THE CANADIAN AND AMERICAN FINANCIAL SYSTEMS: COMPETITION AND REGULATION

Cécile Carpentier
Jean-Marc Suret*

Cirano et Laval University

July 1, 2003

*Cecile.Carpentier@fsa.ulaval.ca, School of Accountancy, Laval University and Jean-Marc.Suret@fsa.ulaval.ca, Cirano Fellow and School of Accountancy, Laval University.
Abstract

Centralization of securities regulation in Canada is a recurring topic which was recently given new impetus. Various participants suggest that the American model is an example of regulatory centralization and could be transposed to Canada. Our study shows the enormous differences which separate these two systems. The SEC may be considered a regulatory monopoly with respect to important securities, in the face of a competitive and fragmented industry. In Canada, provincial securities regulation creates a form of regulatory competition in the face of a very heavily concentrated industry. Consequently, the American regulatory framework is not transferable to Canada, and the risks of significant influence by the industry on the regulatory framework or even regulatory capture are high in Canada.
The debate on the centralization of securities regulation in Canada has recently been reopened in the name of improved efficiency and reduction of costs for issuers and investors. Because of the fragmentation of securities regulation, Canada suffers from a net disadvantage compared to other jurisdictions, which limits development of its market. This argument was put forward in the following manner by the Ontario Teacher’s Pension Plan Board which, in its comments submitted to the Ontario Securities Act Five Year Review Committee¹ (Five Year Committee), wrote: The Provinces need to recognize that Canada is suffering as a destination for business and capital because they refuse to give up jurisdiction to a first class regulatory regime that is administered and enforced by a first class regulator. Centralization of securities authorities in Canada constitutes the first recommendation of the Five Year Committee and the Ontario Securities Commission.

The American situation is often put forward as an example of regulatory centralization and its implementation within a federal state. For example, the Five Year Committee writes (p. 8): Canada competes with other jurisdictions around the world for capital and for investment opportunities. Our regulatory regime must be part of our competitive advantage. This requires that our regulators be able to operate efficiently and that our regulatory requirements not be more onerous than those existing in other jurisdictions (particularly the United States), except as may be required to satisfy our public policy objectives. Various participants recommend total harmonization with the American system². The investment dealers association (IDA), in its answer to the Five Year Committee, proposes that Canadian regulatory Policy must, in general terms, be congruent with the SEC standards, and in some case recognize US standards to ease the
regulatory burden for Canadian Companies. Such statements suggest that American securities regulation is a model for centralization and efficiency. They also suggest that the American model could be transposed to Canada. These two statements require careful analysis which we will discuss here from the viewpoint of concentration and competition.

Market participants agree that a dynamic and innovative market is essential to maintain and develop the securities industry in Canada. In theory, innovation and dynamism go hand-in-hand with competition. In the United States, competition between stock markets grew in the 1990’s and played a decisive role in reducing transaction costs and stimulating innovation. In Canada, to the contrary, the financial system has become progressively concentrated and the six large banks, in addition to controlling most banking activity, control two-thirds of brokerage firms through their subsidiaries. Dealers, through the IDA and the TSX Group, the single remaining market group, play an important regulatory role. The level of concentration in the Canadian financial market has become extreme. The Canadian situation is therefore totally different from that which exists in the United States. This concentration is in part the result of a wish to improve the competitive position of the Canadian securities market faced with an attractive and very dynamic American market. However, proposals respecting the regulatory structure in Canada cannot ignore this reality and the transposition of an American model, although very different from what is generally said, cannot take place without significant adjustments.
The introduction of the dimension of competition into the debate surrounding securities regulation in Canada is essential for several reasons. Firstly, market participants all wish for a dynamic and innovative market; these two characteristics are generally the hallmark of competitive markets. Secondly, several theoreticians of regulation maintain and demonstrate that regulation does not always have a public interest orientation, namely the correction of market dysfunctions and consumer protection. Private interest theories see the regulatory process as a competition between interest groups where the best organized and structured groups are able to capture the benefits of regulation to the detriment of less organized groups. Becker (1983) shows that the most highly concentrated sectors are more likely than others to impose their priorities. Capture theory defends an extreme situation where the regulatory process is subservient to the needs of an industry. Mechanisms which may lead to such situations are the differences in levels of expertise, transfers of human resources from the sector to the regulatory organization and vice versa (the revolving door process) and the infiltration of organizations by upper-level industry staff. Here again, capture is more likely when concentration is great. Furthermore, it has become impossible to deal with securities regulation without dealing with the banking sector, which owns the main brokerage firms in Canada. The main objective of this study is therefore to illustrate the process of concentration of the Canadian financial sector while, however, going beyond the narrow framework of financial corporations. These play a growing and important role with regulatory organizations and this role must be examined. A parallel with the American situation will be drawn.

We will begin by analysing the evolution of the American financial system and its regulation. American securities regulation is more complex than it initially seems, despite
recent changes giving broader powers at the federal level. It is therefore important to understand the main characteristics of American financial regulation. It is also useful to review the current regulatory systems in Canada. This is the second objective of this study. This exercise will give us a better understanding of the enormous differences which separate these two systems and reveal the fact that, in many areas affecting the financial world, American regulation is very broadly decentralized and competitive (third section). In the United States, the SEC may be considered a regulatory monopoly with respect to important securities, in the face of a competitive and fragmented industry. In Canada, provincial securities regulation creates a form of regulatory competition in the face of a very heavily concentrated industry. The establishment of a national commission will lead to the setting up of a regulatory monopoly. Authorization of the mergers of banks, which own the main brokerage firms, and the growing concentration in this sector, seems to be leading Canada to oligopoly. According to the forecasts of regulatory theoreticians, a situation where a regulatory monopoly governs an oligopoly is potentially dangerous. This cannot be ignored in the present discussion surrounding the restructuring of securities regulation in Canada.

1. The American system: market competition, regulatory monopoly

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

In the United States, the stock market has become progressively more competitive, the number of institutions offering trading services has grown, and transaction costs have decreased. It does not appear that this evolution reduced neither liquidity nor the quality of information, in particular because of the existence of data consolidation systems. The regulation of this large collection of institutions and organizations is entrusted to the SEC, which has intervened several times to stimulate competition. It has also promoted the emergence of ATS, despite the fact that setting up these systems fragments trades and potentially harms liquidity. Faced with such fragmentation, a single regulatory body might be best. However, American regulation is not totally centralized and it is, moreover, opposed and sometimes even connected with the recent setbacks of several large corporations.
1.1 Regulation of the securities industry in the United States

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

By using one of the 5 regional Small Capital Offering Regulation (SCOR) programs or other programs (Regulations A, D and Intrastate), start-up businesses may raise capital more easily and less onerously than conducting a traditional initial public offering (IPO). They then register with one or more States in which their shares will be sold, and not with the SEC (under an SEC exemption). They thereby avoid the traditional investors for start-ups who are gluttons in terms of percentage of voting rights (venture capital companies and angel investors) and their alternative, bank financing. Compared to an IPO, the amounts raised are less (between $1 and 20 million), and disclosure requirements are reduced. The gross proceeds of the issue must be put in trust with an independent bank until a predefined minimum amount is reached. This method of
financing has the disadvantage of an illiquid secondary market because of restrictions on the sale of shares and the fact that these shares are not traded on a stock exchange. To address this issue, in 1995 the SEC authorized the Pacific Stock Exchange to publicly list securities subject to SCOR regulation and Regulation A⁹. A great majority of businesses use this type of issue as a private placement, however, and investors hold the shares until the business is sold, is listed on an exchange, or redeems its own shares. The SB-1 and SB-2 legislation corresponds to initial public offerings reserved for start-up companies. Businesses must therefore register with the SEC but the procedure is simplified.

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

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

1.2.1 The accounting and financial scandals argument

It seems paradoxical to invoke financial scandals which mainly affected American businesses to invoke securities centralization in Canada, as the chairman of the OSC did\textsuperscript{10}. These abuses occurred mainly in a country where the essentials of securities regulation for large companies are under the jurisdiction of the federal government and a single commission, the SEC. A study of this argument is, however, an interesting occasion to gauge the steps and effects of intervention by a central government in the securities industry.

For several authors such as Coffee (2002), the Enron affair and other cases are the result of federal intervention in the field of securities regulation. Various elements have played a decisive role in the progressive weakening of barriers able to limit malfeasance by directors. These elements are set out below, after a brief survey of the American regulatory context for securities.
Up to 1933, American securities markets were regulated at the State level. The Securities Act of 1933 set up a system whereby businesses must comply with federal rules as well as those of the States. Under pressure from businesses and the securities industry, in 1996 Congress significantly changed securities regulation. The adoption of NSMIA was a step towards a single regulatory system which, however, left certain powers to the States. The States could therefore no longer register or require compliance of securities known as covered securities, which henceforth are the responsibility of the SEC. It can define what is included in the category of covered securities itself, by adding exchanges to the list drawn up by NSMIA or by defining the term qualified purchaser. The States retain the power to investigate and penalize for fraud and malfeasance respecting securities, disclosure and fees.

NSMIA mainly benefits large issuers by significantly lessening regulatory requirements and costs of issuance. Issuers of covered securities are no longer required to register in each State. Certain States conduct an in-depth analysis of offers submitted to them (merit review), and may refuse to authorize an offer perceived as too risky for investors. The SEC essentially makes an analysis based on disclosure (disclosure review) to ascertain whether the investor has sufficient information to consider the quality of the offer. By eliminating the merit review for covered securities, NSMIA may have indirectly helped reduce investor protection. Finally, the Uniform Securities Act (2002), a framework securities statute for the States, was adopted on January 4, 2003 by American securities authorities. It allows the States to harmonize their securities laws while recognizing that they may keep local differences potentially important for investor protection.
The Private Securities Litigation Reform Act (PSLRA), intended to limit the risk of frivolous lawsuits in the field of securities, was adopted in 1995. The main provisions of this statute were: 1) raising the standards for lawsuits in the securities area well above the level which existed for cases of fraud, 2) substitution of the concept of proportional liability for the concept of joint liability, and limiting penalties which could be imposed on auditors and brokers, 3) restricting the scope of *Racketeer Influenced and Corrupt Organization* status so that lawsuits in securities can no longer go from damage proceedings to triple damage proceedings and 4) the adoption of safe harbour protection for past information which makes conducting a lawsuit much more difficult.

The first effect of the PSLRA is to change the nature of evidence. Henceforth, it must be shown that management of the business sued committed fraud deliberately. The PSLRA also imposes penalties on plaintiffs convicted of frivolous lawsuits. For many, the provisions of the PSLRA discourage not only frivolous lawsuits but also well-founded lawsuits. President Clinton thus wrote in his notice of opposition that the PSLRA *have the effect of closing the court house doors on investors who have legitimate claims* (Ali and Kallapur, 2002). Several researchers and American organizations have tried to measure the effects of this Act. Its coming into force was accompanied by abnormally low returns for securities in the sectors most likely to be sued, such as computer technology, electronics, pharmaceuticals and biotechnology as well as individual portfolio management. The PSLRA was therefore viewed unfavourably by investors because of the restrictions imposed on potential private lawsuits in the field of securities. Several researchers also studied the rate of lawsuits after adoption of the Act, and observed a non significant temporary lessening in lawsuits over securities (Bajaj *et al.*, ...
The post-PSLRA period saw a very high number accounting readjustments and therefore the possibility of lawsuits. It is therefore difficult to say that the post- and pre-PSLRA eras are similar. For several authors and jurors, the PSLRA had the advantage of placing issuers and intermediaries under the same statute, which was not the case when lawsuits were taken at the State level. Thus a national market applied a national law. However, as Weiss et al. (2000) and Loomis (2000) described, different circuit courts applied the uniform act in an extremely varied manner, by taking diametrically opposed positions on significant aspects such as insider trading. As Perino mentions (2002): the picture that emerges (...) is that the PSLRA did not work as intended. The experience of the PSLRA shows that the imposition of centralized regulation and the referral of lawsuits to the federal level is not synonymous with setting up national criteria.

Thomas and Martin (1997) maintain that the PSLRA substantially increase the difficulty of uncovering securities fraud and recommend using State legislation. In fact, this is what a majority of plaintiffs do. The more restrictive conditions for lawsuits under the PSLRA have therefore lead to a transfer of cases from the federal level to that of the States (Ten Things Report and Bliley Report). To counter this movement, the American government adopted the Securities Litigation Uniform Standard Act (SLUSA) in 1998. This statute governs lawsuits at the State level. It is based on the argument that securities class actions belong in federal court because they are national in character. This statute leads to opposition by a large number of securities law specialists as well as the chairman of the SEC, A. Levitt, who later backed it (Painter, 1998). At the end of 2001 and 2002, the SLUSA tried to put an end to several lawsuits initially commenced at the State level.
They dealt with the issue of fixed-income securities\(^{17}\) and brokers against whom three cases had to be abandoned\(^{18}\). In particular, the lawsuit against Merrill Lynch\(^{19}\), was considered to fall under the SLUSA and was prescribed. In all the cases, the courts considered that the lawsuits taken at the State level could not have been because of the SLUSA.

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

Finally the Gramm-Leach-Bliley Act, signed in November 1999 (which allowed the deregulation of the financial sector like the 1987 statute in Canada), abolished the provisions of the Glass Steagall Act which separated commercial banking from investment banking. Part of the problems related to conflicts of interest of analysts may also result from this change in the law.
The wish of the American federal government to impose a uniform securities law seems to have had indirect negative effects. These interventions are seen by certain researchers as direct, although partial, causes of recent financial scandals. The exclusion of the States from lawsuits for securities having national scope eliminated several lawsuits and does not seem to have allowed uniformity of decisions. However, this effect was reinforced by the inaction and lack of means of the central regulatory body, the SEC\textsuperscript{20}. Based on the American example, it does not seem that the Enron affair can be a very solid argument to require uniform securities legislation in Canada.

1.2.2 The regulatory competition argument

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

Regulatory competition may lead to a situation which seems sub-optimal because of inter-jurisdictional differences. However, it presents two major advantages. Firstly, the regulated businesses, intermediaries or investors may indicate their preferences by changing jurisdiction. The needs of those regulated are therefore taken into account more
than in the classic (top-down) approach, where the agents, if they are heavily structured and organized, have more influence on the development of the laws governing them. Secondly, competition between jurisdictions allows more rapid reaction to changes in the economic environment, which are particularly rapid in the financial sector. According to Romano (2002, p. 13): *Regulatory competition, moreover, offers a distinctive advantage over a single regulator for securities law. It better aligns the incentives of issuers, and of regulators, with the interests of investors, and will thereby lead to the promulgation of rules that investors most prefer. That is so because issuers will be drawn to the regime preferred by investors to lower their cost of capital, and regulators will be able to discern the efficacy of their regulatory choices by the flow of firms into and out of jurisdictions.*

An analysis of regulatory competition is beyond the scope of this study. However, it was important to show that regulatory uniformity is not the only means available and that competition between authorities, widely practiced in the United States, has significant advantages.

1.2.3 American regulatory costs

It is difficult to maintain that an alignment of the Canadian regulatory system with that of the United States would reduce costs for Canadian businesses. American regulation is burdensome, costly and complex. Gagné et al. (2002) observe that American regulation of businesses and consumers comprises 130,000 pages in the federal register and 4,000 new regulations are added each year. In banking, Pattisson (1994) notes that institutions face 200,000 pages of banking laws, standards and regulations, of which 4,000 change each year. He writes (p. 2) that *the regulatory structure is disproportionately thick.* In
securities, *the US System is much more costly for market participants than the Canadian system. By US standards, most of our market participants are small and cannot afford the cost of a US style designed for its much bigger markets and players* (answer to the OSC preliminary report, 2002, by the BCSC). In fact, the minimum standards to maintain listing on the NASDAQ require capitalization greater than US$50 million, or around $CDN75 million. Only 590 Canadian businesses meet these criteria, representing 14% of officially listed corporations\(^\text{21}\). Corporations whose securities constitute the TSX 60 index have characteristics quite similar to those whose securities trade on the NYSE (average capitalisation of US$5 billion as opposed to $3.6 billion for NYSE stocks).

1.3 The American banking sector

According to Weelock and Wilson (2001), there were 14,483 banks in the United States at the end of 1984. Consolidation activity accelerated between 1997 and 1999 (Hughes *et al.*, 2002). At the end of 1999 we saw the lifting of the *Glass Steagall Act*\(^\text{22}\) resulting in new consolidation in the industry. However, there nonetheless remained slightly more than 8,000 American banks at the end of 2001 (Olson, 2002).

The American banking system is unique in several ways: it includes a large number of banks and is governed by a multiplicity of regulatory organizations with overlapping authority as well as banking laws which differ from State to State. For example, the Financial Institutions Division of the Ohio Department of Commerce\(^\text{23}\) authorizes the creation of new deposit institutions, approves the restructuring of institutions already registered and checks compliance of institutions with State statutes and regulations. The
Federal Reserve System, the American central bank, is decentralized in the sense that its authority is divided between twelve regional banks governed by a common board composed of seven governors appointed for fourteen years by the President of the United States. According to Olson (2002), the American banking system is characterized by its duality, in the sense that it has developed jointly at the federal level and local level: We have nationally chartered banks supervised by the federal government and state-chartered banks supervised by both state and federal regulators. (...) Now that interstate banking is a reality, I submit that the dual banking system remains an important factor underlying the strength and flexibility of our financial system. As Chairman Greenspan has reminded us in the past, the freedom of banks to choose their regulator is the key to the protection of banks from the potential for unreasonable regulatory behaviour.

1.4 Conclusion

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

The Canadian financial system is traditionally an oligopoly, according to Bordo et al., 1993). To assess the Canadian situation, we successively review the banks and the brokerage industry, the exchange, the clearing houses, and the alternative trading systems.

2.1 Canadian banks and the brokerage industry

In 1987, a timely amendment to the ten-year reform of the 1980 banking legislation allowed banks to acquire brokerage firms. This amendment promoted increased concentration in the sector. Bill C-8, which came into force in October 2001, authorized institutions other than deposit institutions (such as life insurers, money market mutual fund managers and stock brokers) to become members in the Canadian Payments Association. This statute also set up a procedure for reviewing proposed mergers of large financial institutions, which includes a review of their effect on the public. This statute, intended to promote competition through the introduction of foreign players, therefore seems to have had little effect for the moment (International Monetary Fund, 2003, p. 22).

Canadian banking activity is spread between nine national banks and fifty subsidiaries of foreign banks. The six large Canadian banks control approximately 90% of total banking assets and offer a wide range of financial services. Table 1 shows various indicators of Canadian market concentration. For the Task Force on the Future of Canadian Financial Services (MacKay Report), Canada was the developed country with the most concentrated banking sector in 1997. The method used by the Royal Bank gives a ratio...
of Canadian concentration of 46% as opposed to 81% for the MacKay Report, so Canada is surpassed by Switzerland and the Netherlands. However, the study by the Bank for International Settlements confirms the MacKay Report data and also shows strong growth in the concentration, which increased from 60.2 to 77.1% from 1990 to 1997. Such an increase is not seen in any other country. Only the United States saw growth in the same direction but the concentration index was only 11.3% in 1990. Canada, along with the Netherlands, seems to be the OECD country where the banking sector is the most concentrated. Despite this already high concentration, the largest banks have tried several times to merge. According to Cookey (2001, p. 1), in 1998 these attempts lead to new legislation on mergers for financial institutions.

Following the legislation amendment of 1987, the large Canadian banks acquired leading brokerage firms or created their own firms. According to the IDA\textsuperscript{26}, at the end of 2002 the Canadian securities industry included 200 brokerage firms, as opposed to less than 119 at the beginning of 1990. In 2001, the brokerage subsidiaries of the six large Canadian banks had more than 70% of the business in the industry. At the end of 2001, all the large integrated brokerage firms in Canada belonged to the banks, of which six represent more than 90% of total banking assets in 2002. These institutions are heavily involved in the holding of exchanges and various self-regulatory organizations.
2.2 The Canadian Exchange or the TSX Group

The restructuring of Canadian exchanges was carried out quickly. The Alberta and Vancouver exchanges merged in 1999, soon to be joined by the Winnipeg Exchange (2000), to form the CDNX\textsuperscript{27}, the national junior exchange. In May 2001, CDNX shareholders accepted a buyout offer from the TSE, which was approved by the Alberta, British Columbia and Ontario securities commissions in July 2001. The CDNX became a subsidiary operating separately but owned by the TSE, soon using the TSE infrastructure. In October 2001, small cap stocks of the Montreal Exchange were transferred to the CDNX\textsuperscript{28}, which opened an office in Montreal. The Montreal Exchange specializes in derivatives. On April 3, 2000, the TSE was demutualized and continued under the name TSE Inc., and the broker members of the Exchange became shareholders of the new entity. On July 10, 2002, the TSE Inc. was renamed TSX Inc. and the CDNX was renamed the TSX Venture Exchange Inc. On August 31, 2002, no person owned more than 10\% of the TSX Inc.\textsuperscript{29}, and the shareholders were about ninety brokerage firms\textsuperscript{30}.

2.3 Clearing houses

CDS is the sole Canadian entity offering deposit and clearing services for securities other than derivatives\textsuperscript{31}. The CDS offers electronic clearing services which allow participants to declare, confirm and settle securities transactions. The institution is governed at the federal level by the Bank of Canada, and at the provincial level, by the Ontario and Quebec securities commissions\textsuperscript{32}. CDS is a private corporation owned by the large Canadian banks, the IDA and the TSX Group inc.\textsuperscript{33}.
The Canadian Derivatives Clearing Corporation (CDCC), a private business corporation\textsuperscript{34}, issues options, futures and options on interest rate futures and on shares and clears them. These contracts are traded on the Montreal Exchange\textsuperscript{35}. The CDCC is recognized as a SRO in Quebec. It is subject to the joint supervision of the Quebec and Ontario securities commissions. The Montreal Exchange is now the sole shareholder of CDCC\textsuperscript{36}.

2.4 Alternative trading systems in Canada

According to certain participants, the TSE has for a long time been afraid of competition by alternative trading systems (ATS), and succeeded in preventing their introduction in Canada. The Teachers Pension Board Plan, in its brief to the CSA respecting ATS, wrote on November 24, 1999: We expect the Toronto Stock Exchange to propose that they be the consolidator and regulator of ATS. The fear we have with this proposal, is that the TSE has resisted change and been steadfast in its opposition to ATS and Crossing Networks (...). During the fall of 2001, the Canadian securities commissions finally adopted national standards on ATS\textsuperscript{37}. National Instrument 21-101 defines an ATS as a marketplace that does not act as a SRO or list securities for trading, which allows a significant reduction in fixed transaction costs. Following this legislative reform, three alternative trading systems for fixed income\textsuperscript{38} trades emerged in Canada, namely, Bloomberg Tradebook Company Canada, a wholly-owned subsidiary of Bloomberg Canada LLC, CollectiveBid System Inc.\textsuperscript{39}, a private business founded in 1999 in Toronto., and Candeal.ca Inc.\textsuperscript{40} owned by the TSX Group inc. and brokers\textsuperscript{41}. In spite of the emergence of a more favourable regulatory pattern, the markets’ conditions seem to
have limited the venue of ATS in the Canadian market. Their number and their transaction volume are low.

3 Regulatory monopoly and market competition in Canada

The provincial regulatory securities commissions delegate part of their powers to SRO, which regulate their members and supervise intermediation in the Canadian market. Canadian exchanges are self-regulating for members and markets. The disappearance of the Western exchanges and the redefinition of the role of the Montreal Exchange have profoundly affected the traditional situation. Self-regulation of members has become the prerogative of the IDA and market self-regulation is currently the responsibility of RS Inc., owned by the IDA and the TSX Group. Self-regulation, which was previously entrusted to each Canadian exchange, is now more or less under the aegis of a single institution.

3.1 Market regulation

For ATS to function, a new generation of SROs must be created. These providers of regulatory service, recognized by securities authorities, supervise markets and may impose disciplinary measures. Each ATS must be governed by a supplier of regulatory services. The TSX has thus created a subsidiary from its regulatory division, named RS Inc. RS Inc. is recognized as an SRO by the Ontario, Quebec, Alberta, Manitoba and British Columbia securities commissions. It provides regulatory services to the TSX and the TSX Venture Exchange. It manages requirements for business and exchange trading
and oversees compliance of members with these requirements. The only other SRO for a market is the Montreal Exchange\textsuperscript{45}. RS Inc. is owned 50\% by TSX Inc. and 50\% by the IDA\textsuperscript{46}. RS Inc. is a monopolistic not-for-profit business corporation “independent” of its two shareholders. When an ATS wishes to be established, it must come to an agreement with RS Inc. or an exchange, this last option being somewhat theoretical as ATS compete with exchanges. RS Inc. has become a de facto monopoly for market self-regulation.

3.2 Member regulation

Brokers trading on one of the exchanges must be members of a SRO, which governs the broker-client relationship, and sets out rules of ethics and minimal capital requirements to ensure investor protection. In Canada, this self-regulation of members is the mission of the IDA and the Montreal Exchange.

The traditional role of the IDA is to represent the national securities industry. Following the process of demutualization, and the abandonment by the TSE of member regulation in 1996, the IDA also became an SRO\textsuperscript{47}. The IDA registers representatives of participants, ensures that participants and their representatives meet professional standards for qualification, minimum capital, internal organization and manages clients’ complaints\textsuperscript{48}. Everywhere in Canada except in Quebec, the IDA is a monopoly because it is the only recognized SRO\textsuperscript{49}. Under section 351 of the Quebec \textit{Securities Act}, which states that SRO’s existing at the time of the coming into force of the Act may continue their activities (a grandfather clause), the CVMQ has allowed the IDA to carry on its activities in Quebec. In October 2001, the Montreal Exchange specialized in derivatives trading and this redefinition of its role lead to a decrease in the number of its approved
participants, which currently number 74, only 17 of which are exclusive\textsuperscript{50}. The IDA today includes more than 190 stock brokers, effectively making it the sole SRO for members of the securities industry in Canada\textsuperscript{51}.

3.3 Who regulates?

The presence of many representatives of the regulated industries in the regulatory organization is not abnormal. It results from the asymmetry of information between the organizations and the regulated businesses. As Laffont and Tirole (1991) indicate, the clear answer to the problem of regulatory capture would be to reduce the share taken by representatives of the regulated sector or sectors in the regulatory process. It is therefore interesting to estimate the relative importance of participants in the respective sectors directly concerned with regulations in the composition of boards of directors of Canadian regulatory organizations. Table 2 sets out the composition of these boards, taken from annual reports and information available on the web sites of these organizations. Twenty seven percent (27\%) of the directors of SROs come from a deposit institution or related organization. Twenty two percent (22\%) come from a Canadian bank or related institution. Five percent (5\%) come from a Quebec deposit institution or related institution. In total, the securities industry and banking institutions dominate the board of directors of Canadian SRO’s. Issuers hold 10 of the 124 positions, representing 8\% of the total and the investors supposedly protected by these bodies are not present. The financial services industry is therefore able to significantly influence Canadian regulatory organizations, of which they control the boards of directors.
3.4 Conclusion

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

4 Findings and implications

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

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

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

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

The centralization the American government would like to have has not brought about perfect uniformity and the laws and regulations have been applied unequally. For several authors, limitations on the right of legal actions by the States for the benefit of national lawsuits alone have had very negative effects.
The main argument opposing the adoption in Canada of a regulatory framework based on that of the United States relates, however, to the structure of the industries regulated. The Canadian financial sector is already extremely concentrated and this trend is continuing. There is strong pressure to permit the merger of a few existing banks and mergers continue in the related field of insurance. Exchanges have been restructured and the IDA plays a very important role at different levels, including regulation. Representatives of the financial industry constitute the majority of members of SRO’s and key institutions in the financial sector. It seems that the sole competitive element remaining in the entire Canadian financial system is the regulatory aspect and is the result of provincial jurisdiction over securities. The proposed single commission would lead to the regulation of an oligopoly by a regulatory monopoly in a sector where the industry already dominates the regulatory organizations. Unless the capture theory of regulatory organizations does not apply in Canada, the eventual elimination of the single element of competition must therefore be considered with extreme care.

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


Table 1: Concentration ratios in the Canadian banking sector according to various studies

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

4: The ratio equals the total banking assets of the five largest banks over total banking assets.
5: The ratio equals the total banking assets of the five largest banks over total assets of all financial institutions.
6: Indeterminate method of calculation.
7: Data from the United Kingdom and Germany are dated 1998 and that of Switzerland 1997.

Table 2: Breakdown of boards of directors of self-regulatory organizations and other key organizations in the Canadian securities industry

The organizations studied are: the Investment Dealers Association of Canada, the Investment Funds Institute of Canada, The Canadian Depository for Securities Limited, the Canadian Derivatives Clearing Corporation, the Canadian Capital Markets Association, the Montreal Exchange, Market Regulation Services Inc., the Toronto Exchange and the Mutual Fund Dealers Association.

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

Table created from annual reports and web sites.
Endnotes

1 OSC. *Five Year Review, Committee and Substantiating Documents, Reviewing the Securities Act (Ontario)* http://www.osc.gov.on.ca.
2 For example, Romano, of Stikeman Elliott, wrote in his answer to the Five Year Committee (p. 2) (...) we need both to move towards harmonization with the U.S. system and avoid unneeded complexity.
3 The works involving this area are too numerous to be reviewed. Kroszner and Strahan (2000) and Heineman and Schüler (2002) present summaries of them in the area of financial regulation.
6 http://www.state.tn.us/commerce/secdiv.html.
7 Issuances of securities not covered, within the meaning of the National Securities Markets Improvement Act of 1996.
8 An issue may be sold by the business or by a commissioned sales agent, and use mass methods of communication. The Internet represents an ideal media for businesses conducting initial direct public offerings authorized to promote their securities themselves. Shares may be sold to participants in the business (clients, salaries, employees, etc.) and, since 1995, the SEC has authorized the issue of a prospectus via the Internet.
9 Since January 13, 1998, securities listed on Tier 1 of that exchange are covered securities within the meaning of the NSMIA of 1996 and come under the jurisdiction of the SEC.
11 For some not covered securities, the Coordinated Equity Review Program, implemented in 1997, allows the analysis procedure to be coordinated between different States.
14 http://securities.stanford.edu/.
15 *Ten Things We Know and Ten Things We Don’t Know About the Private Securities Litigation Reform Act of 1995*, Joint Written Testimony of J.A. Grundfest and M.A. Perino before the Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs, United States Senate, July 24, 1997 http://securities.stanford.edu/research/articles/19970723sen1.html.
27 See Boisvert and Gaa (2001) for an analysis of the reasons for, consequences and methods of this restructuring.
A first transfer of certain classes of small-cap stocks took place in November 1999. Large-cap stocks were transferred to the TSE on December 6, 1999.

The Montreal Exchange transferred the shares it held in CDS to the Toronto Exchange, in accordance with a memorandum of understanding dated March 15, 1999, between the exchanges.

The Canadian Derivatives Clearing Corporation has been in existence since 1975, but has only been a private corporation since the beginning of 2001: http://www.cdcc.ca/accueil-fr.php/.

Since the beginning of 1999, the CDCC has provided clearing, settlement and administrative services to the Winnipeg Commodity Exchange and the WCE Clearing Corporation.

The Board of Directors of CDCC is composed of the President of Montreal Exchange Inc., one member firm representative, one public director, and CDCC’s Senior Vice-President and Chief Clearing Officer.

National Instruments 21-101 “Marketplace Operation” and 23-101 “Trading Rules” set up a regulatory framework applicable to all Canadian markets, exchanges and ATS.

Several ATS such as Instinet Canada Inc. or Versus Technologies Inc., associated with E-Trade, operate in the field of variable income securities.


It combines quotes and updates the prices offered by the six major brokers on a screen showing the best quotes in real time, which allows institutional clients to have access to a more liquid and more transparent market. http://www.candeal.ca/en_h/index.asp.


Except in Quebec, where the Montreal Exchange governs brokers.

The Montreal Exchange is not covered by RS Inc.

In the mutual fund industry, the Mutual Fund Dealers Association of Canada is recognized as a self-regulatory organization by the Ontario, British Columbia, Saskatchewan and Alberta securities commissions.

http://www.regulationservices.com/whatsNew/. It is expected that any new market will be offered an interest in RS Inc.

http://www.ida.ca/About/roles_en.asp.

Over-the-counter trades are also governed by member regulation.

Note that dealers with a restricted practice must be registered with the Mutual Fund Dealers Association of Canada.

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

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