling the trading of junior equities.
- In 2001 the Toronto Stock Exchange acquired the CDNX. In April 2002 the CDNX was renamed the TSX Venture Exchange and is now part of the TSX Group, which also includes the Toronto Stock Exchange. In May 2002 management of the Toronto Stock Exchange 300 Composite Index was taken over by Standard & Poor's and the index was renamed the S&P/TSX Composite Index.

Note: Unless otherwise indicated, all dollar amounts in this publication are expressed in Canadian dollars.

Department of Finance Canada | Ministère des Finances Canada

Canada

History

Canada's securities industry dates back to 1832, when shares of Canada's first railroad were traded by a small group of brokers in a Montréal coffee house. Canada's first stock exchange, the Montreal Stock Exchange, was incorporated in 1874, followed by the Toronto Stock Exchange, which was incorporated under a special act of the Province of Ontario in 1878. The chartered banks became the first and leading underwriters of Canadian securities, focusing on government debt. They maintained their lead in that field for many years. However, by the turn of the 20th century, their dominance in underwriting had been diminished by the increasing number of bond brokers and the concentration of underwriting business in a small number of specialized underwriting firms. By 1927 about 60 per cent of securities issued were underwritten by five investment dealers and one bank, with the five dealers accounting for 47 per cent of the total.

Until the late 1980s most of the independent securities firms were owned by their senior partners, a structure that became increasingly difficult to maintain due to increasing demands for capital, growing global competition, greater market volatility and cyclical earnings performance. In response, in the mid-1980s the federal and provincial governments introduced legislative changes to open up ownership of the securities industry to Canadian banks and trust companies, as well as foreign securities firms.

The result was a major ownership realignment of the securities industry. In order to enter the retail brokerage sector and to strengthen their activities in investment banking, five of the big six banks acquired major investment dealers, while the sixth built its own brokerage business from the ground up. Today all of Canada's large integrated securities firms are bank-owned (see Table 1). In addition to the large integrated firms, there are smaller integrated firms, which also offer both retail and institutional business to clients.

Structure of the Canadian Securities Industry

The securities industry is made up of integrated, institutional and retail firms. Integrated firms offer products and services that cover all aspects of the industry, including both the institutional and retail markets. Institutional firms provide services

Table 1
Bank ownership of integrated securities firms

Firm	Majority owner
BMO Nesbitt Burns	Bank of Montreal
CIBC World Markets	Canadian Imperial Bank of Commerce
National Bank Financial	National Bank of Canada
RBC Dominion Securities Ltd.	Royal Bank of Canada
Scotia Capital	The Bank of Nova Scotia
TD Securities	TD Bank Financial Group

exclusively to pension funds, insurance companies, mutual fund organizations, banks and trust companies, while retail firms, which include full-service firms and discount brokers, offer a wide range of products and services to retail investors.

The number of firms participating in the Canadian securities industry has risen significantly since 1990 (Chart 1). At the end of 2003 there were 207 securities firms operating in Canada, up 74 per cent from 119 firms in 1990. However, the six largest integrated securities firms, which are owned by the big six domestic banks, continued to account for the largest share of total industry revenues—73 per cent compared to 64 per cent in 1990. Retail firms accounted for 15 per cent of revenues while institutional firms accounted for 12 per cent.

In 2003 there were 17 foreign-owned securities firms engaged in research, sales and trading activities in Canada, including underwriting new issues for corporate clients, trading in fixed-income securities, wealth management, merger and acquisition advice, and the execution of trades on behalf of Canadian residents.

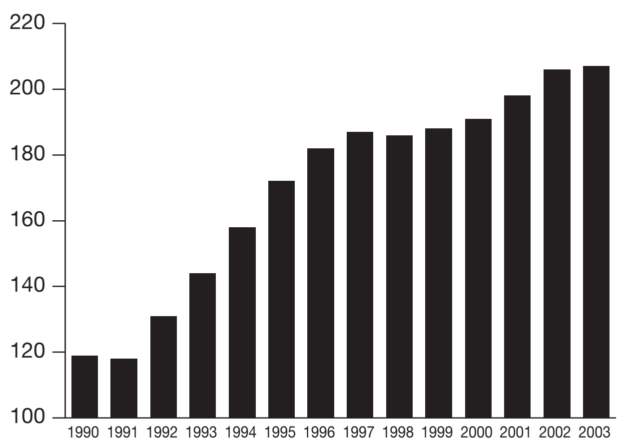
Employment and Access to Capital

Employment in the securities industry has remained above 37,000 for the past three years. Strong employment growth in the industry in the past decade has largely been driven by strength in the retail sector of the industry, reflecting the increasing number of Canadians investing in the equity market as well as an aging population concerned with planning for retirement.

In addition to contributing to job creation, the Canadian securities industry plays a key role in helping corporations and governments raise capital. In 2003 corporate equity issuances rose 27 per cent from the previous year to $22.9 billion due to renewed U.S. growth, increased corporate confidence and the stock market recovery. At $1 billion, initial public offerings remained low compared to levels registered over the past decade (Chart 2).

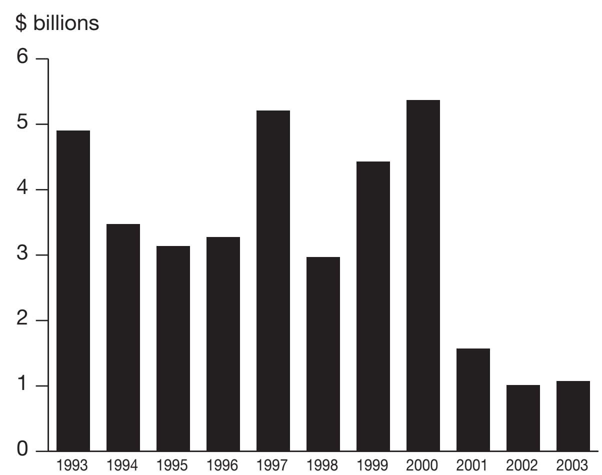
Corporate debt financing totalled $53.9 billion in 2003, up 66 per cent from the previous year. Improved financing conditions and increased corporate profitability were two of the factors contributing to this increase.

Chart 1
Number of securities firms



Source: Investment Dealers Association of Canada.

Chart 2
Initial public offerings



Source: Investment Dealers Association of Canada.

Performance of the Canadian Securities Industry

The overall performance of the securities industry improved in 2003. After declining for two consecutive years, revenues increased to $10.6 billion, up 8 per cent from 2002 (Chart 3). Total net profit for the industry was more than $1.4 billion, up 18 per cent from the previous year, while return on equity averaged 18 per cent, the same as in 2002 and well in line with the 20-per-cent average rate of return over the past 10 years.

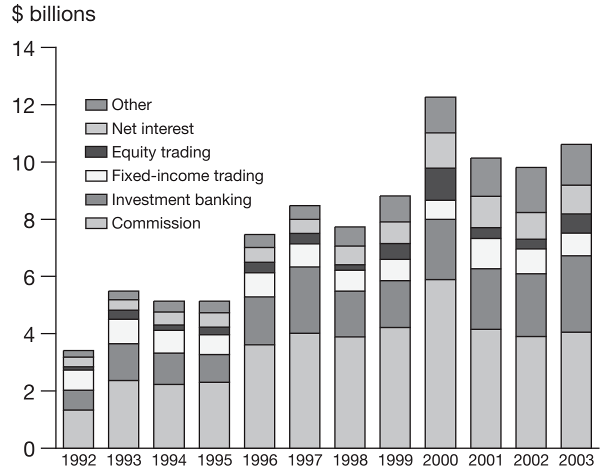
Overall, the industry benefited from the recovery of the stock market in Canada, which rallied on signs of an economic recovery in the U.S. and Canada, and the strengthening of the Canadian dollar, which increased the attractiveness of Canadian securities to foreign investors. Cost containment measures in 2001 and 2002 also continued to have a positive impact on the profitability of firms in the industry.

Performance by Revenue Category

Industry revenue is made up of commission revenues (including mutual fund transactions), investment banking revenues (underwriting fees and merger and acquisition advisory services), fixed-income and equity trading revenues, net interest revenues and other revenues (Chart 4).

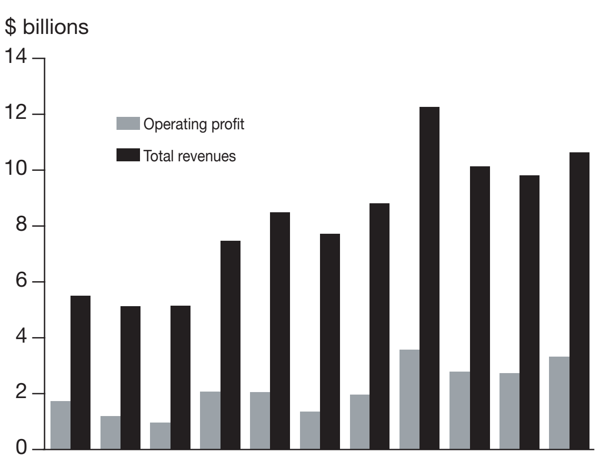
Equity trading revenues experienced spectacular growth in 2003, up 96 per cent from the previous year, while fixed-income trading revenues fell 9 per cent as investors returned to equities (Chart 5). Investment banking revenues also benefited from the positive stock market environment, increasing 22 per cent from 2002. Commission revenues, which account for close to half of industry revenues, rose by 4 per cent.

Chart 4
Revenues by category



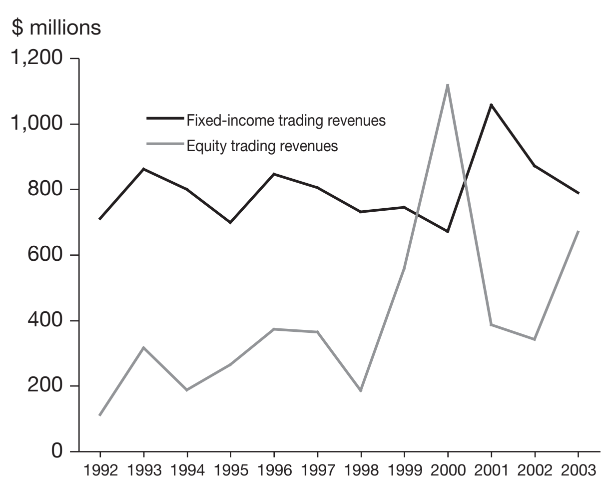
Source: Investment Dealers Association of Canada.

Chart 3
Operating profit and total revenues



Source: Investment Dealers Association of Canada.

Chart 5
Revenues from fixed-income and equity trading



Source: Investment Dealers Association of Canada.

Performance by Type of Firm

Integrated firms, which are involved in all aspects of the industry, benefited from favourable market conditions in 2003. Total revenues increased 8 per cent from 2002 while operating profits rose significantly, up 58 per cent.

Retail firms also posted strong results in 2003, with total revenues up 21 per cent from 2002. This was reflected in retail firms' operating profits, which rose fivefold in 2003, not including one-time proceeds from the privatization of the Toronto Stock Exchange in 2002.

Results for institutional firms were mixed. Canadian firms saw their total revenues climb 24 per cent, reflecting growth in common shares and debt financing. Excluding one-time proceeds from the privatization of the Toronto Stock Exchange, the operating profits of Canadian firms increased 30 per cent in 2003. Results for foreign firms were adversely affected by changes to transfer pricing—revenues declined by 20 per cent from 2002 while operating profits fell by almost 50 per cent.

Structure of Canadian Capital Markets

The two main products traded in the securities industry are fixed-income securities and equities. Fixed-income products, which include bonds, asset-backed securities and money market instruments, are traded in dealer markets. Equity products, which include common and preferred shares, are mostly traded on stock exchanges.

In 1999 Canada's exchanges underwent a major realignment in order to operate along lines of market specialization and to better compete with exchanges abroad and new electronic entrants penetrating the Canadian market. The Toronto Stock Exchange (TSE) became the sole senior equities exchange, the Montreal Exchange became the derivatives exchange (options and futures contracts), and the former Alberta and Vancouver exchanges became the Canadian Venture Exchange (CDNX), assuming control of junior equities. As a further step in this realignment, the Winnipeg Stock Exchange (WSE) and the CDNX merged in November 2000 in order to provide more liquidity and wider recognition to public companies listed on the WSE.

Another important structural change that took place in 2000 was the demutualization of the TSE, the first stock exchange in North America to do so and continue operations as a for-profit corporation. Following the example of the TSE, the Montreal Exchange demutualized that same year. Then in May 2001 the TSE acquired full ownership of the CDNX, thus bringing all of Canada's equity trading under one organization for the very first time. In April 2002 the CDNX was renamed the TSX Venture Exchange and is now part of the TSX Group, which also includes the Toronto Stock Exchange. In May 2002 the management of the TSE 300 Composite Index was taken over by Standard & Poor's and the index was renamed the S&P/TSX Composite Index. A further important change took place in November 2002, when the Toronto Stock Exchange became the first exchange in North America to become a public listed company.

Another Canadian exchange, which was not directly involved in the realignment of the other Canadian stock exchanges, is the Winnipeg Commodity Exchange (WCE), the national agricultural futures and options exchange. This exchange was established in 1887 as an unincorporated association called the Winnipeg Grain & Produce Exchange. The WCE has evolved significantly since its early beginnings as a cash market for wheat, oats and barley, and has played an important role in the development of western Canada's grain industry. Each bid and offer for commodity contracts was still made by open outcry on the exchange's trading floor up until December 20, 2004, when the WCE changed over to electronic trading.

In early 2004 the Ontario Securities Commission recognized the Canadian Trading and Quotation System Inc. (CNQ) as a stock exchange. CNQ provides an Internet-based quotation and trade reporting system for companies that cannot meet the listing requirements of the Toronto Stock Exchange and TSX Venture Exchange or do not wish to list on either of these exhanges. At the end of October 2004, 32 issues were listed and 10 applications were under review.

Since November 2000 NASDAQ Canada, an affiliate of the U.S. NASDAQ Stock Market (NASDAQ), has provided services to Canadian investors through terminals installed in a number of Canadian securities firms, providing direct access to all NASDAQ-listed securities. In addition, a NASDAQ Canada index was created to measure the performance of all NASDAQ-listed Canadian stocks. Originally operating only in Montréal, in November 2003 NASDAQ Canada received authorization to expand into British Columbia. However, NASDAQ indicated that it has abandoned plans to eventually establish a full-fledged exchange in Canada that would compete for listings with the Toronto Stock Exchange.

Table 2
Ten largest stock exchanges by market capitalization of domestic companies

Exchange	**Market capitalization of domestic companies at the end of 2003**
	(billions of U.S. dollars)
New York Stock Exchange	11,329
Tokyo Stock Exchange	2,953
The NASDAQ Stock Market	2,844
London Stock Exchange	2,460
Euronext	2,076
Deutsche Börse (German Exchange)	1,079
TSX Group	889
SWX Swiss Exchange	727
BME (Spanish exchange)	726
Hong Kong Exchanges and Clearing Limited	715

Source: World Federation of Exchanges.

Competitiveness and Activities of Canada's Major Stock Exchanges

The TSX Group ranks among the world's top exchanges in terms of market capitalization and trading volume. As of December 31, 2003, the total market capitalization of the more than 3,600 issuers listed on the TSX Group's exchanges was almost US$889 billion, making the combined exchanges the third largest in North America and the seventh largest in the world (Table 2).

At December 31, 2003, the market capitalization of the 1,340 issuers listed on the Toronto Stock Exchange totalled $1.3 trillion, while it totalled $20.9 billion for the 2,276 companies listed on the TSX Venture Exchange. In 2003 the volume of shares traded on the Toronto Stock Exchange increased by 20 per cent over the previous year to 55.6 billion, while on the TSX Venture Exchange total trading volume increased 52 per cent. In 2003 the total value of securities traded on the TSX Group's exchanges was $655.2 billion, up 2 per cent from 2002; the total value of securities traded on the TSX Venture Exchange stood at $2.4 billion, up 65 per cent from 2002. In 2003, 47 TSX Venture Exchange issuers graduated to the Toronto Stock Exchange, representing 37 per cent of new listings on the senior market.

Canada's other major exchange, the Montreal Exchange, is a major player in the international derivatives market. Recently the Montreal Exchange and its American partners obtained authorization from the U.S. Securities and Exchange Commission to launch the Boston Options Exchange. As a result, the Montreal Exchange became the first foreign exchange authorized to manage the technical operations of an American exchange. In addition, the Montreal Exchange is a member of the GLOBEX Alliance, the first international electronic trading network for derivatives products. Membership in the Alliance allows the Montreal Exchange to further extend its distribution network and provides Canadian derivatives investors access to international markets.

Operating activity was also strong on the Montreal Exchange in 2003. Trading volume increased to over 17.7 million contracts, up 21 per cent from the previous year. This significant growth is largely due to strong growth in interest-rate and index derivatives products, which increased 40 per cent and 15 per cent respectively. In addition, the underlying value of contracts traded averaged more than $30 billion on a daily basis, compared to $20 billion in 2002.

Canadian Activities in Foreign Capital Markets

Technology and globalization are transforming Canada's equity and debt markets. Canadian investors are going global and buying foreign securities to further diversify their portfolios. Government regulations allowing Canadians to hold a larger percentage of foreign assets in their registered retirement savings plans have contributed to greater demand for foreign stocks, with foreign mutual fund assets now constituting the single largest element of investment assets in Canada.

However, net purchases of foreign stocks by Canadians, which had been declining since 2001, fell to $4.3 billion in 2003, their lowest level in 10 years. A stronger Canadian dollar, which reduced the attractiveness of foreign investments to Canadian investors, was partially responsible for the decline. In contrast, foreign investors increased their participation in Canadian markets as a result of the appreciation of the Canadian dollar. The portion of debt raised by Canadian companies in foreign markets amounted to 54 per cent of total debt financing in 2003.

Many Canadian businesses are also listing their shares on foreign stock exchanges, with a total of 184 Canadian issuers being interlisted on U.S. exchanges in 2003. Interlistings generally raise the profile of issuers in the global market, and trading volumes for these issuers' shares often increase across all markets. It is interesting to note that 60 per cent of the trading of interlisted Canadian businesses takes place on the TSX Group's exchanges. To capture a greater proportion of trading in securities of issuers that are listed on other markets, particularly those in the U.S., the TSX Group recently extended trading in U.S. dollars to 16 securities listed on the Toronto Stock Exchange, with additional securities to be added in the future.

To address changes brought on by technology and globalization, the securities industry has been taking steps to improve foreign market access for Canadian issuers and investors. A number of Canadian securities firms, particularly those owned by banks, are building a global platform through the acquisition of foreign businesses operating in niche markets such as discount brokerages, wealth management and investment banking.

Regulatory Environment

The regulation of the Canadian securities industry is carried out by the provinces and territories, with each of them having their own securities regulator. The 13 provincial and territorial regulators collaborate through the Canadian Securities Administrators, whose goal is to develop a national system of simplified and harmonized securities regulation, policy and practices while retaining regional flexibility.

Currently the securities regulatory framework in Canada is under review. In March 2003 the Wise Persons' Committee was established by the Minister of Finance of Canada to undertake an independent, objective review of the current securities regulatory framework and identify an appropriate model for securities regulation in Canada. In its December 2003 report, the committee recommended that a single regulator built on joint federal-provincial participation replace the current system of provincial regulation. The committee conducted extensive consultations over a nine-month period and during that time heard from and received submissions from a large number of market participants. A number of studies as well as the submissions received are available at www.wise-averties.ca.

In the current system, the provincial securities regulators delegate certain aspects of securities regulation to self-regulatory organizations (SROs) such as the exchanges, the Investment Dealers Association of Canada (IDA), the Mutual Fund Dealers Association of Canada (MFDA) and Market Regulation Services Inc., which is jointly owned by the TSX Group and the IDA. The IDA is responsible for the regulation of its member firms, which include more than 200 investment dealers that are actively engaged in securities trading in Canada. The IDA monitors the activities of investment dealers across the country in terms of their capital adequacy and business conduct. It is also responsible for registering qualified member firms. The regulatory capital of the securities industry in Canada stood at almost $14 billion in 2003, continuing an average annual increase of 13 per cent in the last decade.

The MFDA is now recognized as an SRO by the Ontario, British Columbia, Saskatchewan, Alberta and Nova Scotia securities commissions. It is responsible for the distribution side of the mutual fund industry, which currently manages well over $400 billion in assets for Canadian investors. Responsibility for regulation of the funds or the fund manufacturers remains with the securities commissions.

The IDA, TSX Group and Montreal Exchange sponsor the Canadian Investor Protection Fund (CIPF), a trust fund that was established in 1969 to protect investors' assets in the event of the insolvency of an SRO member firm. The CIPF covers separate customer accounts, up to $1 million per account, for losses of securities, cash balances and certain property, such as segregated insurance funds, that result only from the insolvency of a member. It does not cover customers' losses that result from changing market values of securities, unsuitable investments or the default of an issuer of securities.

Another important element of the regulatory environment of the securities industry is the Ombudsman for Banking Services and Investments (OBSI), which was established in August 2002. This organization was created through the merger of the former Canadian Banking Ombudsman with the dispute resolution services of the IDA, MFDA and Investment Funds Institute of Canada. OBSI is an independent and impartial dispute resolution service that is offered free of charge to clients of member firms.

Fostering Investor Confidence

Canada's securities regulators, industry participants and governments have been actively engaged in fostering investor confidence in capital markets in the wake of major corporate and market scandals in the United States. Actions have been taken to strengthen enforcement, improve financial and other disclosures, enhance the quality of the audit process, and strengthen corporate governance and management accountability.

In the 2003 budget, the federal government announced a coordinated national enforcement approach to strengthen the investigation and prosecution of serious corporate fraud and market illegality. At the provincial level, Ontario and Quebec have passed legislation to modernize securities offences, increase penalties and broaden the investigative powers of their securities commissions. In addition, Ontario has empowered its regulator to force issuers to return profits obtained illegally through securities act violations. More broadly, provincial securities regulators have developed a proposed regime that will give investors in the secondary market a simpler procedure to sue companies, directors, officers, underwriters and experts that make misleading or untrue statements, or fail to give full and timely information.

The Accounting Standards Board has reviewed Canadian accounting standards and implemented new accounting rules to improve financial and other disclosures, while the Canadian Securities Administrators has introduced new measures to strengthen the continuous disclosure obligations of public companies. In addition, the Canadian Institute of Chartered Accountants (CICA) has issued guidance to its members to enhance management discussion and analysis disclosures of off-balance-sheet arrangements and related exposures. For its part, the IDA has introduced new rules to promote the independence of research analysts employed by securities firms.

The quality of the audit process in Canada has also been enhanced through the establishment of the Canadian Public Accountability Board (CPAB), an independent public oversight board responsible for overseeing auditors of public companies. The CPAB inspects audit firms and reviews adherence to standards applicable to public company auditors, imposes penalties directly on audit firms and refers disciplinary matters to the relevant provincial institute or association of professional accountants. The CPAB will also make recommendations on accounting standards, assurance standards, rules of professional conduct, and governance practices to the relevant professional institute or standard-setting bodies. In addition, the CPAB has been working closely with the Public Company Accounting Oversight Board, a new U.S. auditor oversight body, to develop a system of mutual reliance in the oversight of public company auditors.

Also, the CICA has developed a new standard on auditor independence to address concerns over potential conflicts of interest at public accounting firms. It has also established an Auditing and Assurance Standards Oversight Council to enhance public oversight of auditing and assurance standards.

Canada has taken action as well to strengthen corporate governance and management accountability, even though it has long been recognized internationally for its strong corporate governance practices. For example, Canada's provincial and territorial securities regulators have issued new rules applicable to public companies requiring certification of financial disclosure and establishing the responsibilities and composition of audit committees. In addition, the Canadian Securities Administrators has proposed corporate governance guidelines and related disclosure requirements designed to replace the TSX guidelines.

Investor confidence in the integrity of capital markets is critical for a well-functioning economy. Looking forward, capital market participants, regulators and governments will continue working together to ensure that the standards for capital markets and public companies in Canada will remain of the highest order.

Looking Ahead

Globalization, technological changes and consolidation continue to be key challenges facing the Canadian securities industry. Proximity to the U.S., the relatively low barriers to entry for foreign securities firms, the advent of alternative trading systems, new entrants such as NASDAQ, and the increasing North American focus of many large Canadian corporations have made the Canadian securities business very competitive.

The consolidation of exchanges around the world is intensifying competition internationally as exchanges compete for limited sources of income. Their ability to raise membership, listing and trading fees is limited as broker-dealers and listing companies can opt to take their business to any number of competing exchanges. Exchanges are responding to these challenges by demutualizing from member-owned cooperative institutions into leaner for-profit firms.

Other challenges facing the industry include increased consumer demand for new products and services, the rapid pace of new information-based electronic technologies, and changes in the nature and delivery of financial products and services. These challenges will require regulators and competitors in the industry to work together towards harmonization among securities and other financial services regulators across jurisdictions.

Pursuant to the Wise Persons' Committee report, the Government of Canada committed in the 2004 budget to work with the provinces and territories towards the development of a single securities regulator to promote greater efficiency in Canada's capital markets.

In December 2003 the Canadian Securities Administrators released consultation drafts of a Uniform Securities Act and a Model Administration Act, which aim at harmonizing securities laws across the country and streamlining the regulatory process.

In addition, a steering committee composed of six provincial ministers was set up in February 2003 to study ways of streamlining Canada's regulatory system. On September 30, 2004, all provincial governments except Ontario signed or committed to sign a Memorandum of Understanding on a passport system of securities regulation. Under a passport system, participating provinces would recognize each other's securities rules but keep their own separate securities commissions in place. Market participants would need only deal with a "primary" or "home" regulator. Ontario, which published its own proposal for an interprovincial securities commission in June 2004, continues to support a single Canadian securities regulator.

This publication is available on the Internet at www.fin.gc.ca.
For additional copies, please contact the Distribution Centre at (613) 995-2855.
Ce document est aussi disponible en français.