# Information

*The Canadian Financial System*

June 2000

## *The Canadian Securities Industry*

### *Overview*

- The Canadian securities industry plays a key role in Canada's financial system, providing a mechanism for raising capital, whether in the form of debt or equity, and a means to channel savings into portfolio investments.
- As of the end of 1999, there were 188 securities firms in Canada employing about 36,000 people. The 7 largest firms account for about 70 per cent of the industry's capital.
- Since 1987, when federally regulated financial institutions were first permitted to own securities firms, most large, full-service securities dealers have been bought by Canada's chartered banks.
- The industry remains highly competitive. In recent years there has been a significant increase in the number of securities firms in Canada.
- The profitability of the industry rebounded in 1999 from the weaker performance of 1998. Net income for the industry was $582 million, up 47 per cent.
- The overall return on equity for the industry has traditionally been superior to that of deposit-taking institutions and insurers. And within the industry, bank-owned firms have exhibited a significantly stronger performance than independent dealers.
- The major Canadian exchanges have recently gone through a realignment of responsibilities; each exchange now specializes in a certain area. The Toronto Stock Exchange (TSE) is now the sole market for senior equities, the Montreal Exchange has assumed responsibility for all derivatives trading and the new Canadian Venture Exchange is now the major market for junior equities.
- The Nasdaq Stock Market recently concluded an agreement with the Quebec government to facilitate the establishment of Nasdaq in Canada. The TSE is exploring the possibility of forming a Global Equity Market with the New York Stock Exchange and eight other stock exchanges around the world.
- As in other countries, technological change has spurred the entrance of new alternative trading systems (ATSs). A few firms that operate as ATSs in the United States have entered Canada, and regulators are presently re-examining ATS regulation as part of a larger review of equity market regulation.
- In 1999, almost all equity issues and about 60 per cent of the bond financing of Canadian corporations took place in Canada.
- The securities industry is regulated at the provincial and territorial level in Canada. The securities regulators delegate some regulatory authority to self-regulatory organizations.
- The Canadian Securities Administrators is the forum where the provincial and territorial securities regulators meet quarterly to further the goals of regulatory harmonization and mutual recognition of standards.

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## History of the Canadian securities industry

Canada's securities industry dates back to 1832, when the shares of Canada's first railroad were traded in a Montréal coffee house. Canada's first stock exchange, the Montreal Stock Exchange, was incorporated in 1874. The first Canadian securities underwriters were the chartered banks, but by the turn of the century the industry was dominated by independent securities firms, such as Wood Gundy and Company and Dominion Securities.

Until the late 1980s, most Canadian securities firms were owned by their senior partners. Increasing demands on capital, an environment of intensified global competition, increasing market volatility and cyclical earnings performance made this structure difficult to maintain. A major ownership realignment of the securities industry took place after the removal of provincial foreign ownership restrictions and the elimination of federal restrictions on the ability of federal financial institutions to own securities dealers in 1987. The purchase of securities firms was particularly attractive to Canada's banks, which wanted to offer customers a one-stop financial services provider. Currently, all but one of Canada's large, full-service securities firms (Merrill Lynch Canada) are bank-owned (see Table 1).

Table 1

**Bank ownership of full-service securities firms**

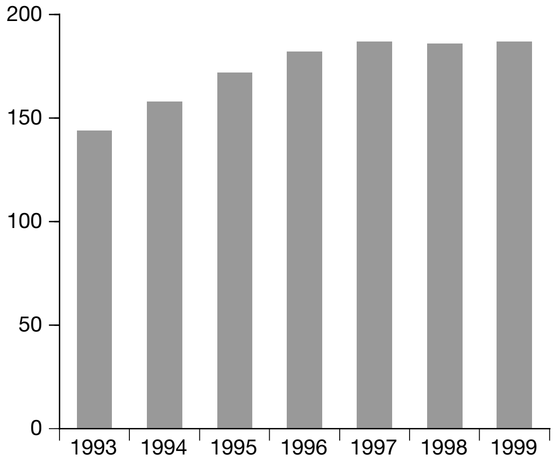
| Firm | Majority owner |
|---|---|
| BMO Nesbitt Burns | Bank of Montreal |
| CIBC World Markets | Canadian Imperial Bank of Commerce |
| National Bank Financial | National Bank of Canada |
| RBC Dominion Securities | Royal Bank of Canada |
| Scotia Capital | The Bank of Nova Scotia |
| TD Securities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

## Structure of the Canadian securities industry

At the end of 1999 there were 188 securities firms operating in Canada. Of these, 7 can be considered large integrated full-service firms, offering a wide range of services, 53 primarily service the institutional market, and the remaining 128 firms are concentrated in retail brokerage. The number of firms increased by 26 per cent between 1993 and 1997 and has remained fairly steady since then (see Chart 1).

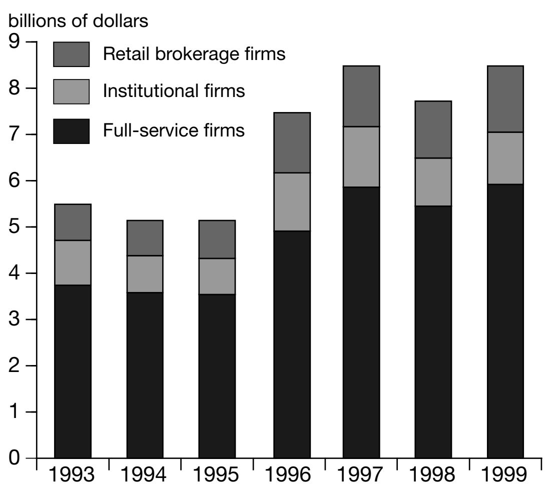
In 1999, securities firms assisted corporations in raising $39 billion in debt and $21 billion in equity. Table 2 gives an indication of the major participants in the corporate market. Securities firms also assisted provincial governments in raising $25 billion in debt and participated in the syndication and auction of $50 billion of Government of Canada marketable bonds.

Chart 1
**Number of securities firms**




Source: Investment Dealers Association of Canada

Chart 2
**Securities industry revenues by type of firm**




Source: Investment Dealers Association of Canada

Table 2
**Market share of Canadian corporate financing, 1999**

| **Securities firm** | **Market share** (per cent)[1] |
|---|---|
| RBC Dominion Securities | 15.5 |
| BMO Nesbitt Burns | 13.8 |
| CIBC World Markets | 12.7 |
| Scotia Capital | 10.2 |
| TD Securities | 9.7 |
| Merrill Lynch | 6.8 |

Source: *The Globe and Mail*

[1] Measured by sales of common equity, preferred shares, trust and corporate debt worth $5 million or more, and excluding medium-term notes and securities sold to the U.S. market.

In 1999, gross revenues of the industry were about $8.8 billion. Of this amount, $6.2 billion (70 per cent) was accounted for by the large full-service firms, $1.1 billion (13 per cent) went to firms geared to the institutional market, while $1.5 billion (17 per cent) was earned by retail brokerage firms (see Chart 2). The retail brokerage group has exhibited the greatest revenue growth in percentage terms since 1993.

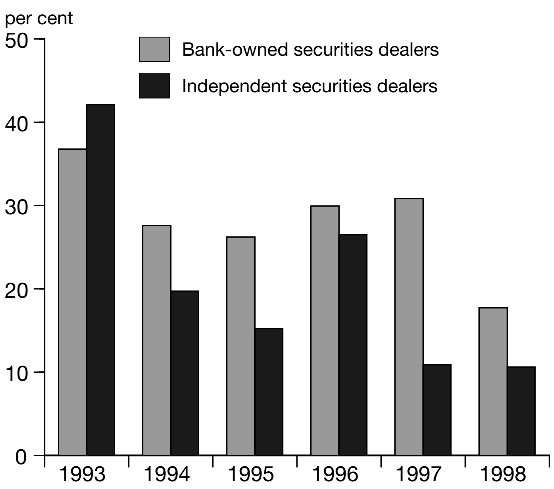
Employment in the securities industry increased steadily for most of the 1990s. From just under 20,000 in 1992, employment in the industry increased to almost 36,000 by the end of 1999.

## *Profitability and capital*

After a year of weaker profitability, the securities industry rebounded strongly in 1999. Net income for the industry increased 47 per cent to $582 million in 1999 from $395 million in 1998. However, this result is still well below the record net income of $850 million set in 1996.

The return on equity (ROE) of the securities industry as a whole has been superior to that of deposit-taking institutions and insurers. As well, within the industry there has been a considerable gap between the performance of bank-owned and independent securities dealers. In 1998, bank-owned dealers achieved an ROE of 17.7 per cent compared to an ROE of 10.6 per cent for the independent dealers (see Chart 3).

Chart 3
**Return on equity of bank-owned and independent securities dealers**




Source: The Conference Board of Canada

At the end of 1999, the regulatory capital of the securities industry in Canada totalled $8.7 billion. Close to 70 per cent of this was accounted for by the large, full-service firms. The capital requirements of the various securities regulators are largely the same.

## *Structure of Canadian capital markets*

The established Canadian exchanges recently underwent a major realignment in order to allow them to better compete with exchanges abroad and new electronic entrants to the Canadian market. The Toronto Stock Exchange (TSE) is now the sole senior equity market in Canada and the Montreal Exchange (ME) has assumed responsibility for all derivatives trading.[1] The Canadian Venture Exchange (CDNX), created through a merger of the Alberta Stock Exchange and the Vancouver Stock Exchange, is now Canada's major junior equity market. Both the Canadian Dealing Network in Ontario, a dealer-driven over-the-counter market geared towards small firms, and the Winnipeg Stock Exchange (WSE) have agreed to consolidate with the CDNX.

Canadian capital markets remain among the most active in the world for government and corporate debt and equity issues. The TSE, with a domestic market capitalization of US$789 billion, was the world's seventh largest stock exchange in 1999 (see Table 3) and had total trading of just over US$332 billion.

[1] A small number of Quebec-based junior equities remain listed on the ME.

The ME has recently expanded the types of derivatives products it trades to include stock options and stock index options, and the new CDNX, which began trading on November 29, 1999, has seen trading volumes increase by 130 per cent over the first three months of operation.

Table 3
**Ten largest stock exchanges by market capitalization of domestic companies**

| **Exchange** | **Market capitalization of domestic companies at the end of 1999** |
|---|---|
| | (billions of US dollars) |
| New York Stock Exchange | 11,432 |
| The Nasdaq Stock Market | 5,205 |
| Tokyo Stock Exchange | 4,455 |
| London Stock Exchange | 2,855 |
| ParisBourse | 1,503 |
| Deutsche Börse | 1,432 |
| Toronto Stock Exchange | 789 |
| Italian Exchange | 728 |
| Amsterdam Exchanges | 695 |
| SWX Swiss Exchange | 693 |

Source: International Federation of Stock Exchanges

On April 3, 2000, the TSE became the first stock exchange in North America to demutualize, transforming itself into a shareholder-owned, for-profit firm. This change in corporate structure should provide the TSE with improved access to capital. The TSE is also exploring the possibility of forming a Global Equity Market with the New York Stock Exchange and eight other stock exchanges around the world.

As in other countries, technological change has spurred the emergence of new players in Canada's securities exchange environment. Firms such as Instinet and VERSUS Technologies Inc., which operate in the U.S. as alternative trading systems (ATSs), have entered Canada. Canadian securities regulators are presently re-examining ATS regulation as part of a larger review of equity market regulation.

Another new player about to enter the Canadian market is Nasdaq, which recently concluded an agreement with the Quebec government to facilitate the establishment of Nasdaq in Canada. Initially, the agreement proposes to allow Canadians better access to stocks listed on Nasdaq trading in U.S. dollars. Once the agreement is fully implemented, Canadian investors and issuers will have access to a global exchange system.

## *Regulatory environment*

All Canadian securities dealers are registered by the provincial and territorial securities regulators, which are responsible for the regulation of the industry.[2] The Canadian Securities Administrators is the forum where the provincial securities regulators meet quarterly to further the goals of regulatory harmonization and mutual recognition of standards.

The provincial securities regulators delegate some authority to the self-regulatory organizations (SROs), which have a long history of regulating and supervising market intermediation in Canada. The well-recognized SROs are

[2] Certain securities activities may be carried on by a bank in-house (not through a securities subsidiary). These activities are supervised by the Office of the Superintendent of Financial Institutions, the federal regulator.

the TSE, ME, CDNX, WSE and the Investment Dealers Association of Canada, whose membership includes the majority of firms actively engaged in securities trading in Canada. Another association, the Mutual Fund Dealers Association of Canada, has applied to be recognized as an SRO. When it is fully operational, it will be responsible for regulating all sales of mutual funds in Canada, except in Quebec. It will not, however, assume responsibility for regulating the funds themselves. Firms that do not belong to an SRO are regulated directly by their respective provincial securities regulators.

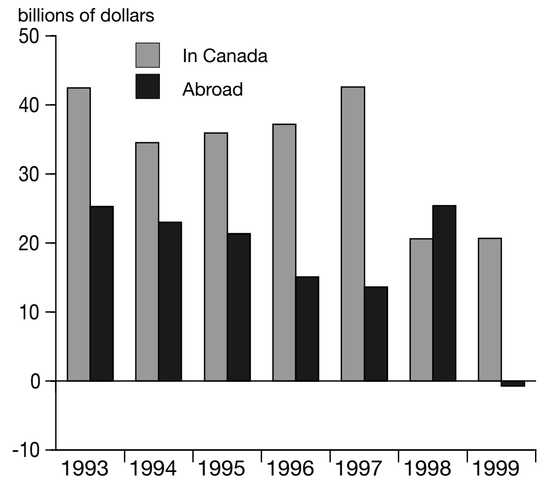
The five SROs mentioned above sponsor the Canadian Investor Protection Fund (CIPF), which was established in 1969 to protect customers in the event of an insolvency of an SRO member firm. The CIPF covers separate customer accounts, within certain guidelines, up to $1 million per account. The fund, which is financed through assessments on SRO member firms, has rarely been called on to settle claims.

## *Canadian activities in foreign capital markets*

Canadian corporate and government issuers have been tapping foreign capital markets since the late 1800s. This is one factor which has led Canadian securities firms to establish offices in the United States, Europe and, to a more limited extent, Asia.

In 1999, net new bond financing abroad by Canadian corporate issuers totalled $8 billion, compared to $12 billion within Canada. Government issuers, which in the past have made extensive use of foreign debt markets, reduced their foreign exposure in 1999. That year, net new government bond financing in Canada totalled $9 billion, compared to net redemptions of $9 billion abroad. Thus net new bond financing for public and private issuers combined totalled $21 billion in Canada as opposed to net redemptions of about $1 billion outside Canada (see Chart 4).

Chart 4
**Net new bond financing by Canadian issuers**

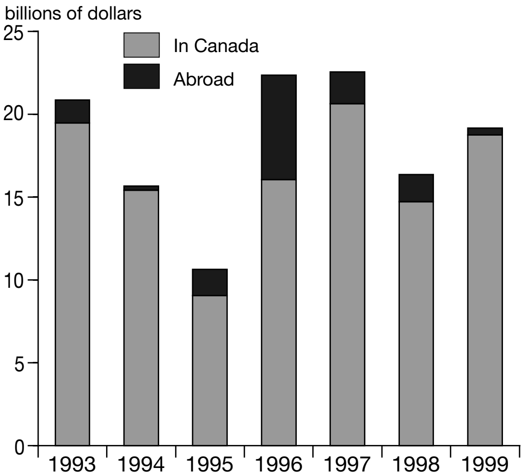



Source: *Bank of Canada Review*

Canadian equity issuers rely on foreign markets much less than Canadian debt issuers. Between 1993 and 1999, more than 95 per cent of Canadian equity issues took place in domestic markets (see Chart 5).

Several Canadian securities firms, particularly those owned by banks, have been exploring niche opportunities, such as discount brokerage and wealth

Chart 5
**Net new equity issues by Canadian corporations**



Source: *Bank of Canada Review*

management, in the U.S. and other select markets. As Canadian banks continue to expand overseas, their securities arms will be integral to that expansion, supporting banking operations and exploiting new business opportunities.

## *Activities of foreign firms in Canada*

A number of foreign-owned securities firms, particularly U.S.-owned firms, have a long history of operating in Canada. However, although several foreign firms have pursued an increased share of the retail brokerage business, only Merrill Lynch has been successful in obtaining a substantial market share. Foreign firms are increasingly active in arranging issues for corporate clients, trading in fixed-income securities and advising on mergers and acquisitions.

## *Recent developments*

The Canadian securities industry, like many of its counterparts in other countries, has been faced with the challenges of globalization, rapid technological change and consolidation. Proximity to the U.S., the relatively low barriers to entry for foreign securities firms, free movement of capital and an increasingly North American focus of many large Canadian corporations have made the Canadian securities business more competitive. As a response, larger Canadian securities firms have been improving their ability to service clients on a North American basis.

Canadian exchanges have also been facing an intensifying competitive environment. Issuers of capital are increasingly able to access global markets, bypassing local markets and intermediaries. A growing number of Canadian firms are choosing to list their stock on U.S. exchanges. In addition, as mentioned above, Nasdaq has concluded an agreement with the Quebec government to establish in Montréal.

This is part of a series of short monographs by the Department of Finance describing the Canadian financial system.
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