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**THE POLITICAL ECONOMY OF THE LIBERALIZATION
OF ENTRY AND OWNERSHIP IN THE CANADIAN
INVESTMENT DEALER INDUSTRY**

BY

STEPHEN L. HARRIS

**A THESIS SUBMITTED TO
THE FACULTY OF GRADUATE STUDIES AND RESEARCH
IN PARTIAL FULFILLMENT OF THE
REQUIREMENTS FOR THE DEGREE OF
DOCTOR OF PHILOSOPHY**

**DEPARTMENT OF POLITICAL SCIENCE
AND
SCHOOL OF PUBLIC ADMINISTRATION**

**CARLETON UNIVERSITY
OTTAWA, ONTARIO
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**THE POLITICAL ECONOMY OF THE LIBERALIZATION OF
ENTRY AND OWNERSHIP IN THE CANADIAN INVESTMENT DEALER INDUSTRY**

submitted by

Stephen L. Harris, B.A., M.A.

in partial fulfilment of the requirements
for the degree of Doctor of Philosophy

Chair, Department of Political Science

Thesis Supervisor

External Examiner

Carleton University
May 8, 1995

ABSTRACT

The purpose of this dissertation is to explain the factors and processes which, in 1986-87, gave rise to the decisions by the federal and provincial (Ontario and Quebec) regulatory authorities to liberalize entry into, and ownership of, the investment dealer industry in Canada. These decisions would be a watershed with respect to the subsequent deregulation of the functional separation of the traditional four pillar structure of the Canadian financial services industry. The traditional four pillars comprised the chartered banks, the trust and mortgage loan companies, the life insurance industry and the investment/securities dealers. The aforementioned decisions by the governments in question permitted the other elements of the four pillars, and non-residents as well, to have equity participations in member firms of the securities industry. This represented a fundamental reversal of the beliefs, values and ideas surrounding the four pillars doctrine. The nature of this analysis is such that it requires the examination of the rather long period of history from 1969 to 1987.

The *central thesis* of the dissertation is that the regulatory decisions by Canadian authorities surrounding the ownership and entry provisions in the securities industry, though directionally similar to those taken in the UK and the US and elsewhere in the OECD area, can be explained by the combined influence of: the demands of the various interest groups representing the members of the four pillars; self-interest seeking behavior of securities industry regulators and politicians at the federal and provincial levels; inter-provincial competition over Toronto and Montreal as financial market centers; and, changes in global regulatory policy and regulatory policy ideas transmitted internationally.

Accordingly, the thesis suggests that most other Canadian and comparative explanations that have sought to analyze financial industry deregulation are incomplete. These analyses, primarily by economists and in government reports, give insufficient explanatory weight to the more particular array of political factors, such as those noted above, which determine national choices. Although aspects of the Stiglerian model for

regulatory policy supply have been used in Canada and are used here as well, the overarching analytical framework of this thesis systematically adds political economy and/or political rationality as important explanations of the supply of financial regulation.

More generally, in the context of Canadian political science, public policy, public administration and political economy literature, the contribution of the thesis is that it is *one* of the first in-depth analyses of any aspect of the Canadian financial services industry. Indeed, it is remarkable, given the power and influence of this industry, that so little research in these aforementioned disciplines has been undertaken on it. In addition, the thesis contributes to a more precise understanding of the dynamics of regulatory change in Canada by devising a framework that encompasses variables drawn from the politics and economics of interests and interest groups. Moreover, one of the features of the analytical framework which is developed in this project is that it is useful for understanding the whole of the time period examined.

The thesis and the framework used is centered in *three streams of literature*: the political economy of regulation; related aspects of the study of interest groups, interests, and the public interest; and, comparative and Canadian analyses of policy toward the financial services industry in general and investment banking in particular.

The empirical aspects of the dissertation, although qualitative in character, are guided by the following *analytical framework*. The dependent variable in the analysis is the 1986 decision to liberalize entry and ownership in the Canadian investment dealer industry. The policy action leading up to this decision, over both time and space, is explained by: the influence of interest groups on the demand side of the policy equation; the factors which influenced appointed and elected officials to supply a certain type of regulatory policy; inter-provincial competition between Ontario and Quebec over which city, Toronto or Montreal, would be Canada's financial center; financial policy liberalization developments outside Canada and the role and international transmission of ideas.

The empirical methodology used in the dissertation is rooted in three sources: (i) a detailed examination of an extraordinarily large number of unpublished official and

unofficial documents in the files of the relevant governmental and agency archives, of the transcripts of many regulatory hearings conducted by the Ontario Securities Commission and of submissions to them, and of official published government reports; (ii) many unstructured interviews with current and former securities regulators and officers of the self regulatory organizations, with federal and provincial cabinet ministers, with senior investment industry participants, and with senior public servants in the relevant government ministries and agencies. These lengthy and very wide ranging discussions were granted to the author on the condition that their names would not be quoted in the final manuscript. Indeed, had I not agreed to the requests for anonymity I would not have received the needed cooperation from these key actors to reconstruct the relevant events nor the required frank disclosure of the required information to add the necessary subtlety to the dynamic of the events; and (iii) an extensive review of the relevant scholarly literature in political science, economics, political economy, and public administration from both a Canadian and comparative perspective.

ACKNOWLEDGEMENTS

This project has had a rather long gestation period -- some five years -- and many people have played an important role in bringing it to a successful conclusion. The study is interdisciplinary. It draws on economics, political science and political economy. Since I became a student of these latter two disciplines comparatively late -- in my second academic career -- and this academic career came comparatively late in life, a special intellectual debt is owed to both Bruce Doern and Allan Maslove -- of the School of Public Administration at Carleton University. Professor Doern introduced me to the science of policy studies and to policy analysis and to how these disciplines can enhance one's understanding of the policy-making process -- especially economic policy making. Similarly, Professor Maslove introduced me to the precepts of the public choice paradigm and how economics can enhance the understanding of politics and policy and the motives driving policy actors. The influence of these two stimulating teachers, and now friends, has allowed me to ease the constraints of policy analysis within the economists' neoclassical paradigm. I must also acknowledge the intellectual influence of Rianne Mahon, Jane Jensen, Stan Winer, Glen Toner, Conrad Winn and the late Khayyam Paltiel. My "world view" has changed because of the influence of all of them and for that I am grateful.

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This journey never would have been started if Gordon Thiessen, now Governor of the Bank of Canada, and John Crow, the former Governor of the Bank, had not granted me a one year leave of absence from my responsibilities at the Bank to begin the doctoral program in public administration and public policy at Carleton during the 1987-88 academic

year. Chuck Freedman, now a Deputy Governor at the Bank, was also helpful and encouraging in this regard. To all of them I am grateful.

Many other individuals, perhaps too many to mention, and many who cannot be mentioned because of a request for anonymity, have been instrumental in the ultimate completion of the dissertation. Those who requested anonymity were in one form or another participants in the policy process which is the focus of this study. Indeed, without exception, they encouraged me to "dig" for answers so that our understanding of the decision processes surrounding financial liberalization in Canada -- at least that part of it relating to the investment dealer industry -- could be better understood. Many of those individuals whom I interviewed strongly indicated to me that the story I was working on was one that should be told. Thus, without their insights and encouragement this story could not have been told.

There are a number of people I can acknowledge explicitly.

The official Ontario Government papers of the late 1960s and early 1970s were made available to me by the Ontario Archives. The long hours spent by Stormie Stewart, a Freedom of Information Officer, in reviewing relevant Ontario Securities Commission documents of the period is greatly appreciated. Eileen Andrews, Secretary of the Investment Dealers' Association, provided me with access to relevant documents in the Archives of the Association without which many questions would have remained unanswered. The Office of the Secretary of the Ontario Securities Commission was equally accommodating in respect of the transcripts of the many official hearings which were conducted during the period covered by the study.

Gunther Broker, former head of the Financial Markets Division at the OECD Secretariat in Paris, helped me search the Organization's archives for relevant documents which would indicate the influence of the apparatus of that Organization in the global liberalization process. Rinaldo Pecchioli, now the Deputy Director of the Directorate for Financial, Fiscal and Enterprise Affairs at the OECD, allowed me access to the agendas of the Committee on Financial Markets, since its inception in the early 1970s, in order that I

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A number of colleagues at the Bank of Canada were also very supportive. The staff of the Library, especially Louise Gibson, the Head of Reference Services, Helene Paquette, Document Management Supervisor, and Marc Lacourciere, Circulation Technician were particularly helpful and showed extraordinary patience with my persistent reluctance to return overdue items. Jane Witty, former Archivist at the Bank was also helpful on a number of occasions.

As this project was nearing completion Ken Eng, the LAN Administrator in the Securities Department of the Bank, translated the manuscript, which had originally been written in the Word 5 DOS environment, into Framemaker for the UNIX environment. My Secretary, Ruth Loukota, formatted the text once it had been translated and moreover has been very helpful in putting the manuscript into its final form. I owe her a special thank you.

My late father would have been proud to see me complete this project, while my mother continuously expressed worry at "how hard" I seemed to be working. Her thoughtfulness and concern were always appreciated.

My friend Andrea showed patience, understanding and provided encouragement in the final year and a half of this work. On the occasions when I took a break from the travail of "writing" she ensured that our hikes in the Gatineau Hills, and our bike rides in the Ottawa Valley and upstate New York were periods of genuine relaxation. Those distractions were necessary and greatly appreciated.

Finally, I want to turn to my children, Lisa and Richard. They have been extraordinarily supportive through the whole of this journey -- more than they will ever know and more than I know how to express in words. Indeed, at times they seemed excited by the thought that their "aged" father could be embarking on a second academic career while they started on their first. That alone stimulated me to continue when I thought I was too

old for this endeavour. Lisa often wondered who would be a "doctor" first. She beat me by a year -- but she is a real doctor! And Richard, who is a real "scholar," will now realize that "formal study" can end sometime -- and it is exhilarating. Without both of them "rooting" for me I would not have completed this project.

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GLOSSARY OF ACRONYMS

BIS	Bank for International Settlements
B-J	Beck and Johnston
BNS	Bank of Nova Scotia
CAN\$	Canadian Dollars
CBA	Canadian Bankers' Association
CEO	Chief Executive Officer(s)
CFM	Committee on Financial Markets at the OECD
City	Financial District in the City of London (UK)
CSE	Canadian Stock Exchange
ECC	European Commission
FEI	Financial Executives Institute
GATT	General Agreement on Tariffs and Trade
GLIS	Green Line Investment Service
IBC	International Banking Center
IBRD	Internat'l Bank for Reconstruction and Development
ICC	Interstate Commerce Commission (US)
IDA	Investment Dealers Association
IMF	International Monetary Fund

JIC	Joint Securities Industry Committee
JIC2	Second Joint Securities Industry Committee Report
JIR	Joint Industry Report
JSIC	Joint Securities Industry Committee
LDC	Developing Country
LSE	London Stock Exchange (UK)
MSE	Montreal Stock Exchange
NAPO	National Anti-Poverty Organization
NYSE	New York Stock Exchange (US)
OECD	Organization for Economic Cooperation and Development
OFT	Office of Fair Trading (UK)
OSC	Ontario Securities Commission
OTC	Over the Counter (Market)
QSC	Quebec Securities Commission
SEC	Securities and Exchange Commission (US)
SIRC	Securities Industry Review Committee
SICMC	Securities Industry Capital Markets Committee
SRO	Self-Regulating Organization
TD	Toronto-Dominion Bank
TML	Trust and Mortgage Loan Companies
TSE	Toronto Stock Exchange

UK	United Kingdom
US	United States
US\$	United States Dollars
USGBGFRS	Board of Governors of the Federal Reserve System (US)
VSE	Vancouver Stock Exchange

INTRODUCTION

The purpose of this dissertation is to explain the factors and processes which, in 1986-87, gave rise to the decisions by the federal and provincial (Ontario and Quebec) regulatory authorities to liberalize entry into, and ownership of, the investment dealer industry in Canada. These decisions, rather narrowly based as they were, would nonetheless be a watershed with respect to the subsequent deregulation of the functional separation of the traditional four pillar structure of the Canadian financial services industry. The traditional four pillars comprised the chartered banks, the trust and mortgage loan companies, the life insurance industry and the investment/securities dealers. The aforementioned decisions by the governments in question permitted the other elements of the four pillars, and non-residents as well, to have equity participations in member firms of the securities industry. This represented a fundamental reversal of the beliefs, values and ideas surrounding the four pillars doctrine. The nature of this analysis is such that it requires the examination of the rather long period of history from 1969 to 1987.

The *central thesis* of the dissertation is that the regulatory decisions by Canadian authorities surrounding the ownership and entry provisions in the securities industry, though directionally similar to those taken in the UK and the US and elsewhere in the OECD area, can be explained by the combined influence of:

- the demands of the various interest groups representing the members of the four pillars;
- self-interest seeking behavior of securities industry regulators and politicians at the federal and provincial levels;
- inter-provincial competition over Toronto and Montreal as financial market centers; and

- changes in global regulatory policy and regulatory policy ideas transmitted internationally.

Accordingly, the thesis suggests that most other implicit Canadian and comparative explanations that have sought to analyze financial industry deregulation are one-dimensional, and hence incomplete. These explorations, primarily by economists and in government reports, give insufficient explanatory weight to the more particular array of political factors, such as those noted above, which determine national choices. Indeed, these analyses focus on the more technical factors associated with regulation. The engine driving the economists' rationale for regulation and deregulation in the financial services industry is, for example, economic efficiency, systemic stability, investor protection and avoidance of industry and/or market concentration. These explanations are more or less rooted in some conception of the public interest and only peripherally rely on rent-seeking behavior of the key policy actors as explanations of policy change. Although aspects of the Stiglerian model¹ for regulatory policy supply have been used in Canada and are used here as well, the analytical framework of this thesis will systematically add political economy and/or political rationality as important explanations of the supply of financial regulation.

More generally, in the context of Canadian political science, public policy, public administration and political economy literature, the contribution of the thesis is that it is one of the first in-depth analyses of any aspect of the Canadian financial services industry. Indeed, it is remarkable, given the power and influence of this industry, that so little research in these social science disciplines has been undertaken on it. In addition, the thesis contributes to a more precise understanding of the dynamics of regulatory change in Canada by devising a framework that encompasses variables drawn from the politics and economics of interests and interest groups. Moreover, one of the features of the analytical framework which is developed in this project is that is useful for understanding the whole of time period examined.

¹ George J. Stigler, "The Theory of Economic Regulation," in Chicago Studies in Political Economy, ed. George J. Stigler (Chicago: University of Chicago Press, 1988).

The thesis and the framework used is centered in *three streams of literature*:

- the political economy of regulation;
- related aspects of the study of interest groups, interests, and the public interest; and
- comparative and Canadian analyses of policy toward the financial services industry in general and investment banking in particular.

The empirical aspects of the dissertation, although qualitative in character, are guided by the following *analytical framework*. The dependent variable in the analysis is the 1986 decision to liberalize entry and ownership in the Canadian investment dealer industry. This decision reflected the actions of policy actors in Quebec, Ontario and in the federal government. The policy action leading up to this decision, over both time and space, is explained by: the influence of interest groups on the demand side of the policy equation; the factors which influenced appointed and elected officials to supply a certain type of regulatory policy; inter-provincial competition between Ontario and Quebec over which city, Toronto or Montreal, would be Canada's financial center; financial policy liberalization developments outside Canada and the role and international transmission of ideas.

The thesis is organized into two parts. Part One, consisting of four chapters, examines the conceptual and policy issues, reviews three contributing literature streams, and derives the framework used to examine the 1986 decisions by the Ontario, Quebec and federal governments to liberalize entry and ownership in the securities industry. Chapters One and Two review the relevant literature on the financial services industry and the politics and economics of economic regulation, respectively. Chapter Three, which addresses comparative issues and developments, is necessarily empirical in character in order to portray the convergence of the relationships among the state and investment industry across three countries. Indeed, it introduces the readers to the relationship between the state and the securities industry and facilitates the understanding of the journey to follow. Chapter Four rounds out both the literature survey the analytic framework.

Part Two of the dissertation, comprising seven chapters, presents the qualitative empirical analysis. It will review the genesis of the restrictions on entry and ownership in the securities industry in the late 1960s, the influence of liberalization abroad on the competitive position of the indigenous industry and the response of public and private decision-makers to this international conjuncture.

The empirical methodology used in the dissertation is rooted in three sources: (i) a detailed examination of an extraordinary large number of unpublished official and unofficial documents in the files of the relevant governmental and agency archives, of the transcripts of many regulatory hearings conducted by the Ontario Securities Commission and of submissions to them, and of official published government reports; (ii) many unstructured interviews with current and former securities regulators and officers of the self regulatory organizations, with federal and provincial cabinet ministers, with senior investment industry participants, and with senior public servants in the relevant government ministries and agencies. These lengthy and very wide ranging discussions were granted to the author on the condition that their names would not be quoted in the final manuscript. Indeed, had I not agreed to the requests for anonymity I would not have received the needed cooperation from these key actors to reconstruct the relevant events nor the required frank disclosure of the required information to add the necessary subtlety to the dynamic of the events; and (iii) an extensive review of the relevant scholarly literature in political science, economics, political economy, and public administration from both a Canadian and comparative perspective.

PART ONE

Introduction to the Financial Services Industry

and

The Analytical Framework

CHAPTER ONE

THE REGULATORY ENVIRONMENT OF THE FINANCIAL SERVICES INDUSTRY

Introduction

The operating environment surrounding the Canadian financial sector in general and the investment banking industry in particular has been altered dramatically in recent years. The changed environment reflects developments offshore and subsequent responses by regulatory authorities in Canada, at both the federal and provincial levels, to ensure the continued viability of the indigenous industry.

The purpose of this chapter is to review these developments at a high level and set the stage for the analysis of the policy decisions by Canadian regulatory authorities which deal with the ownership structure of the Canadian investment dealer industry. The importance of understanding the concept of the traditional "four-pillar" structure of the Canadian financial system will be underscored, its endurance will be noted because so many interests were wedded to this structure, and the domestic and international phenomena which gave rise to the pressure for change will be noted. In this regard it will be demonstrated that in a comparative perspective, the issues facing Canadian authorities were not unique, but the policy decisions which were to be produced by public decision-makers had to take account of the developments, structures, and changes in the financial markets and institutions of the most important developed democracies.

Moreover, it will be shown that the focal point of the policy considerations for the Canadian regulators related to the ownership structures of the financial sector and the degree to which the "four-pillars" should be allowed to be blurred. The blurring of the "four-pillars" ultimately would result in the devolution of control of the investment dealer industry from industry participants themselves to financial conglomerates and to a lesser extent to a sharing of market opportunities with foreign owned investment dealers. In any event, in both instances, the traditional power of industry participants would be diminished.

The Four-Pillar Issue: A Question of Ownership and Function

Traditionally the structure of the Canadian financial system is based on the concept of "four-pillars." The pillars refer to the functional separation of various types of financial institutions according to the character of their business. Thus specific types of financial activities such as, short-term finance for business and industry, mortgage finance for individuals, short-term loans to the household sector, and securities trading, were restricted to the different types of financial institutions that evolved in Canada over 100 years or so. The "four-pillars" comprised the chartered banks, the life insurance companies, the finance companies and the securities/investment dealers.¹ Cross-ownership among the pillars was not permitted because of the fear by regulatory authorities that the activities in one part of a financial firm's business could contaminate all of its affairs, result in insolvency and impose an onerous cost on society. Also, up until relatively recently, participation by non-residents in the Canadian financial sector was severely curtailed.

The separation of financial industry powers in Canada -- the creation of the four pillars system -- was formalized in the 1920s following both the failure of the Home Loan Bank and the pressures to which the financial system was subjected during the years of the

¹ For a discussion of the early evolution of the four pillars in Canada see Report of the Royal Commission on Banking and Finance (Ottawa: Queen's Printer and Controller of Stationery, 1964), 101-108.

depression.² The evolution of the structure of the financial system was largely dictated by federal legislation which prescribed the powers of financial institutions.³

In addition to the separation of functions within the financial system, there also exists in Canada a two-tiered regulatory structure divided among the federal and provincial jurisdictions. That is to say, the federal Parliament has the power to incorporate and regulate the business of banking -- although banking is not defined in the Constitution Act of 1867 nor in the Bank Act,⁴ while the provincial legislatures have exclusive authority over the securities industry. The provinces and the federal government, both, are authorized by the Constitution to incorporate and regulate trust and mortgage loan companies (TMLs) and life insurance companies.

Ontario and Quebec have established a thorough regulatory apparatus, while most of the other provinces have delegated to the federal regulator -- the Office of the Superintendent of Financial Institutions -- the power to regulate provincially incorporated or registered institutions. Most life insurance companies are federally incorporated.⁵ Thus the policy dynamic surrounding the regulation of the financial system is compounded in Canada by jurisdictional problems -- especially, at times, the lack of convergence of the regulations among the different provinces and between the provinces and the federal authorities. The lack of convergence across provincial boundaries complicates the capacity of firms to offer comparable services and products across the country. Moreover, the regulatory function from a public administration perspective is unduly complicated. While it can be argued that competition among jurisdictions can be beneficial, it will be seen that in Canada reaching a regulatory equilibrium can be a lengthy process for the key public and private actors involved.

² Economic Council of Canada, Competition and Solvency: A Framework for Financial Regulation (Ottawa: Supply and Services Canada, 1986), 1.

³ Report of the Royal Commission on Banking and Finance, 101-108.

⁴ Report of the Royal Commission on Banking and Finance, 114.

⁵ Economic Council of Canada, Competition and Solvency, Chapter 2.

Evolution of Ownership and Entry Liberalization in the Canadian Securities Industry

So up until the mid-1980s the basic structure of the financial services industry was underpinned by the separation of functional responsibilities of financial institutions. This separation was sanctioned by statute or regulatory decree. However, in February 1985 the Ontario Securities Commission (OSC) released a Report⁶ which addressed the question of entry to and ownership of the Canadian securities industry. The essence of its judgement was to reduce the extent of the then existing restrictions on foreign and financial institution participation in the domestic securities industry. Inasmuch as this issue was politically charged at the time, the Commission, in its policy output, was constrained to preserve, to the extent possible, both a *substantially* Canadian owned industry and the *traditional functional composition* of the Canadian financial sector while it awaited the conclusions of the federal government's review of its policies regarding the regulation of financial institutions in Canada.⁷ Ultimately, as will be seen, the OSC was compelled to liberalize its entry and ownership restrictions completely. This liberalization took place against the background of strong opposition from the influential members of the securities industry participants. The industry wanted continued shelter from the vagaries of the competitive marketplace in order to preserve its "monopoly rents."

Subsequent to the release of the OSC's Report dealing with entry into and ownership of the investment dealer industry, in November 1986, the federal government provided the Bank of Nova Scotia (BNS), via the temporary investment provisions of the Bank Act, the opportunity to establish a wholly owned subsidiary in Quebec to carry on a securities business in that province before its own review of the regulatory framework for financial institutions had been completed. Quebec already permitted non-resident and

⁶ Ontario Securities Commission, A Regulatory Framework for Entry into and ownership of the Ontario Securities Industry: A Report of the Ontario Securities Commission to the Minister of Consumer and Commercial Relations (Toronto: OSC, February 14, 1985).

⁷ In the event the federal government's Green Paper recognized some need to overlap (the term "blur" is the traditional jargon of policy community) the functionality of financial institutions. See Department of Finance, Regulation of Canadian Financial Institutions: Proposals for Discussion (Ottawa: Minister of Supply and Services, April 1985).

institutional ownership in the securities industry. Around the same time, but prior to the BNS action, Ontario had proposed to grant federally regulated institutions (i.e., chartered banks) permission to have *minority* ownership interest in securities firms.

The decision of the BNS had the effect of putting Toronto at a competitive disadvantage relative to Montreal in respect of non-industry investment and the Ontario government moved quickly to adjust its earlier policy proposal. In this regard it is instructive to think about a "disadvantaged Toronto," and the regulator's response to it, in the broadest possible context. This view would take account of the potential impact of the likely negative welfare effects of a decline in the relative importance of Toronto as a financial center upon careers of bureaucrats and appointed officials. These effects, however measured, would enter the utility functions of officials and consequently influence the character of subsequent policy outputs. In the event, in December 1986, the Ontario government announced plans to allow banks, trust companies, non-financial companies and non-residents permission to take over 100 percent of securities firms during a two year period beginning in June of 1987.

In regard to the timing of the regulatory changes, it is noteworthy that the Ontario proposals were announced some eight months after the Senate of the United States had authorized "fast track" free trade negotiations with Canada. The policy initiative by the Ontario government was apparently a source of conflict between the federal and provincial authorities because it implied important free trade negotiating levers had been given away.

The issue of entry into and ownership of the industry became a public policy issue in the late 1960s when Merrill Lynch, Pierce Fenner & Smith (a United States based company) acquired Royal Securities (an old and well established Canadian firm). Up until 1969, foreign owned firms had operated successfully and in a relatively unencumbered way. Indeed, the public policy issue of foreign ownership in the securities industry arose in the face of the nationalistic sentiments generally during this period in Canada, which ultimately gave rise to the federal government's Foreign Investment Review legislation in 1971.

The foreign ownership issue surfaced again in 1983 when the Daly Gordon Securities Company (a Canadian firm now known as Gordon Capital) proposed a joint venture with the Lambert Brussels Corporation (a Belgium based firm) to deal in the unregulated sector of the securities market under the name of Gordon Capital. The regulated portion of the business would continue to operate under the earlier noted corporate identity. This proposal raised the same questions that had been explored more than a decade earlier⁸ and which resulted in the restrictions on entry and ownership in the Canadian securities industry. It was the Daly Gordon proposal which served to stimulate the re-examination (by the Ontario, Quebec and federal regulatory authorities) of the ownership and entry structures in the Canadian securities industry. It will be seen as the watershed event with respect to the ultimate restructuring of the ownership arrangements of the Canadian securities industry.

A Comparative Perspective on the Ownership Question

The restrictions on both the co-mingling phenomenon and the character of ownership generally of the various pillars in the financial system was not restricted to Canada. Indeed, in a comparative perspective, a number of organizational configurations of financial systems can be identified.⁹ *First*, in North America (and Japan too), traditional institutional banking-type activities have been separated from securities-type activities carried on by investment dealers or merchant banks. The conventional arguments for this separation of activities reflected both the differential assessments of the risks that confront the two types of intermediaries and, the public interest requirement for macroeconomic stabilization. Furthermore, the liabilities of the banking system (money) are the means of payment for a capitalist economy (the oil that lubricates its engines) and in order to

⁸ Trevor F. Moore, Report of the Committee to Study the Requirements and Sources of Capital and the Implications of Non-Resident Capital for the Canadian Securities Industry (Toronto: Privately Printed, May 1970).

⁹ At this point the objective is to identify the broad menu of organizational characteristics from which public policy decision-makers can choose to structure the financial system. It is not the purpose, at this point to identify how the organization of the financial sector influences outputs in substantive policy areas. In this regard see John Zysman, Governments, Markets, and Growth: Financial Systems and the Politics of Industrial Change (Ithaca and London: Cornell University Press, 1983).

preserve system stability, confidence in the institutions which hold these liabilities is a public policy requisite. Thus, state authorities carefully regulate the activities of the banking system with a view to limiting systemic risk. Normally, systemic confidence is perceived to be further enhanced by the provision of deposit insurance funded by both the institutions with the state acting as lender of last resort. This, despite the moral hazard implications associated with such investor "protection" -- as evidenced by the debacle in the US Savings and Loan industry. Another reason for the special concerns about the activities of the banks is their role as one of the mainsprings of the central bank in achieving macroeconomic stabilization, however defined, through monetary policy.

Unlike the banking industry, where the important precept is the protection of the public interest, in securities trading and investment activities, the risks and rewards associated with the investment decisions made by market participants are very much greater than those intended by the almost passive actions of bank depositors. In securities trading the decisions to confront the risk/reward trade-off are made by the individual/institutional investor or firm against the background of available information and their interpretation of it. Thus, at a general level, it can be asserted that regulation of the securities industry is in the public interest, but this is achieved by regulating the ethics and conduct of industry participants as well as its ownership structures. In this regard, it is in the nature of the investor to assess risk in securities markets given the framework for information disclosure which is required by the state's regulatory authorities.

The OSC had traditionally been the lead securities regulator in Canada because of Toronto's important position as a financial center. Its principal areas of activity are:¹⁰

- the licensing and registration of individuals and firms trading in securities;
- reviewing prospectuses and disclosure documents;
- monitoring disclosure documents; and
- enforcing the Ontario Securities Act.

¹⁰ Ontario Securities Commission, Annual Report 1994 (Toronto: Queens Printer for Ontario, 1994), 10.

This dissertation is concerned exclusively with the OSCs activities related to licensing and registration -- which includes the entry and ownership questions -- and not with its functions related to reviewing disclosure documents and administering the Securities Act more generally.¹¹

In the case of banking, on the other hand, because the regulatory objective is preservation of systemic stability, broadly defined, state authorities impose no public disclosure requirements which would require the investor/depositor to make a judgement about riskiness of his/her actions. In this regard, the investment powers of the banking industry are prescribed, their liabilities are regulated, and their ownership structures (generally widely held compared to the traditionally more narrowly held securities firms) are limited. Indeed, the less said publicly about the financial condition of a bank, or any deposit taking institution, the better! For example, in the case of the demise of Standard Trust in the spring of 1991

The paramount concern for the trust company's regulators was its ability to pay depositors. They told the public as little as possible because of concerns that disclosure could cause depositors to panic and spark a run on deposits.

'The integrity of that sector depends on public confidence,' said a securities lawyer. 'Public confidence is easily undermined by adverse information going out. Any adverse information tends to be treated gingerly.'¹²

¹¹ The work of the OSC is divided into two distinct parts. One part relates to the function of the Commission as an autonomous statutory tribunal. Its eleven members are appointed by Order-in-Council. The other part relates to the work carried on by the Commission. The statutory tribunal consists of a full-time chairman, two full-time vice-chairs, and eight part-time Commissioners. The Commissioners are drawn from various fields related to securities industries, including lawyers, accountants, dealers and investors. The OSC formulates policy, sits as an administrative tribunal in hearings, acts as an appeal body from decisions made by the Executive Director (the OSCs chief operating officer) and staff and hears appeals from decisions from the SROs. The OSC is empowered to grant official recognition to Self Regulatory Organizations (SROs), and has recognized the TSE and the IDA. The SROs impose financial and trading rules on their members that are enforced through independent audit and compliance checks. The OSC reviews such rules and hears appeals from decisions of the SROs. From Ontario Securities Commission, *Annual Report 1994* (Toronto: Queens Printer for Ontario, 1994), 10.

¹² Karen Howlett, "Shall we tell the public?" *Globe and Mail*, 21 May 1991.

In a more notorious case

Canada's top financial regulator says he took unprecedented regulatory action against the Bank of Credit and Commerce Canada last December but didn't advise the public for fear of sparking a run on the bank.

Superintendent of Financial Institutions Michael Mackenzie told the House of Commons that he decided Dec. 12 to renew the bank's licence for three months rather than the customary one year.¹³

More generally, Mackenzie warned that

In Canada we can't afford to have public speculation whether my money is safe in that bank or trust company...We do not accompany our regulatory action with press conferences and banner headlines.¹⁴

The situation in respect of investment dealers which run into financial difficulty is very much less opaque -- partly reflecting the regulatory culture of disclosure and partly the fact that the turbulence surrounding the failure of a dealer is unlikely to threaten the stability of the financial system. Indeed, the problems surrounding Osler Inc.'s financial problems were disclosed by the Toronto Stock Exchange very shortly after they were uncovered.

The Toronto Stock Exchange has launched a full investigation into Osler Inc., the small investment dealer that had to be bailed out by the industry after suffering a \$30 million loss in its bond business last Friday.

'The loss that put the firm under water in terms of capital requirements on Friday had to do with a course of conduct or dealings with a client,' Keith Boast, vice-president of listed company and member regulation at the Toronto exchange said yesterday.¹⁵

Also, as noted earlier, where co-mingling of business is permitted, either through an affiliated company or "in-house," there is concern that losses in one part of banks'

¹³ Alan Freeman, "SCC Canada on short leash," Globe and Mail, 23 August 1991, B3.

¹⁴ Brian Milner "Mum's word for financial regulator," Globe and Mail, November 14, 1991, B1.

¹⁵ Kenneth Kidd, "TSE launches probe into Osler's loss in bond business," Toronto Star, December 18, 1987, C1.

business will contaminate its other parts.¹⁶ In the US for example, prior to the banking collapse of the 1930s there was no separation of the powers of banks and securities dealers. In the 30s, following the collapse, and in the face of charges of conflicts of interest, securities speculation, destructive competition and concentration of power in the banks, the US Congress enacted the Glass-Steagall Act to separate banking from investment banking.¹⁷ In this regard and with respect to both the motivation of political actors to supply public policy and political rationality, the views of George Benston are notable.

The argument for these constraints were couched in terms of concern for the safety and soundness of the banks or fear of centralized power by the banks. But the Glass-Steagall Act prohibitions were not based on empirical findings demonstrating that the provisions of securities services by banks contributed to failures or to cheating of customers. Rather, the evidence supports the belief that the investment bankers and underwriters were concerned about severe competition from banks and bank affiliates and sought (successfully in 1933) to eliminate those competitors.¹⁸

On the other hand, Henry Wallich, former Member of the Board of Governors of the Federal Reserve System (USBGFRS), was of the view that "the safety factor has always been a good reason for regulation"¹⁹ in the financial industry because of the pervasive effects of financial failure on the rest of the economy. However, the USBGFRS has since taken the lead in liberalizing the precepts of the Glass-Steagall Act -- where it had the powers to do so. For example,

The Federal Reserve Board drove a historic crack in the wall separating investment banking and commercial banking by authorizing J.P. Morgan &

¹⁶ Organization for Economic Co-operation and Development (OECD), International Trade in Services: Securities, (Paris: OECD Publications Service, 1987), 13.

¹⁷ George W. Benston, "Federal Regulation of Banking: Historical Overview," in Deregulating Financial Services: Public Policy in Flux, ed. George G. Kaufman and Roger C. Kormendi (Cambridge, MA, Balinger Publishing Company, 1986), Chapter One.

¹⁸ George W. Bentson, "Federal Regulation of Banking: Historical Overview," 11.

¹⁹ Henry C. Wallich, "A Broad View of Deregulation," Remarks at the Conference on Pacific Basin Financial Reform sponsored by the Federal Reserve Bank of San Francisco, December 2, 1984, 1.

Co. to underwrite stocks. It is the first time a bank has had that power since the 1933 Glass-Steagall Act outlawed it because of abuses during the Great Depression.

...the Fed signaled in January 1989, when it gave banks the power for the first time to underwrite corporate debt, that it also intended to give banks the power to underwrite equity securities.²⁰

These activities had been the exclusive preserve of the investment dealer industry in the US. The US Congress, on the other hand, in the second half of the 1980s, has been preoccupied with the political fallout of the failures in the Savings and Loan Industry and thus reluctant to be seen allowing further liberalization in the financial sector. In any event, the case for separation of functions in the financial services industry, based as it was on systemic stability grounds, did not appear to be rigorous. There is an apparent underlying uncertainty regarding the rationale for the protection accorded the securities industry by the Glass-Steagall provisions. The generalities of this latter point are implicitly reviewed in the discussion of the universal bank model which follows immediately.

Second, one can point to the universal-type banking system typically found in Western Europe²¹ -- of which the (West) German system is frequently pointed to as an example. In such a regime, the banks are permitted to undertake a wide range of financial activities including operations in both primary and secondary securities markets²² (and other activities typically associated with investment dealers/merchant bankers) as well as operations which, in Canada, would be delegated to trust and mortgage loan companies (estate, trust and agency management, real estate brokerage, and construction financing), finance companies (leasing and factoring) and insurance companies. Another important distinguishing feature of the (West) German financial system is the close linkages between the banks and private industry. Traditionally, the large German banks control significant

²⁰ Paul Duke Jr., and Randall Smith, "Fed Allows J.P. Morgan to Underwrite Stocks," The Wall Street Journal, 21 September 1990, C-1.

²¹ OECD, International Trade in Services: Securities, 14-15.

²² Financial markets dealing in outstanding securities are known as "secondary markets" as opposed to new issue securities which occurs in what are called "primary markets."

blocks of equities in industry, even though such arrangements are seen as merely another form of finance.²³ Such activities would be prohibited in Canada.

In addition to the concerns regarding institutional contamination, other common criticisms of the universal banking system, by those convinced that a compartmentalized system is "better," are: the potential negative effects of the concentration of economic power; the implied restriction of competition because the number of institutions is limited; and, the less efficient capital and money markets in those countries with universal banking systems and the potential for conflicts of interest to undermine confidence in the financial system itself. The Canadian securities industry, for a long time, successfully utilized most of these arguments in its attempts to defeat the forces that would cause it to conduct its affairs in a more competitive environment.

The counterpoint to these arguments is that universal banks are better able to spread risks than are the more narrowly focused institutions and hence the probability of institutional failure as a consequence of losses in any one service area (e.g. real estate lending) is reduced. With respect to competition, advocates of the universal system point to the fact that banks can offer a wide variety of services and hence competition will remain keen as long as the number of banks is large.²⁴ Indeed, in 1979, a (West) German inquiry determined that it was not possible to substantiate the criticisms that are normally directed at universal banking systems.²⁵

The Commission believes that a departure from the system of universal banks is not recommendable. On the whole, the universal bank system has proved successful; the supposed or actual deficiencies of the present banking system do not provide sufficient reason for changing the system.²⁶

²³ John Zysman, Governments, Markets, and Growth: Financial Systems and the Politics of Industrial Change, 64.

²⁴ OECD, International Trade in Services: Securities, 14.

²⁵ Federal Republic of Germany, Report of the Commission of Inquiry 'Basic Banking Questions'-- Summary (Bonn, 1979).

²⁶ Report of the Commission of Inquiry 'Basic Banking Questions'-- Summary (Bonn, 1979)

This view was reinforced recently by George Benston when he noted that

After considering issues of financial stability, economic development, competition among financial institutions, concentration of economic and political power, consumer choice and conflicts of interest, I find that universal banking can provide considerable benefits and would pose few problems for the economy.²⁷

The Canadian federal government ultimately iterated to the same view as that of the German authorities. In the 1985 Green Paper²⁸ it was proposed that co-mingling among the various pillars of the financial services industry could occur only through a financial holding company regime -- but each entity within the conglomerate structure had to have its own board of directors. This paper was silent on the question of the ownership of and entry into the investment dealer industry because these issues were under the purview of the provinces. In December 1986 -- following the abrupt decision of the BNS to take an equity position in the investment dealer industry -- the federal government published a White Paper²⁹ which markedly modified its earlier view and proposed to allow financial institutions to hold financial subsidiaries in other pillars of the financial services industry. Moreover, these proposals suggested that financial institutions would be permitted some "in-house" securities related powers. It was suggested that the earlier restrictions no longer served the public interest and the proposed new liberalized environment would benefit competition, efficiency and innovation for users of the Canadian financial markets. Finally, in the Fall of 1990, a paper accompanying the introduction of the financial sector reform legislation³⁰ used the bank-securities dealer relationship that had been sanctioned in 1986 as a model for further reform of the ownership arrangements within the financial services industry. Thus, the structure of the

²⁷ George Benston, "Universal Banking," Journal of Economic Perspectives, Summer 1994, 140.

²⁸ Department of Finance, The Regulation of Canadian Financial Institutions: Proposals for Discussion.

²⁹ Minister of State for Finance, New Directions for the Financial Sector (Ottawa: House of Commons, December 18, 1986).

³⁰ Minister of State (Finance), Reform of Financial Institutions Legislation: Overview of Legislative Proposals, (Ottawa: Department of Finance, Fall 1990).

Canadian financial services industry had moved from one extreme of the ownership continuum -- complete separation -- to the other extreme -- virtually approaching the universal banking system model. It was the combination of the environment in which the institutions operated (the emerging global stage) and the opportunities and constraints confronting regulators and politicians that gave rise to the altered framework in which the financial services industry would operate.

Finally, there is a *third* system where national financial regulatory authorities try to separate the market intermediary function in secondary securities markets from other securities related functions. This system was characteristic of the United Kingdom until the early 1980s. In the UK case, banks and brokers took orders from their customers, but actual trading took place on the organized exchanges through licensed brokers which had a monopoly to act in secondary markets. The national authorities which were advocates of this type of system were concerned about the consequences of manipulative trading practices by large institutions (banks) if they dominated the secondary markets. Brokers were seen merely as uninterested actors in the market, not licensed to take positions for their own accounts -- they were true market intermediaries.³¹

However, in the UK there had never been a tradition of the separation of powers between banks and investment dealers. Nonetheless, the banks, for reasons related to the way in which the Bank of England implemented monetary policy, and to the dominance of the banks in the supply of credit to the private sector, did not participate fully in the investment banking business until the 1970s when the functions of the financial and market intermediaries began to blur -- as was the case more recently in Canada. More generally, however, the pressures pushing the UK officials toward major restructuring were virtually the same as those present in Canada -- only they were more intense.

³¹ OECD, International Trade in Services: Securities, 15-16.

International Influences on the Liberalization Phenomenon in the Investment Dealer Industry

The evolution of the financial liberalization phenomenon was rooted in the globalization of the international economy. Over the past two decades or so the economic systems of the western democracies have become increasingly integrated and consequently interdependent. The roots of this interdependence can be found in the evolution of the international trading system. Examples of the processes that have facilitated this interdependence are: the successive rounds of General Agreement on Tariffs and Trade (GATT) sponsored negotiations which resulted in reductions in the traditional barriers to exchange of goods among the trading nations and/or trading blocks in the world, the ongoing economic and political integration of the members of the European Economic Community, and more recently the Canada-United States Free Trade Agreement (now the North American Free Trade Agreement).

In the latest Uruguay round of GATT negotiations the impediments to trade in services were added to the agenda for trade liberalization. Not surprisingly, this systematic dismantling of the obstacles to a less encumbered world trading system has been mirrored by an increasing "globalization" of the financial systems of these same trading nations. The term globalization refers to "international integration"³² and has been an important phenomenon characteristic of financial markets in the 1980s "caused in part by recent liberalization of some domestic capital markets."³³ Indeed, this interdependence of financial markets can be seen as "one of the most profound changes in the world's economic and financial landscape during the 1980s."³⁴ Specifically,

This interdependence was brought about by a number of important trends which laid the foundation for the global securities markets of today. The elimination of exchange controls in several industrialized countries and the

³² Bruce G. Resnick "The Globalization of World Financial Markets," Business Horizons, November-December 1989, 34.

³³ Bruce G. Resnick "The Globalization of World Financial Markets," 35.

³⁴ Securities and Exchange Commission, The Securities Markets in the 1980s: A Global Perspective, Washington D.C., January 26, 1989, 2.

implementation of capital market regulatory liberalization greatly facilitated cross-border investment flows. This led to increased competition and greater innovation in the provision of financial services. These factors, coupled with improvements in global telecommunications and the growth in institutional investors with a global investment horizon, led to the integration of domestic and international financial markets.³⁵

It will be recalled from the earlier discussion that one of the major impediments to liberalization in the Canadian securities industry was rooted in the reluctance of regulatory authorities in Ontario to allow foreign firms to participate on an equal footing with Canadian owned firms in the domestic markets. Thus, from a public policy perspective, an interesting characteristic of the liberalization process in the financial services industries across the developed democracies, compared to that of the goods producing industries, is its slowness.³⁶ The contrast is interesting because the financial services industry has, for many years, been on the leading edge of the transfer and development of communications technology, has been able, with lightening speed, to develop and market financial instruments to accommodate virtually any commercial risk or opportunity that arises, and has been the engine of finance for the liberalized exchange of goods across fading international boundaries.

There are a number of reasons that can be cited for the relatively slow liberalization of the financial services industry -- but the most penetrating reason is that

³⁵ Securities and Exchange Commission, The Securities Markets in the 1980s: A Global Perspective, 2-3.

³⁶ Trade in (financial) services is very different from trade in more conventional goods. Meaningful liberalization must reflect movements in cross-border trade, trade based on commercial presence and direct investment. For example, in the case of manufacturing, goods can be produced in one country and marketed in another through independent sales representatives in the importing country or through an affiliate of the producer. In the case of (financial) services, however, the service has to be transported to the user in a way that typically requires the presence of the supplier in the importing country. Thus, it is not possible to conceive of free trade in financial services without extensive foreign direct investment. Liberalization of foreign direct investment has not followed a straight-forward path, especially in Canada, compared to the persistent easing of tariffs under the auspices of the GATT. For a discussion of the elements of a framework for trade in financial services see the Organization for Economic Cooperation and Development, Elements of A Conceptual Framework for Trade in Services (Paris: OECD, 1987) and Ingo Walter, Barriers to Trade in Banking and Financial Services, Thames Essays Number 41 (London: Trade Policy Research Center, 1985).

this component of the business sector is seen, with varying degrees of intensity, as a key industry.³⁷ Ingo Walter has identified a number of factors that can lead to a protectionist stance by the state under the guise of the "key" industry precepts: the need to ensure that proper financial control by the monetary authorities for purposes of macroeconomic stabilization would not be diluted by the arrival of foreign financial institutions; the need to ensure that the safety nets put in place to protect investors and/or depositors would not be jeopardized by the entry of offshore intermediaries; and finally, with respect to competition, the indigenous financial intermediaries may be judged unable to compete adequately with foreign competitors.³⁸ Effectively, the concern is that the capacity of the state, whether acting as an autonomous actor, or at the behest of an interest group, will be impaired to a degree that would not otherwise be the case.

On the other hand, Hindley and Smith counter Walter's argument by suggesting that it is in the power of the state to protect the "public interest"³⁹ first, by providing information to the users of financial services upon which they can rely for guidance when making financial/investment decisions. As long as the supervisory agency provides the appropriate information there is no justification for discriminating between foreign and domestic institutions. In any event, the host state can always deny operating privileges to those institutions which do not meet the minimum operating or prudential standard.⁴⁰

³⁷ The concept of the key sector utilized here is taken from the Canadian context of the early 1970s. That is, "These are industries that play a critical part in the functioning of the economy as a whole...They could include industries in such fields as transportation, communications, power and certain financial intermediaries. [A] key sector policy is one which emphasizes a certain degree of Canadian ownership and/or control of Canadian firms...Under the key sector approach, Canadian control' generally implies sufficient Canadian ownership of the shares of a company that the management effectively rests in Canadian hands, regardless of the percentage of shares that requires... [T]here are certain sectors of such intrinsic importance to the nation economically or socially -- or both -- that it is either essential or highly desirable that the firms within that sector be wholly or largely under Canadian control. Underlying this approach is a belief that certain objectives of the Canadian government and people cannot be fulfilled satisfactorily without the presence of Canadian controlled firms in certain sectors of the economy." Foreign Direct Investment in Canada (the Gray Report) (Ottawa: Information Canada, 1972), 496.

³⁸ Ingo Walter, Barriers to Trade in Banking and Financial Services, 13

In respect of competition, Hindley and Smith argue that the benefits of enhanced competition in the financial services industry exceed the costs. They point particularly to the United States' experience of relaxing membership requirements in the New York Stock Exchange, and liberalizing the broker commission determination process, which they claim had the effect of reducing monopoly profits to holders of stock exchange seats but did not result in the destructive competition that had been feared by those who had resisted such changes.⁴¹ More generally, the OECD noted in its study of obstacles to trade in the securities business that

The service sector is an area of critical importance to the economies of OECD Member countries and one where liberalization might readily contribute to the process of macroeconomic adjustment, the elimination of structural impediments to the free functioning of markets, and thus to an improvement in long-term economic performance.⁴²

These are representative of the technical/rational arguments often found in the social sciences, mainly in economics, but more recently in political science, for moderating the intrusiveness of the state. Economists traditionally view the consequences of state intrusiveness along an efficient - inefficient continuum. State regulation of prices, output, entry, rates of return, for example, inasmuch as it contributes to efficiency by

³⁹ Hindley and Smith do not define the term "public interest." There does not appear to be a consensus among political scientists regarding the understanding of the term "public interest." Moreover, given the antagonism that surrounds most public policy decision-making processes, political scientists would probably find it easier to agree that the public interest does not exist and it is easier to define individual or group interests. Nonetheless, public policy-makers use the concept to justify public policies and thus one is compelled to choose among the alternative definitions. Sandel suggests that the public interest can be seen from the perspective of either the utilitarian or a rights oriented concept. In the case of the former, it becomes simply the sum of individual preferences -- a calculus performed by interest groups or cost-benefit analysis. Economists, in discussing financial regulation would rely on the utilitarian view and argue that the public interest is defined by a Pareto efficient solution. In the case of the latter, there is a requirement for individual rights and basic entitlements.

See Michael J. Sandel, "The Political Theory of the Procedural Republic," in The Power of Public Ideas, ed. Robert B. Reich (Cambridge, MA., Ballinger Publishing Company, 1988), 2-3;

Brian Barry, "The Public Interest," in The Bias of Pluralism, ed. William E. Connolly (New York, Atherton Press, 1969);

Charles Lindblom, "Who Needs What Social Research for Policy Making," in Democracy and Market System, ed. Charles E. Lindblom (Oslo, Norwegian University Press, 1988).

counteracting the effects of market failures and/or negative externalities, is seen as desirable. If such actions by the state reduce efficiency they are judged to be undesirable.⁴³ An efficient allocation of resources is regarded by economists as a Pareto efficient one -- a state of affairs where no one can be made better off without making one other person worse off as a consequence of a reallocation of resources.⁴⁴ A Pareto efficient allocation of resources would be in the public interest according to the precepts of this reasoning.

However, we will want to look beyond this one-dimensional perspective for other explanations of public policy outputs in the domain of financial regulation -- particularly in respect of the investment dealer industry. Indeed, Eads suggested that the legitimacy of traditional economic regulation was undermined during the 1970s because

it showed itself incapable of dealing with rapid structural change -- change in the rate and direction of technological advance; change in individual factor prices, especially the prices of energy and capital; change in the general price level; and change in the growth rate of the economy.⁴⁵

Structural change, Eads argues, altered the issues that regulatory agencies had to deal with and the frequency with which issues had to be met.

⁴⁰ For example, the Canadian operations of the Bank of Credit and Commerce, 77 percent owned by the ruling family of Abu Dhabi, were shut down by Canadian federal regulatory authorities because of indications of fraud and corruption within the international banking group. See Brian Milner, "Bank Regulators lock BCCI Branches," *Globe and Mail*, 6 July 1991, B1.

⁴¹ Brian Hindley and Alasdair Smith, "Comparative Advantage and Trade in Services." Paper prepared for an International Conference convened by Wilton Park and the Trade Policy Research Centre on Restrictions on Transactions in the International Market for Services, London, 1984, 7.

⁴² OECD, *International Trade in Services: Securities*, 7.

⁴³ Roger G. Noll, "Government Regulatory Behavior," in *Regulatory Policy and the Social Sciences*, ed., Roger G. Noll (Berkeley: University of California Press, 1985), 11.

⁴⁴ Robin W. Boadway and David E. Wildasin, *Public Sector Economics* (Boston: Little, Brown & Company, 1984), 14-15.

⁴⁵ George C. Eads, "The Reform of Economic Regulation in Telecommunications and Transportation," paper prepared for a conference on The Impact of Regulatory Reform in Canada and the United States, May 20, 1982. From Martha Derthick and Paul J. Quirk, *The Politics of Deregulation* (Washington, DC: The Brookings Institution, 1985), 21.

rearranged winners and losers within regulatory coalitions, generated new potential entrants, and created customer dissatisfaction with the services being received from regulated industries.⁴⁶

The relative importance of a smoothly functioning financial system for the welfare of the capitalist state has caused public policy makers to be equally cautious in respect of decisions which influence the organization and ownership of both indigenous and, when entry is permitted, foreign entities comprising the financial system. Aside from issues associated with trade in financial services, the rhetoric of the regulatory and supervisory authorities, other public policy officials and academic economists,⁴⁷ has traditionally dealt with the risks of institutional contamination (contagion), perhaps as a result of self-dealing or conflicts of interest, in an environment where cross-ownership of financial institutions or multifunctional financial institutions are permitted.⁴⁸ Thus, financial regulation is seen as preventive rather than as remedial.⁴⁹

The Canadian Issue in a Global Context

Against the background of the internationalization of the economies of the industrialized democracies, Canadian financial markets, over the course of the decade ending in the mid-1980s, had been buffeted by a number of phenomena commonly characterized as globalization, securitization, bought deals, and integration. Globalization

⁴⁶ Martha Derthick and Paul J. Quirk, *The Politics of Deregulation*, 21.

⁴⁷ John Chant, "Regulation of Financial Institutions -- A Functional Analysis," (Ottawa: Bank of Canada Technical Reports Number 45, January 1987), 76-80; Charles Freedman, "Comments," in *Canadian Financial Institutions: Changing the Regulatory Environment*, ed. Jacob Ziege!, Leonard Waverman, and David Conklin (Toronto: Ontario Economic Council, 1985), 89-92; Economic Council of Canada, *A Framework for Financial Regulation* (Ottawa: Canadian Government Publishing Centre, Supply and Services Canada, 1987), 57-61.

⁴⁸ Institutional contamination can result from such activities as conflicts of interest ("a situation in which the interests of one person and the interests of someone else {including a financial institution} acting on behalf of that person are at variance"), from non-arm's-length financial transactions (between two institutions associated through ownership link or between an institution and its owners, directors or managers), and from self-dealing ("a situation that occurs when a conflict of interest results in harmful non-arm's-length transactions for the sole advantage of the person or institution making the decisions"). These definitions were taken from the Economic Council of Canada, *Completion and Solvency* 121-123

⁴⁹ John Chant, "Regulation of Financial Institutions -- A Functional Analysis," 2.

refers to the internationalization of financial markets as a consequence of technological innovation that permits 24-hour securities trading around the world; securitization is the descriptor for the practice of repackaging of commercial bank loans in such a way that they can be resold on the capital market to investors (individuals and institutions) as securities such as bonds or commercial paper but collateralized by the original indebtedness of the borrower -- an activity which impinges on the work of the investment dealer industry; a "bought deal" describes the process where a single investment dealer buys outright the securities offering of a borrower without using the traditional dealer syndicate to sell the securities on a best efforts basis -- an activity which impinges on the work of commercial banks;⁵⁰ and integration refers to the overlapping functions of and services offered by the key financial institutions such as banks, investment dealers, trust and mortgage loan companies, insurance companies, etc. In Canada, the latter development has often been referred to as the blurring of the "four pillars".⁵¹ As well, the development of the "euro" bond and money markets -- located largely in London -- gave rise to the establishment of foreign entities in that market which provided financial services which domestic authorities in many countries, including Canada and the US, would not permit. Thus foreign subsidiaries of domestic institutions were competing for business with their parents and with other indigenous institutions.

These developments gave rise to important changes in public policy objectives and outputs (decisions) with respect to the regulation and supervision of the financial industry, not only in Canada, but also in the UK, in most of the continental European countries and in Australia and in the US.⁵² The policy outputs, generally characterized as liberalization or deregulation, have typically had a number of observable effects as well as more opaque

⁵⁰ The risks associated with a bought deal are very much greater for the individual dealer than the risk associated with a syndicate offering where a number of dealers share in the liability. As a consequence the capital requirements for a bought deal are also greater than for a traditional deal.

⁵¹ The four pillars of Canada's financial sector revolve around the four types of institutions noted earlier. The blurring of the four pillars describes the phenomena of the activities of one type of institution impinging on those of another. For example, investment dealers were paying interest on their client credit balances -- an activity which competed directly with the deposits of the chartered banks; groups of banks on the other hand were engaged in making syndicated loans -- which because of their unusually large size could not be prudently managed by one institution. Syndicated loans competed directly with securities issues which were managed by the investment dealers.

ones. The more observable and economically rational effects envisaged were: enhanced competition among a set of financial or market intermediaries across a broad range of services, more liquid and efficient financial markets and more favorable transactions terms for the users of financial services and of course global trading which served to integrate the formerly more independent national financial markets.

The politically rational factors, which typically lingered in the background of such decisions and were thus more opaque than the aforementioned effects, were as important in driving public policy decision-making as those that were more prominent on the public agenda. In this regard, for example, one can hypothesize that elected and appointed officials supplied public policies that would preserve the importance of the economic stimulus (i.e., direct employment and associated income, potential technological development and associated research expenditures, fixed investment in real estate, etc.) primarily attributable to local financial market activity (e.g., London in the UK, New York in the US, Toronto and Montreal in Canada). That is to say, supplying public policies that would preserve a vibrant financial community would surely not impinge negatively on the careers, influence, and power of appointed and elected officials.⁵³ At worst, such policies could be seen as sustaining the status quo and would have a neutral effect on the careers of these policy-makers. One would also want to consider the possibility that the self-regulatory agencies, which supervised the investment dealers' activities in both the formal exchanges and in the over-the-counter markets, acted on behalf of those interests they were supervising rather than in the public interest.⁵⁴ Furthermore, in the face of rising public sector deficits -- at both the federal and provincial levels -- it was in the interests of

⁵² Bank for International Settlements, Changes in the Organization and Regulation of Capital Markets (Basle: BIS, March 1987), ix-xiv.

⁵³ A good discussion of political rationality and choice of governing instrument is contained in M.J. Trebilcock, R.S. Prichard, D.G. Hartle, and D.N. Dewees, The Choice of Governing Instrument: A Study Prepared for the Economic Council of Canada (Ottawa: Minister of Supply and Services Canada, 1982) Chapter 3.

⁵⁴ This idea was first raised by George J. Stigler, "The Theory of Economic Regulation," in Chicago Studies in Political Economy, ed. George J. Stigler (Chicago: University of Chicago Press, 1988). The issue has since been elaborated upon by many scholars in the public choice paradigm and is an important component of Mitnick's typology in The Political Economy of Regulation: Creating, Designing, and Removing Regulatory Reforms (New York: Columbia University Press, 1980).

the state to ensure that the indigenous financial apparatus would be able to provide the advice and practical support to finance rising financial requirements. Indeed, these new activities in the securities industry, just noted, brought about by the enhanced competition globally, raised questions regarding the financial capacity of the industry to carry on in this new environment without augmenting its resources.

Conclusion

This chapter was designed to set the stage for the subsequent analysis of the liberalization of the regulatory framework surrounding the Canadian investment dealer industry. The survey demonstrates that there were many crosscurrents which had an influence on both the original protection accorded the investment banking industry in Canada and its subsequent liberalization. The matrix of governments, institutions and interests, both domestically and off shore, which would influence the character of public policy respecting the securities industry create a very complicated drama indeed.

At one level, the erosion of the four pillar structure in Canada would reflect the exogenous influence of the globalization of the world economy. The regulatory response of the state to these developments reflected the melange of interests that typically emerge within the context of competitive federalism in Canada but with the additional obstacle of having to account for the interests of a wealthy, powerful and influential securities industry elite whose preferred status was to be eroded. At a second level, the resolution of this clash of interests will be instructive because the traditional explanations for the new equilibrium have already been called into question -- not only in Canada but in the US as well. At a third level, the financial capacity of the industry to meet indigenous requirements had to be addressed, in one way or another, by public policy decision-makers.

CHAPTER TWO

ECONOMIC REGULATION: THE SIGNIFICANCE OF INTERESTS

Introduction

It was noted in the introduction to the dissertation that it is intended that this project augment the traditional explanations of the supply of financial regulation by the state. To that end, the intellectual journey requires that we first consider the question: "why financial regulation?" The traditional theory, it will be recalled, relies on the economists' explanation, which ultimately boils down to a matter of interests. From the perspective of this work we are inclined to ask: "whose interests?" In general, "mainstream" economics typically infers that it is the public's interest which is in question.

It is not our intention to discard the ideas that some conception of the "public interest" is important, but it is necessary to draw attention to the fact that in matters related to the supply of public policy, in a non-crisis environment, it is very helpful to identify and/or narrow-in on the interests that will be the beneficiaries or the casualties of regulatory actions by the state. Therefore, when one comes to understand the policy process, consideration of particularistic interests will be as important, if not perhaps more important, than the public interest.

Thus, the purpose of this chapter is to examine the first stream of literature -- dealing with interests and interest groups -- which provides guidance to this project. This will be undertaken from the perspective of two academic disciplines: one dominated by political scientists and the other by economists. It will be shown that the traditional pluralists themselves, questioned the existence of the "public interest" construct. Similarly, in welfare economics, the aggregate utility or social welfare function -- and the

concepts of Pareto optimality and Pareto superiority -- have served as a useful analytical tool, but only when used in a normative fashion for benchmarking public policy outputs.

One is then left with a residual form of interests from both of these social sciences -- particularistic interests including those of the groups being regulated as well as those of the regulators and elected officials themselves. This chapter emphasizes the usefulness of thinking about the Stiglerian view as an powerful explanatory force for economic regulation. Moreover, this view is the genesis of the perspective that the dissertation brings to the understanding of the supply of financial regulation in Canada.

Economists vs. Political Scientists on Regulation

The discussion in Chapter One anticipates a world that was to be influenced by the profound changes in public philosophy regarding the regulation of financial institutions which has been witnessed over the past fifteen years. It also anticipates the influence of the general questioning by academics as to why a particular business activity should be organized this way or that way, or why the government should be involved at all in regulating economic activity that may better be sorted out through market forces directly. That latter idea is important in the context of the securities industry because the character of the regulatory policy supplied by the state confers a benefit (cost) on the industry whose costs (benefits) are borne by the general public.

This brings us to a discussion of the alternative theories of economic regulation. These theories influence the character of analysis of and motivation for financial sector regulation. There is a certain tension within the economics and political science disciplines regarding the rationale for regulation of private sector activity by the state. Specifically, it will be useful to begin this review of the theories of regulation by separating those which have largely informed political scientists and those which have conditioned the thinking of economists.¹ There is naturally some overlap between the two conceptions.

¹ Richard Posner makes the distinction between theories that have their roots in economics and political science. "Theories of Economic Regulation," Bell Journal of Economics and Management Science, Autumn 1974.

First, we speak of theory as a set of "systematically related generalizations...and principles associated with the practice of a field of enquiry."² According to Mitnick, "A full theory of regulation must...explain how regulation is proposed, formally considered and approved, put into effect, administered, has impact, is evaluated, and is altered."³ Thus, theory must provide the grounds for making predictions about the actions of the actors involved in the policy setting process. In this same vein Noll characterizes a utilitarian theory of regulation as one which supplies, among other things:

empirically verifiable propositions on the relationships among structure, responsibility, powers, and performance of a regulatory agency... and propositions about how private organizations influence policy design...⁴

However, it is not apparent that this "ideal type" theory as it applies to regulation has been realized. Nonetheless, it is not the purpose of this project to develop a theory of regulation, and the absence of a generally accepted theory will not impede this analysis. The objective is to apply the "received theory" to explain the observed evolution of the regulatory environment -- entry, ownership, pricing, service levels -- surrounding the investment dealer industry in Canada.

Traditionally when economists talk about economic regulation they are referring to efficiency in the allocation of resources. With the exception of a market failure (for example, the existence of a natural monopoly or a positive or negative externality in a production process which is reflected in private benefits or costs but not in public ones, or a situation of incomplete information), it is assumed that the market allocation of resources is efficient. That is to say, in the absence of a market failure "the Invisible Hand Theorem asserts that a market allocation will automatically be efficient"⁵ -- and hence by

² Ronald H. Chilcote, Theories of Comparative Politics: The Search for a Paradigm (Boulder: West View Press, 1981), 15.

³ Barry M. Mitnick, The Political Economy of Regulation, 80.

⁴ Roger G. Noll, "Government Regulatory Behavior," 15.

⁵ Nicholas Barr, The Economics of the Welfare State (London: Weidenfeld & Nicolson Ltd., 1987), 80. Essentially the same point is made in Roger Noll, "Introduction," and "Government Regulatory Behavior," in Regulatory Policy and the Social Sciences, ed., Roger G. Noll.

definition in the public interest.

Among political scientists, however, it is not unusual to view economic regulation as directed to objectives that are primarily unrelated to considerations of economic efficiency. Indeed, economic regulation can be directed at considerations of market power, income distribution and, indeed, restriction of competition.⁶ Public choice theory attempts to fuse these two conceptions.

...an analysis of a limited number of actual forms of [regulatory] intervention indicate that eliminating market failures does not appear to be the sole or even primary motivation. Studies of the total effect on economic efficiency of various regulatory regimes indicate that social welfare is reduced not increased in many cases. If regulation is intended to eliminate market failures and increase economic efficiency, how can this be allowed to happen?⁷

This is a constantly recurring question, and at times a latent question, that permeates this project.

Noll suggests that economists have been most influential in the social sciences with respect to research on regulatory policy. This, in part, reflects what Hartle suggests is the "proven efficacy"⁸ such that public policy problems are formulated in a way which optimizes the use of the economists' methodology. Political scientists, on the other hand, deal with a "gaming problem that is not solvable 'analytically,' particularly because of the multiplicity of probabilistic relationships concerning both information flows and competitive reactions."⁹ Cynically, but with truth, Hartle notes that political science

⁶ Richard Schultz, Federalism and the Regulatory Process (Montreal: Institute for Research on Public Policy, 1979), 10-11.

⁷ M.J. Trebilcock, L. Waverman and R.S. Prichard, "Markets for Regulation: Implication For Performance Standards and Institutional Design," in Government Regulation: Issues and Alternatives (Toronto: Ontario Economic Council, 1978), 28.

⁸ Douglas G. Hartle, Public Policy Decision Making (Toronto: Institute on Research on Public Policy, 1978), 24.

⁹ Douglas G. Hartle, Public Policy Decision Making, 25.

describes behavioral responses while economic science assumes them! Thus the economists' theory is questionable.¹⁰

Hartle, however, failed to pass judgement specifically on the pluralist notion of state-society relations. This "theory" suggested that the state, acting as a neutral arbiter, would ensure that the equilibrium policy outcome was in fact an efficacious one. This theory also endures a credibility¹¹ gap and consequently the cynicism and/or skepticism that has infiltrated the relevant social science literature is also latent throughout the analysis in this dissertation.

Political science has for the most part crystallized the *public interest* and *capture* theories to explain the supply of regulatory policy, while economic science has derived the *bureaucratic* and *self-interest seeking/utility maximizing* theories. More recently, political scientists, especially those in the US have been drawing upon the methods and tools of economists. We will deal first with the views of regulation which are derived from political scientists, and then turn to economic science.

Political Scientists: Interests and Economic Regulation

It was noted in Chapter One that there is no generally accepted view within political science regarding the existence of the "public interest." However, the concept does have meaning when seen from the perspective of group/private interests.

Public interest theories assume that the state has a role to play in protecting participants in the "market" from the "ill-effects" of the market itself.¹² From this basic assumption, the supply of economic regulation -- in general -- is perceived as in the public interest and the state becomes the underwriter of risk. The basic problem with this perspective is that the state is seen as responding to special interests. Indeed, Parenti suggests that the business class is the ruling class¹³ -- business interests are seen as the

¹⁰ Douglas G. Hartle, *Public Policy Decision Making*, 25.

¹¹ Christopher Ham and Michael Hill, *The Policy Process in the Modern Capitalist State* (London: Wheatsheaf Books, 1986), Chapter 4.

¹² Richard Posner, "Theories of Economic Regulation," 335.

public interest. In this same fashion Domhoff suggests that "ruling class domination of government can be seen most directly in the workings of lobbyists, backroom superlawyers, trade associations and advisory committees to governmental departments and agencies."¹⁴ This idea of the socialization of capitalism¹⁵ saturates the earlier influential pluralist literature of Herring, Bentley and Truman, in their theorizing about the concept of the public interest.

Herring, in his analysis of the relationship between the bureaucracy and special interest groups, concludes that

The public interest is the standard that guides the administrator in executing the law...To hold out the *public interest* as a criterion is to offer an imponderable. Its value is psychological and does not extend beyond the significance that each responsible civil servant must find in the phrase for himself. Acting in accordance with this subjective conception and bounded by his statutory competence, the bureaucrat selects from the special interests before him a combination to which he gives official sanction. Thus inescapably in practice the concept of the public interest is given substance by its identification with the interests of certain groups.¹⁶

Bentley was unequivocal in his understanding of the term "interest." He viewed the concepts of group and interest as interchangeable. That was to say "There is no group without its interest."¹⁷ Given this group perspective, the public interest did not exist for Bentley.

We shall never find a group interest of the society as a whole. We shall always find that the political interests and activities of any given group -- and there are no political phenomena except group phenomena -- are directed against other activities of men, who appear in other groups,

¹³ Michael Parenti, Power and the Powerless (New York: St. Martin's Press, 1974), 189.

¹⁴ G. William Domhoff, The Powers That Be (New York: Vantage Books, 1979), 25.

¹⁵ Michael Parenti, Power and the Powerless, 191.

¹⁶ E. Pendleton Herring, Public Administration and the Public Interest, (New York: McGraw-Hill Book Company, 1936), 23-24.

¹⁷ Arthur Bentley, The Process of Government (Evanston: Principia Press, 1949), 211.

political or other...The society itself is nothing other than the complex of the groups that compose it.¹⁸

Truman's conception of the public interest mirrors that of Herring and Bentley -- a "totally inclusive interest... does not exist,"¹⁹ save perhaps during periods of national crisis such a war, but in general the term does not relate to any "actual or possible situation"²⁰ in a democratic society.

Noll accepts the generalities of the scholarly literature with respect to the conundrum of identifying the public interest, but suggests an alternative source of information for gauging the public interest: the external-signal theory. The focus of this theory is the regulatory agency itself. The agency judges the public interest from the responses of other state and private institutions to its policy outputs. These institutions vary from the courts, to the legislature, to constituents, and the executive.²¹ The lower the decibel meter²² readings -- absence of negative feedback -- from these institutions, the more likely is the regulatory agency to conclude that it is acting in the public interest. Of course, one could just as easily conclude that the agency is being very effective in concealing the narrower interests at work.

A Canadian characterization of the public interest can be deduced from Presthus' research on the domestic policy process which he saw rooted in a prototype corporatist political apparatus "in which government delegates many of its functions to private groups, which in turn provide guidance regarding the social and economic legislation

¹⁸ Arthur Bentley, The Process of Government, 222.

¹⁹ David B. Truman, The Governmental Process: Political Interests and Public Opinion (New York: Alfred A. Knopf, 1964), 51.

²⁰ David B. Truman, The Governmental Process, 51.

²¹ Roger G. Noll, "Government Regulatory Behavior," 41-43.

²² Terry M. Moe, "The New Economics of Organization," American Journal of Political Science, November 1984, 767.

required of the modern national state."²³ As was the case with the American pluralist school, the public interest is, in reality, the group interest.

Another Canadian perspective, that of Hodgetts, suggests that the role of interest groups is to persuade the state that its interests are in the public interest. The state for Hodgetts comprises both elected and appointed officials, of which the former are the more influential in defining the public interest. Thus

For practical purposes and especially in pluralistic democratic community we are left...not with a public interest but with any number of interests pursued by many publics. One's perception of how responsive governments are to the so-called public interest will greatly depend on how well one's own interests have been accommodated by government programs.²⁴

The rationale for regulation from this perspective represents the attempt to protect the wider interests in a democratic society from the particularistic interests manifest in the demands of special interest groups. The reasoning behind this argument is that groups are perceived to represent the public interest -- but in reality the groups are acting in their own self-interest and therefore there is a need to insulate the unregulated and/or unprotected from the vagaries of the powerful interests.

Power is therefore the issue for pluralists -- more specifically how to control it, if indeed it can be controlled. Bachrach suggests that when private corporations ("private governments according to Bachrach's terminology"²⁵) perform a public function, such as what Easton characterizes as authoritatively allocating values, then they must be "within the reach of the Constitution *and* democratic principles."²⁶ This can be interpreted as a

²³ Robert Presthus, Elite Accommodation in Canadian Politics (Toronto: Macmillan Canada, 1973), 25.

²⁴ J.E. Hodgetts, "Government responsiveness to the public interest: has progress been made?" Canadian Public Administration, Summer 1981, 219 -220.

²⁵ Peter Bachrach, The Theory of Democratic Elitism: A Critique (Boston: Little, Brown and Company, 1967), 103.

²⁶ Peter Bachrach, The Theory of Democratic Elitism, 103.

direct call for regulation of the private corporation. Moreover, to satisfy his conception of democratic principles, Bachrach would move further to the right along the Doern-Wilson instrument continuum²⁷ by prescribing nationalization as a way to ensure that private (oligarchic) corporations act in the public interest.²⁸

This argument, and that of pluralists more generally, is almost circular. That is to say, the theoretical justification for regulation is to protect the public interest on the one hand, but on the other hand private interests are equated with the public interest. Thus, private interests can seek the sponsorship of the state to support their own interests. This circularity contributes to the crippling of the pluralist/public interest arguments as an explanation of economic regulation -- but adds support to the hypothesis that it is indeed self-interest seeking behavior which motivates economic regulation.

In the context of the investment dealer industry, for example, the pluralist conception of the demand for public support of the industry, in the form of entry barriers and commission regulation, can be seen to be argued from the perspective of destructive competition, concentration of power, efficient capital markets, absence of foreign intervention -- all of which were categorized as being in the public interest. In reality, however, it will be shown that these demands had little to do with the public interest and more to with the industry's private interest rent-seeking objectives. The shortcoming of the pluralist explanation in part relates to the fact that it does not meet the criteria of good regulatory theory set out by Mitnick and noted earlier. In this context, Posner suggests

Theoretical revision has both stimulated and been reinforced by a growing body of case studies demonstrating that particular schemes of government regulation...cannot be explained on the ground that they increase wealth, or by any widely accepted standard of equity or fairness, the justice of society.²⁹

²⁷ G. Bruce Doern and V. Seymour Wilson, "Conclusions and Observations," in Issues in Canadian Public Policy, ed. G. Bruce Doern and V. Seymour Wilson (Toronto: Macmillan of Canada, 1974), 339.

²⁸ Peter Bachrach, The Theory of Democratic Elitism, 104-105.

²⁹ Richard Posner, "Theories of Economic Regulation," 336.

For Lowi, interest group liberalism (pluralism) undermines democratic precepts of governance. The apportioning of governing power to rent-seeking groups is essentially a conflict of interest which "is made a principle of government rather than a criminal offense..."³⁰ Moreover, interest group liberalism "creates and maintains privilege" and supports the status quo by resisting change.³¹

Meier is also critical of the public interest explanation of regulation.³² For him, the concept itself is rather slippery and the fact that private interests are cloaked in the public interest further reinforces the idea that predictions from this theory would be inaccurate if not impossible.

While the discussion of the public interest concept has so far concentrated on the political science view, it is not unnatural that economists would have something to say about it as well. For economists, a public policy is a welfare improvement for society if the winners from the policy change can theoretically compensate the losers and still be better off. However, the Scitovsky Paradox suggests that it would be possible, in some situations, for the reversal of the original policy also to have a welfare improving result.³³ From this perspective, the public interest continues to be elusive. Indeed, Arrow concluded that the preference ordering of individual social welfare functions was not possible to achieve in a democratic society. His conclusions of course are sensitive to the number of actors and number of issues.

Traditionally the securities industry has been satisfied to have its "freedom" of operating scope limited through state imposed restraints on competition among its members. More directly, for many years (until the mid-1980s) the industry appears to have co-opted the state's regulatory authorities into supplying distributive policies, in the form

³⁰ Theodore J. Lowi, The End of Liberalism: The Second Republic of the United States (New York: W.W. Norton & Company, 1979), 59.

³¹ Theodore J. Lowi, The End of Liberalism, 60.

³² Kenneth L. Meier, Regulation: Politics, Bureaucracy, and Economics (New York: St. Martin's Press, 1985), 9.

³³ Of course, at some point in time a policy reversal might not be an unusual outcome -- and an outcome which could be a welfare improvement.

of price controls and entry restrictions, which favored the industry. As a political process, we minimally witnessed an accommodation between the regulators and the regulated. This interaction resulted in a distributive policy outcome³⁴ which approached "a complete privatization of the public."³⁵ This process has been characterized by Presthus as "elite accommodation" and he assigned its practice an important role in policy formulation in Canada. The survival of this process is ensured "by a continuous interaction and mutual adjustment achieved through a highly institutionalized process of bargaining and compromise."³⁶ For Lindblom, "business simply needs inducements, hence a privileged position in government and politics, if it is to do its job."³⁷

Regulatory Capture

The qualitative judgements regarding the relationship between the state and the Canadian investment dealer industry, immediately preceding, brings us to the second discourse on the political science contribution to the debate surrounding economic regulation -- capture theory. The capture theory has been influential in the American literature on economic regulation; Kolko, Bernstein, Domhoff, Wilson, Barke and Riker and Stigler (an economist).³⁸ Simply put, the basic precept of the capture theory is that regulation will be supplied at the behest of the industry being regulated -- that is to say in the interests of the industry -- at the expense of society. Wilson has stated the concept quite precisely: "regulation will not succeed in constraining business firms to act in accordance with socially valuable objectives because the agencies that administer these regulation will be captured by or otherwise serve the affected industries."³⁹ Kolko debunked the

³⁴ G. Bruce Doern, "Introduction: The Regulatory Process in Canada," in The Regulatory Process in Canada, ed., G. Bruce Doern (Toronto: Macmillan Canada, 1978), 4; Barry M. Mitnick, The Political Economy of Regulation, 9.

³⁵ Theodore J. Lowi, "Four Systems of Policy, Politics, and Choice, Public Administration Review, July/August 1972, 300.

³⁶ Robert Presthus, Elite Accommodation in Canadian Politics, 72.

³⁷ Charles Lindblom, Politics and Markets: The World's Political-Economic Systems (New York: Basic Books, Publishers, 1977), 175.

³⁸ Stigler was of course writing from the economists perspective, but his influence on these matters cannot be ignored in this discussion.

traditional historians' assumption that railroad regulation in the US was contrary to the railroads' interests by suggesting that "the intervention of the federal government not only failed to damage the interests of the railroads, but was positively welcomed by them...Indeed, the railroads...were the most important single advocates of federal regulation"⁴⁰ in the latter part of the 18th and early 19th centuries. From Mitnick's perspective regulatory capture "is a theory of how regulators may acquire predispositions to add new regulation that serves the regulated interest, or to produce ongoing regulatory activities that serve the regulated interests rather than public interest ends."⁴¹

At a more practical level, Herring suggested that as soon as the state begins to intrude into the micro affairs of the private firm, "the greater must be their degree of consent and active participation in the very process of regulation, if regulation is to be effective or successful."⁴² In this regard (and an extreme example), pluralists explain the phenomenon of self-regulation as energized by the technical complexity of the matters being regulated. Lindblom explains that

Physicians in the United States enjoy privileges in policy making on health because government officials fear that their performance will be adversely affected if they do not.⁴³

Thus, from the capture theorist's perspective, regulation can only be successfully carried out by the group which itself is being regulated. Therefore, as intimated just above, the phenomenon of self-regulation delegates a good deal of power to the regulator -- which inevitably takes into account the interests of its constituency in carrying out the regulatory mandate.⁴⁴ Regulation which benefits industry can be observed in any of the

³⁹ James Q. Wilson, "The Politics of Regulation," in The Political Economy: Readings in the Politics and Economics of American Public Policy, ed. Thomas Ferguson and Joel Rogers (Armonk, NY: M.E. Sharpe, Inc., 1984), 96.

⁴⁰ Gabriel Kolko, Railroads and Regulation: 1877-1916 (Princeton: Princeton University Press, 1965), 3.

⁴¹ Barry M. Mitnick, The Political Economy of Regulation, 80.

⁴² E.P. Herring, Public Administration and the Public Interest, 192.

⁴³ Charles Lindblom, Politics and Markets, 176.

"governing instruments" but is typically manifest, for example, in entry restrictions, limitations on competitive pricing, and control of rates of return.

In Canada, the political science literature generally rejects capture theory as an explanation of the supply of regulatory policy. The rejection, in part stems from comparison of studies of the careers of bureaucrats in Canada and the United States. In the US literature⁴⁵ a heavy weight is applied to the "revolving door"⁴⁶ phenomenon -- the high degree of mobility of regulators between employment in the regulatory agency and the industry being regulated and/or in a firm of professionals representing the industry being regulated -- in drawing informed conclusions about regulatory capture. In Canada, it is generally accepted that the same variables do not substantiate the validity of the capture theory because of "the significant extent to which Canadian regulators are drawn from bureaucratic careers as opposed to industry."⁴⁷ Doern's observations are based on a study by Caroline Andrew and Rejean Pelletier who conclude that

the role of the civil service seems to be stronger than is suggested by the 'captivity' thesis. There are a greater number of regulators who had public-sector experience in areas closely related to the work of their regulatory agency than those with private-sector experience in areas as closely related.⁴⁸

Schultz is more equivocal about the supporting evidence for the applicability of the capture theory to the Canadian regulatory experience. However, to whatever evidence exists, Schultz would include other variables that could impact on the origins of the regulation that emerges in any substantive area (i.e., organizational and political

⁴⁴ See Paul Pross, Group Politics and Public Policy (Toronto: Oxford University Press, 1986), 94.

⁴⁵ See Barry M. Mitnick, The Political Economy of Regulation, 206-240, for an example of the analysis of the relationship between the careers of bureaucrats and the notion of regulatory capture.

⁴⁶ Barry M. Mitnick, The Political Economy of Regulation, 238.

⁴⁷ G. Bruce Doern, "Introduction: The Regulatory Process in Canada," 25

⁴⁸ Caroline Andrew and Rejean Pelletier, "The Regulators," in The Regulatory Process in Canada, ed., G. Bruce Doern, 162.

variables)⁴⁹, because like other theories in political science (e.g., functional and culture based theories), capture theory can appear to explain everything.

In the context of decision-theory, however, we will want to discover why the investment dealers were able to capture the regulators through the mid-1980s. It was around this time that the policy outputs of the regulators took a decided shift -- not only in Canada but also abroad.

For purposes of this analysis, the proposition of regulatory capture cannot be dismissed as easily when applied to the investment dealer industry -- both in the Canadian context and in a comparative perspective. The evidence for capture, however, does not have to rely solely on the "revolving door" speculation. Indeed, a typology introduced by Mitnick, which he characterizes as a "partial theory,"⁵⁰ *based on information*, can also help identify the presence of regulatory capture. Thus, *the control of the particularistic knowledge possessed by the regulated firms, the complexity of the knowledge*, coupled with the rent-seeking behavior of the constituents of the industry sets the stage for the regulator "to make decisions and take actions consistent with industry preferences. And these predispositions are associated with actions that favor the industry, i.e., 'capture'."⁵¹ The state, in carrying out its functional responsibilities, requires the advice of the objects of its policy. This is an important anchor for the explanation of capture of the regulator by the securities industry in respect of the rules surrounding entry and ownership.

Looking at capture from the perspective of Bernstein's life cycle hypothesis⁵² does not provide a solid foundation from which one can employ the capture theory in the Canadian or international securities industry. Indeed, it seems more appropriate to turn the life cycle on its head in respect of this industry. That is, the analytic model around which

⁴⁹ Richard Schultz, "Regulatory Agencies," in Canadian Politics in the 1980s (Second Edition), ed. Michael Whittington and Glen Williams (Toronto: Methuen, 1984), 435-437.

⁵⁰ Barry M. Mitnick, The Political Economy of Regulation, 202-214.

⁵¹ Barry M. Mitnick, The Political Economy of Regulation, 213.

⁵² Marver Bernstein, Regulating Business by Independent Commission (Princeton: Princeton University Press, 1955), Chapter 3.

the analysis of entry and ownership regulation in the securities business is constructed, suggests that right at the outset, the regulatory agencies involved were captured by the industry's interests and thus the principal function of the agencies involved was "maintenance of the *status quo* in the regulated industry and its own position as recognized protector of the industry."⁵³ This phenomenon is characterized as Phase IV⁵⁴ of Bernstein's life cycle hypothesis -- the final stage -- debility and decline. In the circumstances of the investment dealer industry, preservation of the status quo occurs at the outset of the regulatory cycle. In the second phase⁵⁵ of its life, the agency, according to Bernstein's theory, is aggressive in its attempt to promote the public interest. This setting for the securities industry occurs virtually at the end of the cycle, when the regulatory agencies become aggressive in eliminating entry and pricing restrictions on the industry. Agitation for changing the restrictions surrounding the industry occurs in the phases leading up to deregulation -- where change is not optimal but incremental or satisficing. The fundamental change occurs when the role of the state, in influencing the structure of the securities industry (and the financial system more generally), is minimized. The stylized regulatory life cycle as it is observed in the securities industry is depicted in the following Table.

⁵³ Marver Bernstein, Regulating Business by Independent Commission, 92.

⁵⁴ Marver Bernstein, Regulating Business by Independent Commission, 91-95.

⁵⁵ Marver Bernstein, Regulating Business by Independent Commission, 79-84.

Table One
The Life Cycle Hypothesis and the Securities Industry

<u>Cycle Phase</u>	<u>Bernstein</u>	<u>Securities Industry</u>
Phase I	Gestation	Serve Industry
Phase II	Youth	Analyze Regulations
Phase III	Maturity	Confidence to Change
Phase IV	Decline	Deregulate

In short, it is asserted that in Canada, the securities industry captured the regulatory elites long before the regulatory agencies had matured and before Bernstein's life-cycle model would have predicted the occurrence of agency capture.

Barke and Riker⁵⁶ attempt to both discredit and reformulate the theory of regulatory capture. Their critique occurs at two levels: the first questions the degree of concurrence between the actions of the bureaucrats and the intentions of legislators; and the second reflects on the answers to a series of questions which imply that if regulatory capture was a valid/empirically observable phenomenon, then regulated firms would be better off (financially) than actually measured and/or would have the power to prevent the end of regulation and/or deregulation.⁵⁷

More telling, however, is their analysis which suggests that a theory of public sector decision-making, in the field of economic regulation, must account for the inconsistency between goals and policy -- the incongruity which they had observed in Interstate Commerce Commission (ICC) decisions on railway abandonments. This contradiction was manifest in a variation in the class of winners and losers (between shippers, carriers and communities) which arose in the decisions of the ICC. The problem

⁵⁶ Richard P. Barke and William H. Riker, "A Political Theory of Regulation With Some Observations on Railway Abandonments," *Public Choice* 39, Number 1, 1982.

⁵⁷ Richard P. Barke and William H. Riker, "A Political Theory of Regulation With Some Observations on Railway Abandonments," 74-79.

with capture theory, according to Barke and Riker is that it is always and everywhere consistent. That is to say, the theory predicts (as already noted earlier) that the special interests are always winners -- at the expense of the public interest -- however defined.⁵⁸

Barke and Riker also suggest that regulatory capture fails to explain how it is that legislators pass the laws while administrators are the ones captured. Capture theory, they (and others) claim, stumbles when it comes to explain the differences in the patterns of actions of the two groups of actors -- mainly because they view regulatory policies as benefitting minority interests, which in turn have to generate majority support. Barke and Riker explain the ability of legislators to satisfy this canon via the logrolling mechanism. This mechanism is not available to the bureaucrats in regulatory agencies because they have nothing to trade except regulatory policy -- which would be of little interest to other "policy-making bureaucrats" in unrelated policy areas. The logrolling process can result in an inconsistency in policy supply.⁵⁹

The inconsistency in policy supply can in part be explained by the serial method of constructing a regulatory system. That is to say, demands for policy supply to correct a market failure or some perceived injustice in turn creates an injustice and generates a demand for policy (regulations) to correct it -- and so on. These short run changes, according to Barke and Riker, can fool the analyst into accepting the capture theory -- when it really is only the first step in a process.⁶⁰

The Barke and Riker critique of regulatory capture accentuates the difficulty of developing a rigorous theory of economic regulation more generally. Indeed, the history of theory in the field of economic regulation, despite the requirements enunciated by Mitnick and Noll, seems to be more properly characterized as an ex post narration of state -societal relations, with the patterns of state coercion forming the essence of the "theory."

⁵⁸ Richard P. Barke and William H. Riker, "A Political Theory of Regulation With Some Observations on Railway Abandonments," 83-96.

⁵⁹ Richard P. Barke and William H. Riker, "A Political Theory of Regulation With Some Observations on Railway Abandonments," 97-101.

⁶⁰ Richard P. Barke and William H. Riker, "A Political Theory of Regulation With Some Observations on Railway Abandonments," 102.

Moreover, a good deal of the "theory" of economic regulation is industry specific -- which partly undermines the relevance of the deductive process as theory.

Barke and Riker's critique is helpful in a second way, as well. It underscores the idea that economic regulation is a process that occurs over time -- thus reinforcing the basic underpinnings of the life cycle hypothesis developed by Bernstein. This conceptualization of the regulatory process is also of benefit for the case study in this dissertation because financial sector regulation is process which occurs not only over time but over space as well.

Economists: Interests and Economic Regulation

Economists have traditionally looked at the causes of regulation as rooted in market failure. That is to say, in this "old" theory, the inability of the private market to deal on its own with the consequences of monopoly, for example, gave rise to state intervention on behalf of the public interest. Beginning with the work of Stigler⁶¹ (the "new" theory⁶²), the economic theory of regulation developed into a doctrine of self-interest seeking behavior (utility maximization) in respect of all of the actors participating in the process -- the firms subject to regulation, the elected officials which enact the regulatory legislation and the bureaucrats (in agencies, commissions or departments) which "implement" the wishes of politicians. Indeed, it is frequently difficult to disentangle the precepts of the capture theory fathered by political scientists and the self-interest seeking behavior of commissioners and bureaucrats which has influenced the thinking of economists over the past two decades. Stigler's pioneering approach to the study of economic regulation gave rise to embellishments rooted in the reassessments and critiques⁶³ by Peltzman⁶⁴.

⁶¹ George J. Stigler, "The Economic Theory of Regulation," in The Citizen and the State: Essays on Regulation, ed., George J. Stigler (Chicago: University of Chicago Press, 1975).

⁶² I first ran across this terminology in Martin Neil Bailly, "Summary of the Papers," in Brookings Papers on Economic Activity: Microeconomics (Washington, D.C.: Brookings Institutions, 1989).

⁶³ Surprisingly there seems to be a consensus regarding the major influential contribution to the new theory. See Sam Peltzman, "The Economic Theory of Regulation after a Decade," in Brookings Papers on Economic Activity: Microeconomics and Donald G. McFetridge and Ashish Lal, "Is There a Theory of Deregulation?" in Breaking the Shackles: Deregulating Canadian Industry, ed. Walter Block and George Lerner (Vancouver, B.C., The Fraser Institute, 1991).

Posner⁶⁵, Becker⁶⁶, and other scholars writing from the perspective of the public choice school.

At the general level, Stigler is responsible for developing a theory of economic regulation which predicts that special or particularistic interests will use their economic and political influence to obtain policy supply from the state which will serve their interests. Particularistic interests, defined here as groups which are well organized and "suitably" financed, are able to buy the desired policies from elected officials with political and/or economic resources⁶⁷ -- using votes and money -- as the means of payment. The policy-making actors try to ensure that this means of payment persists as a store of value by continuously supplying policies which maintain the support of those subject to the regulations in question. The state is able to do this because of its monopoly on coercive power.⁶⁸

Because of the state's power to coerce, industries will seek favors in the form of: (i) direct subsidies of money, (ii) control over entry by new rivals, (iii) control over substitutes and complements, and (iv) price-fixing.⁶⁹ It will be shown, that these fundamental tenets of Stigler's theory -- were useful predictors of the behavior of the investment banking industry. However, in this model, as was the case in the Barke and Riker analysis, the direct linkages between the elected officials and the regulated industry are not clear -- because of the intermediation of regulatory commissions -- and thus must be deduced. We will train light on this opacity when we examine the patterns of regulation in Canada (and the US and UK).

⁶⁴ Sam Peltzman, "Toward a More General Theory of Regulation," in Chicago Studies in Political Economy, ed. George J. Stigler.

⁶⁵ Richard Posner, "Theories of Economic Regulation."

⁶⁶ Gary Becker, "Public Policies, Pressure Groups and Dead Weight Costs," in Chicago Studies in Political Economy, ed. George J. Stigler.

⁶⁷ Stigler, "The Economic Theory of Regulation," 126.

⁶⁸ Stigler, "The Economic Theory of Regulation," 116.

⁶⁹ Stigler, "The Economic Theory of Regulation," 116-118.

Indeed, one of the weaknesses of Stigler's theory is that he does not address directly the linkages between the environment, the politicians, and the bureaucrats -- the functionaries who administer the regulations. Thus like Easton's "Black Box"⁷⁰ one cannot be sure of the dynamics within the "regulatory system" between inputs, demands and supports on the one hand and decisions, actions and outputs on the other.⁷¹ It is this superficiality which sometimes generates frequent skepticism, by political scientists, of public choice explanations of public policy supply.

Peltzman's embellishment of the Stiglerian model is based on the notion "that the costs of using the political process limit not only the size of the dominant group but also their gains."⁷² Thus for Peltzman, the same incentives for the regulator to supply regulation enunciated by Stigler are accepted; however, there are diminishing returns to the regulated industry which ultimately results in the demise of the regulatory regime. For the politicians, they will supply policies to groups as long as the marginal benefit (in terms of votes or some other store of value) exceed the costs. That is to say, as the wealth transfer to the regulated industry from "other groups" increases, it is in the interests of the "other groups" to determine the costs to them of the regulation and ultimately to lobby politicians to alter the regulations and thus to reverse or eliminate the wealth transfer (i.e., deregulation in the extreme). These other groups will expend resources to both inform themselves about and oppose the regulatory regime to the extent that the benefits of this activity will exceed the costs. Albert Breton characterizes this process a utilitarian fashion:

If a tax burden -- whose value is subjectively determined in relation to the value of the public benefits received -- is deemed unfair, a citizen will feel coerced and because of this will be motivated to participate in the political process. Alternatively, if a tax burden is seen to be fair, coercion will not exist, and as a result a citizen will not engage in political action unless he

⁷⁰ Mitnick made reference to the missing dynamic as the "black box." See Barry Mitnick, The Political Economy of Regulation 115.

⁷¹ See David Easton, A Systems Analysis of Political Life (Chicago: The University of Chicago Press, 1979), 32.

⁷² Sam Peltzman, "Toward a More General Theory of Regulation," 237.

expects the activities of other citizens to be successful and to result ultimately in a situation of coercion.⁷³

The bottom line in Peltzman's analysis is that the costs of both obtaining information and organizing opposition to the policy supply by those bearing the cost of regulation (i.e., the wealth transfer alluded to above) determines how long the regulatory burden will persist. This determination is somewhat more transparent than the "Black Box" of the pure Stiglerian formulation.

Becker picked up on this idea. For him the benefits and costs of regulation (public policy more generally) are a function of the pressure exerted by the various interest groups affected by the policy. The more efficient the group is in exerting pressure the greater the wealth transfer at the expense of the less efficient groups. Interest group efficiency depends on the organizational capacity of the group to supply resources to politicians. Becker's principal contribution in this regard was that the greater the social costs of the regulation the more likely the pressure will mount to reduce or eliminate them.

Dead weight costs of regulations and other policies often rise over time as labor and capital become more mobile, as substitutes develop for products that have been made more expensive, and other costly methods of evading and avoiding the effects of particular regulations are discovered. For example, the dead weight cost of regulating security transactions rose significantly as institutional investors with elastic demands became important,...the cost of banking regulations grew as interest rates became higher and more variable and new methods of intermediation were invented.⁷⁴

The "compensation principle" from welfare economics is an important part of Becker's analysis⁷⁵. That is to say, if the gains from the regulatory policy are greater than the costs, *and the gainers could compensate the losers*, the gainers would be likely to exert

⁷³ Albert Breton, The Economic Theory of Representative Government (Chicago: Aldine Publishing Company, 1974), 72.

⁷⁴ Gary Becker, "Public Policies, Pressure Groups and Dead Weight Costs," 97.

⁷⁵ Gary Becker, "Public Policies, Pressure Groups and Dead Weight Costs," 101.

more political pressure than the losers, and the policy would likely be implemented. If the gainers were unable to compensate the losers, the policy would not be implemented unless of course the gainers had undue influence on politicians.⁷⁶

Trebilcock, Hartle, Prichard and Dewees use the marginal calculus embedded in the compensation principle to draw out a number of axioms in respect of instrument choice for distributive/redistributive policies which is an important precept in the public choice literature. They assert that the state will supply policies to marginal voters and allocate the costs to inframarginal voters. The marginal voters typically will be the influential, well financed, and well informed interest groups, while the inframarginal voters will be widely dispersed, unorganized and ill-informed.⁷⁷

Doern and Phidd⁷⁸ are critical of this marginal calculus largely because they are of the view that instrument choice (and consequently policy supply) "are not matters of technical efficiency" but questions of the legitimate use of coercion.⁷⁹ In either case, it can be reasonably assumed that policy-makers have an objective function (a goal) and they will use the instruments available to achieve the objective. Thus, in both interpretations we are dealing with "politically efficient" policy decisions -- if the controversy over technical efficiency is not resolved. It will be seen that the regulation of the securities industries, globally, in the first instance reflected politically efficient decisions. Any economic/technical efficiency gains which may have occurred as a consequence of the liberalization period can be categorized as an externality resulting from a politically efficient decision.

Posner also builds on Stigler's theoretical framework by explicitly exploiting the laws of supply and demand, to determine the allocation of economic regulation. He also

⁷⁶ Gary Becker, "Public Policies, Pressure Groups and Dead Weight Costs," 101.

⁷⁷ M.J. Trebilcock, E.G. Hartle, R.S. Prichard, and D.N. Dewees, The Choice of Governing Instrument, 33.

⁷⁸ G. Bruce Doern and Richard W. Phidd, Canadian Public Policy: Ideas, Structures, Process (Toronto: Methuen Publications, 1983), 130.

⁷⁹ G. Bruce Doern and Richard W. Phidd, Canadian Public Policy: Ideas, Structures, Process, 131.

capitalizes on cartel theory to assist in determining the demand and supply by assessing the costs and benefits of the regulation.⁸⁰ The costs of cartelization essentially encompass the organization costs for determining price and output restraints and the resources required to police the agreement in the face of incentives of cartel members to violate the concord in order to increase profits. Enhanced profits are the driving force of cartels. The smaller the group of firms involved and the greater the likeness of mind, the smaller will be the costs of the cartel. These factors will also minimize the likelihood of free-riders. If small numbers facilitate cartelization then large numbers facilitate regulation by lobbying, voting power, and provision of financial resources to politicians. Thus, if an industry demands regulation (e.g., entry limitations and minimum commissions or dealing rates as in the case of the securities industry) then the industry must come to grips with the cost side of acquiring regulatory policy. In general the lower the costs the more favorable the regulation is to the industry.

The bottom line of the new theory is that

regulation is a device for transferring income to well organized groups if the groups will return the favor with votes and contributions to politicians. The theory predicts that regulators will use their power to transfer income from those with less political power to those with more...Of the theories of regulation that focus on the agencies themselves, [bureaucratic behavior] most also predict outcomes favorable to organized interests.⁸¹

Thus, if self-interest seeking behavior drives the supply and demand for regulation, it will be useful to examine the decision-making of politicians and bureaucrats against the background of the factors that enter into their utility functions. The controversy in the literature is not whether the policy-relevant actors operate from a self-interest perspective, but the characteristics of their utility functions.

⁸⁰ Richard Posner, "Theories of Economic Regulation," 344.

⁸¹ Paul L. Joskow and Roger C. Noll, "Regulation in Theory and Practice: An Overview," in Studies in Public Regulation, ed Gary Fromm (Cambridge, MA.: MIT Press, 1981), 36, 37.

The analytical paradigm of utility functions is an important element for understanding the cycle of regulatory changes surrounding the investment dealer industry. Early on, say up to the mid-1980s, the investment dealer industry was able to sustain its protection by the state because the costs of protection were widely dispersed among both institutional and individual investors -- and the benefits were concentrated. Subsequently, however, as the institutional investor became the dominant player in the securities markets, the costs of protecting the investment dealer industry became concentrated -- and those bearing the costs were able to organize themselves to oppose the supply of protection to the securities dealers. Moreover, as the state became overloaded in the 1980s, the apparent "inefficiencies" (broadly defined) of regulation began to impinge on the welfare of the elected and appointed officials. Thus, there was an incentive for policy actors to shift attitudes towards deregulation/reregulation.

With this framework of self-interest seeking behavior, the typical overarching goals of regulators and regulatory commissions are:⁸²

- first, to seek longevity and prosperity;⁸³
- second, to strive to fulfill their legislative mandated responsibilities;⁸⁴
- third, to supply regulation in such a manner that it is not reversed in a legal/judicial review;⁸⁵ and finally;
- to ensure that the regulated industries under their jurisdiction remain profitable and viable.⁸⁶

In general, if the regulatory agency fails to meet the basic operational objectives (two through four above), its legitimacy will be undermined and its very survival (objective one) will be called into question. It is not likely that an agency would be

⁸² See Larry N. Gerston, Cynthia Fraleigh, and Robert Schwab, The Deregulated Society (Pacific Grove: Brooks/Cole Publishing Company, 1988), 73.

⁸³ Kenneth L. Meier, Regulation: Politics, Bureaucracy, and Economics, Chapter 2.

⁸⁴ Kenneth L. Meier, Regulation: Politics, Bureaucracy, and Economics, Chapter 2.

⁸⁵ Barry M. Mitnick, The Political Economy of Regulation, 133.

⁸⁶ Barry M. Mitnick, The Political Economy of Regulation, 133.

legislated out of existence over night, but once the competence of the agency falls into disfavor, problems recruiting staff will be experienced, and legislators will be continuously second guessing the rulings of the agency.

The basic underlying principle is that regulatory decision-makers "are hypothesized to maximize a...utility function containing both pecuniary and non-pecuniary variables."⁸⁷ The arguments in the regulators utility function can encompass one or more of the following elements: personal prestige, wealth, convenience (ease and security of managing the enterprise), working conditions, desire to please other officials and voters, desire to expand the agency's budget (size of the enterprise), a desire implement a conception of the public interest, and to minimize conflict.⁸⁸

The character of the regulatory policy supplied according this theoretical contribution is driven by the internal dynamic within the agency or bureau rather than by some overarching sensitivity to the public good which was evident in the earlier discussion of the public interest theory, or by some desire of politicians to maximize the likelihood of re-election. A typical assumption of this genre of theory is that all of the elements in the utility function are substitutable⁸⁹ and thus "the regulator's choice among

⁸⁷ Louis De Alessi, "An Economic Analysis of Government Ownership and Regulation: Theory and Evidence from the Electric Power Industry," Public Choice, Fall 1972, 2.

⁸⁸ See Albert Breton, The Economic Theory of Representative Government, Chapter 9, 161-175; De Alessi, "An Economic Analysis of Government Ownership and Regulation;" Anthony Downs, Inside Bureaucracy (Boston: Little Brown and Company, 1967), Chapter VII, 75-91; Ross D. Eckert, "On the Incentives of Regulators," Public Choice, Spring 1973, 83-84; Paul L. Joskow, "Inflation and Environmental Concern: Structural Change in the Process of Public Utility Price Regulation," Journal of Law and Economics, October 1974, 297-299; Jean-Luc Migue and Gerard Belanger, "Toward a General Theory of Managerial Discretion," Public Choice, Spring 1974, 28-29; William Niskanen, Bureaucracy and Representative Government (Chicago: Aldine-Atherton, 1971), Chapter 4, 36-42.

⁸⁹ Migue and Belanger ("Toward a General Theory of Managerial Discretion," 28-29) question the assumption of substitutability of elements in the utility function in the face of a fixed budget. Consequently the validity of examining what is going on the mind of a bureaucrat is problematic. That is better left to psychologists than economists. To get around this "technical" problem Migue and Belanger treat the bureaucrat as a consumer dividing it's income between various goods and services. This technical point is not of critical import to the analysis which follows because of its qualitative character, but the Migue and Belanger critique has been generally accepted by public choice economists -- especially Niskanen to whom the observations were directed.

alternative policies is not determined by his focusing on a single element of the decision and ignoring all other elements, but by comparing the resulting packages of utility gains and costs -- as *he* judges them -- that are implied by the various decisions."⁹⁰

The relevance of the arguments in the regulators utility function for the oversight of the securities industry is symbolized in Eckert's analysis. Regulators will have to make choices with respect to the entry of new firms into an industry. However, the larger the number of firms comprising the industry, the more complicated the compliance and regulatory work of the agency/bureau becomes, the more frequent are disputes within the industry, and the more time is required to resolve disputes.⁹¹ Thus, "Commissioners will more often choose to restrict entry of new firms and to reduce the disagreements among existing firms to make their duties less onerous."⁹² Commissions will favor monopolization or cartelization of the industries they regulate.

De Alessi also examines the incentive structure for regulators in independent commissions. He recognizes that while a commissioner may be more autonomous than a senior bureaucrat in a line department, the commissioner is subject to close political assessment when reappointment considerations arise.⁹³ "Casual empiricism suggests that commissioners who antagonize the industry seldom survive."⁹⁴ As a consequence, an independent commissioner will choose those elements for his utility function which facilitate the work load with a minimum degree of conflict and thus the following institutional structure will prove relevant when examining the regulation structures surrounding the securities industry⁹⁵:

⁹⁰ Ross D. Eckert, "On the Incentives of Regulators," 84.

⁹¹ Ross D. Eckert, "On the Incentives of Regulators," 85.

⁹² Ross D. Eckert, "On the Incentives of Regulators," 85.

⁹³ Louis De Alessi, "An Economic Analysis of Government Ownership and Regulation," 3.

⁹⁴ Louis De Alessi, "An Economic Analysis of Government Ownership and Regulation," 3.

⁹⁵ Louis De Alessi, "An Economic Analysis of Government Ownership and Regulation," 3.

- self regulation by the industry,
- restrictive entry policies,
- liberal attitude toward mergers and takeovers,
- bias toward large size firms
- price regulations, and
- infrequent rule changes.

De Alessi concludes that

Once regulation is introduced, larger users -- with great wealth at stake -- have greater incentive to seek lower rates...by lobbying before the regulators and by exercising political pressure. In general,...regulators may be expected to respond to the more intensive persistent, and persuasive pressure exerted by larger users. Politicians similarly have greater incentive to favor larger users...⁹⁶

Regulatory change, when it comes, according to Joskow, will be at the initiative of the industry being regulated. That is because the organizational structure of the "regulatory process" is designed to achieve an equilibrium with its environment (given the relevant elements comprising the regulators utility function). "The regulatory process is therefore extremely passive."⁹⁷ Regulators take no action regarding its functional responsibility unless structural changes within the regulated industry itself initiate a call for examination. Thus, it is the industry itself which sparks a review.⁹⁸ The later analysis suggests that this element of the theory cannot be universally applied as an overarching explanation of the economic regulation.

The incentives surrounding the regulators could relate more to their post-public service career than to any immediate benefits that can be associated with the character of policy supply. For example, restriction on entry into the industry could be driven by the

⁹⁶ Louis De Alessi, "An Economic Analysis of Government Ownership and Regulation," 10.

⁹⁷ Paul L. Joskow, "Inflation and Environmental Concern," 298.

⁹⁸ Paul L. Joskow, "Inflation and Environmental Concern," 298

rents that would be generated and the salary that could be gleaned in an industry related post-regulatory career.⁹⁹

Conclusion

The conclusion one draws from this narrowly focussed, but interdisciplinary, survey of the literature on interests is that in the realm of regulation, particularly economic regulation, one would not be inclined to use the concept of the "public interest" as an explanatory variable in the policy supply function. Indeed, it is even doubtful that the public interest would appear in the utility function of policy-makers -- neither politicians nor regulatory bureaucrats -- because it is concluded, on balance, that there are only particularistic (i.e., special and/or group interests) interests which can be defined in a non-crisis or non-emergency environment. This phenomenon -- the lack of a public interest -- is an important explanatory force within the framework derived in this dissertation for analyzing regulatory decision-making in Canada. Financial regulatory policy caters to particularistic interests -- public or private.

The economists' conclusion of a negative relationship between technical efficiency and regulation, except in the case of a market failure, does not seem to have had an important influence on those scholars who write from a public choice perspective. Similarly, the theoretical construct of a "public interest" has been largely debunked by the pluralists and neo-institutionalists writing from the political science perspective. Thus, the traditional explanations for financial services regulation, put forward by economists, which relies on the precepts of the public interest, are on balance repudiated as the primary interpretation motivating public decision-makers in this field. The framework for analysis once again stresses particularistic interests -- and therefore capture of the regulator by the industry.

The social benefits (or costs) arising out of regulatory policy (including deregulation and/or deregulation) are merely accidental. In the jargon of economists these benefits (or costs) can be characterized as positive (or negative) externalities. They are

⁹⁹ Ross D. Eckert, "On the Incentives of Regulators," 97-98.

important to society over some longer term horizon, but only of shorter or transitory importance to state officials (elected or appointed). This phenomenon is also an important element in the analytical framework of the dissertation. That is to say, given the limited time horizon facing elected and appointed officials, in most cases they only want to be seen to be doing the "right" thing -- because the consequences of their policies may only be realized after they have passed from the scene.

Economic regulation is thus seen as distributive policy, the consequences of which are an explanatory variable in the utility (political or industry support) function of the policy-maker. In this case policy causes politics and policy-decision makers implicitly undertake the calculus to determine the direction in which the policy pushes their utility functions. This idea will be important in understanding the rationale for the evolution of financial regulation in Canada.

The immediately following analysis of the liberalization of broker commissions is designed to validate the usefulness of this interpretation of the "interests" literature while at the same time setting the conditions for the analysis of the decision to liberalize entry and ownership in the Canadian securities industry.

CHAPTER THREE

THE POLITICS OF REGULATING STOCK EXCHANGE COMMISSIONS: A COMPARATIVE ANALYSIS OF STATE AND INVESTMENT INDUSTRY RELATIONS

Introduction

This is a rather simple chapter to read but its purpose is rather elaborate and as a consequence it may be seen to be rather unnecessarily complex. *First*, it uses the policy decisions and processes surrounding the liberalization of stock broker commission rates in the US, Canada and the UK as a way of revealing the manner in which state interfaces with the securities industry. What this discussion will show is that there are a number of overlapping relationships among the key actors which encircle "liberalization" in the securities industry.¹

The fact that these relationships are not constrained by national borders gives rise to the globalization phenomenon. The relationships which have been identified are between the regulators and dealers, between the dealers and investors, and between the

¹ It should be kept in mind that when we speak of the liberalization process in the securities industry we are not talking about the abandonment by the state of its regulatory responsibility. Indeed, our concern with the liberalization process is one of the character of the policy supplied and why it is supplied. This dissertation has no pronouncements on the matter of prudential supervision -- except when it is used as an excuse to protect the special interests from the effects of the market. A recent paper by Coleman suggests that deregulation in the financial services industry has been accompanied by an expansion of the state's regulatory apparatus. Against the background of the precepts of the public choice school this is not surprising, given the additional risks that accompany market and institutional globalization. See William D. Coleman, "Financial Services and Government Intervention," in Canada at Risk? Canadian Public Policy in the 1990s, ed. G. Bruce Doern and Bryne B. Purchase (Toronto: C.D. Howe Institute, January 1991).

regulators and investors. Elected officials are situated in an overarching position relative to all of the other actors. There is also a relationship between each of these actors across international boundaries.

It is this melange of interests which gives rise to pressures for adjustments to regulatory policies which encompass the industry. These pressures and resulting policy changes are identified. Inasmuch as there is a dependency relationship among the securities industries (and other pillars of the financial services industries) within each of the "nation-states," which itself acts as a rudder for the liberalization process, where one cuts into this international system is circumscribed not only by space but also by time. We will begin the exposition with the United States.

Second, this chapter applies the discussion of interests in the second chapter to the case studies across the three countries. The usefulness of the interest theory, when extended across this domestic-international alliance serves to clarify the link between the state and the securities industry. Furthermore, it validates the usefulness of the theoretical approach which is anchored in political economy compared to the traditional "economic" explanations of regulatory liberalization. It also fleshes out explanations of policy supply surrounding the securities industry in Canada that is itself novel because it relies on the above noted theoretical approach to portray the dynamic between special interests and the state.

Third, this chapter is also designed to tell the story of how the globalization of securities markets and intermediaries began and to identify the forces that would continue to propel this kind of structural adjustment over time. In this respect, this chapter introduces a third stream of literature which informs this dissertation.

The Roots of the Liberalization Phenomenon

It is interesting, when we consider the root of the deregulatory process in the US, Canada and the UK, that the common seed is the struggle to liberalize membership in the organized stock exchanges and to "unfix" dealer commissions for transacting stock deals for their clients. The first shoe to drop in this regard was in the US followed by Canada

and then the UK. In the case of the US, the formal argument for the liberalization of commission setting was based on the paradigms put forth by the economics profession (competition, concentration, efficiency²). In the UK, the government's case was brought to the political agenda by the Department of Trade and Industry against the backdrop of the laws surrounding unfair trading practices. In Canada, the pressure for change came initially from the developments in the US which were seen to be a prospective threat to the viability of the Canadian securities industry and subsequently from within the OSC itself. Indeed, the key interests involved in the commission liberalization dilemma, across all three countries, were initially opposed to measures which would alter the status quo.

The US Experience

As noted above, the watershed with respect to the phenomenon of deregulation began in the US in the middle 1970s when fixed rate commissions on stock exchange transactions were abolished -- after having been in effect since the inception of the Exchange. This action followed the protracted consultative and decision-making processes of the US Congress, the Securities and Exchange Commission (SEC) -- the federal institution responsible for the regulation and supervision of both the investment company industry and the national securities markets³ -- and the New York Stock Exchange (NYSE).

Academics had long criticized the SEC's toleration of fixed NYSE brokerage rates. They contended that the fixed commission rates were supra-competitive and that the price umbrella restricted trading, enriched brokers, and fostered economic inefficiency. In other words, they said, the NYSE was a cartel, and the SEC its enforcement arm.⁴

The fundamental weakening of the NYSE cartel occurred during the 1965-75 period as a consequence of the rapid growth and increased relative importance of the

² See Gregg A. Jarrell, "Change at the Exchange: The Causes and Effects of Deregulation," The Journal of Law and Economics, October 1984, 273.

³ Joel Seligman, The Transformation of Wall Street (Boston: Houghton Mifflin Company, 1982) 416.

⁴ Gregg A. Jarrell, "Change at the Exchange: The Causes and Effects of Deregulation," 273.

equity portfolios of the major institutional investors compared to private individual investors, their domination of trading activity on the NYSE, and the pressures these institutions exerted on the Exchange to alter its restrictive rules regarding the costs of transacting business. The institutional investors were looking for a way to minimize their costs of dealing on the NYSE. The Exchange was, in turn, coerced into responding to the challenge of the institutional investors because of a fear that the Exchange itself could not survive the effects of persistent rigidity in broker commissions. Nevertheless its leadership, and its members, struggled for about a decade to safeguard the benefits associated with protection from competitive forces accorded by the fixed commission rules of the Exchange.

The survival of the NYSE was called into question because the institutional investors were welcomed into membership in a number of regional exchanges -- notably the Philadelphia-Washington-Baltimore Exchange -- where they could transact business on their own behalf at significantly lower unit costs than those at the NYSE. Concurrently, a number of price competition practices (known in the industry as "give-ups") were developed in order to circumvent the limitations on commission rate determination:⁵

- a. a practice where the trading client authorized the dealer executing the trade to direct a portion of the commission to third parties who in turn supplied the client with other services (also known as fee splitting);
- b. a practice where the transacting dealer would supply research and other support activities to the client without additional charges;
- c. a practice of providing gifts, insider information, special allocations of new issues and overt bribes.

The mere development of these practices confirmed that brokerage commissions were higher than necessary, or why, then, would the brokers be giving them away. According to Paul Samuelson these curious practices were "a dramatic way of revealing

⁵ Michael Keenan, "The Scope of Deregulation in the Securities Industry;" Dan Roberts, Susan Phillips and J. Richard Zecher, "Deregulation of Fixed Commission Rates in the Securities Industry," in Deregulation of the Banking and Securities Industry, ed. Lawrence J. Goldberg and Lawrence J. White, (Lexington MA., Lexington Books, 1979), 118, 155-57.

the [NYSEs] distorted rate structure...a kind of loophole through which a little competition could asthmatically breathe."⁶ From Samuelson's perspective it would have been desirable for the efficient and equitable operation of the US capital market to eliminate fixed commissions and thus permit the dealers to determine the appropriate level of commissions -- given the demand for their services -- and as well permit direct institutional access to the NYSE.

The brokerage houses in response to the pressure from the institutional traders unsuccessfully lobbied both the Congress, for federal legislation which would prohibit direct exchange trading by institutions for their own account, and the NYSE listed companies, to refuse to transfer ownership on their books of any dealing that had not taken place on the NYSE.⁷

The SEC, during the 1968-75 period, in response to representations from the financial institutions, the Congress and the Department of Justice, enacted measures which gradually introduced some semblance of a market determination process for commission rates. The SEC seemed to follow an iterative or incremental approach to these matters despite the fact that it had the statutory power to act in a comprehensive way with the restrictive practices of the NYSE.⁸ For example, when the SEC studied the rules of the NYSE:

- The Staff found that Rule 394 which prohibited exchange members from transacting in the over the counter market (OTC) for a stock listed on the NYSE -- even if the OTC dealer could provide a better price -- to have the effect of minimizing competition and was probably illegal under US antitrust laws.⁹

⁶ Securities and Exchange Commission, Commission Rate Hearings, October 30, 1968. Quoted in Seligman, The Transformation of Wall Street, 398.

⁷ Michael Keenan, "The Scope of Deregulation in the Securities Industry", 121.

⁸ The statutory basis for the SEC to act decisively was "Section 19)(b) of the 1934 Securities Exchange Act, which empowered the SEC 'to alter or supplement' registered stock exchange rules when 'necessary or appropriate for the protection of investors or to ensure fair dealing' with respect thirteen categories of exchange rules, including 'the fixing of reasonable rates of commission.'" From Joel Seligman, The Transformation of Wall Street, 384

⁹ Joel Seligman, The Transformation of Wall Street, 387-88.

- The Staff found that in the face of the increased importance of the institutional investor in the US capital market that NYSE membership was confined to individuals and firms which spend most of their time in the securities business. These rules were designed to prevent the large institutional investors from participating directly on the Exchange, which would allow them to avoid the payment of high commission rates.¹⁰
- The Staff recommended the elimination of “give-ups” and prepared draft rules to that effect. But the basis for the Staff’s recommendation was the potential for conflict of interest rather than Samuelson’s characterization of them as a signal of the distortions in the commission rate structure.¹¹

In response to prodding from the Antitrust Division of the Department of Justice the SEC extracted concessions, in 1972, from the NYSE in respect to “unfixing” commissions on large block transactions.¹² This was a major breakthrough for the SEC in the face of both its own past dithering on the issue and the self-interest seeking behavior of the NYSE. Indeed, the behavior of the NYSE resulted in numerous false starts towards reform of its restrictive rules. The Exchange, on a number of occasions, committed itself to change, but because of the lack of consensus among the interests of Exchange members, it always reneged on carrying out reforms. Indeed, it was only after it became apparent that the Exchange was going to lose the battle (on all fronts) did its President admit to the folly of its actions:

As recently as 1967, the regional exchanges and the third market [OTC] combined to account for just over 10 percent of all trading in our listed stocks. Today [17 November 1970], they account for almost 20 percent. Thus, in the past three years there has been a doubling in the share of off board trading...The New York Stock Exchange, to put it crassly, no longer has the only game in town.

Unless the New York Stock Exchange is willing to compete effectively with markets where commission fees are presently negotiated it faces a

¹⁰ Joel Seligman, The Transformation of Wall Street, 395-96.

¹¹ Joel Seligman, The Transformation of Wall Street, 397-98.

¹² Joel Seligman, The Transformation of Wall Street, 470.

continued reduction in its share of overall trading, and at an accelerated pace. I submit it is not in the long-term interest of our members or the public to permit a continued erosion in the liquidity of our marketplace.¹³

Subsequently, other members of the securities industry saw the writing on the wall and joined the NYSE President in opposing fixed commission. Nonetheless, this ad hoc approach to liberalization of the NYSE's rules was seen as unacceptable by both the Antitrust Division of the Department of Justice and by the key committees in the US Congress. Indeed, in February 1972 the Senate Securities Subcommittee in its "Securities Industry Study" stated:

Between the middle of 1968 and the present, the securities industry went through a complete boom-and-bust cycle, during which its members' ability to respond to economic pressures by adjustments in their rates was severely limited by the fixed-commission-rate schedule. The fact is that in a dynamic and volatile industry like securities, the length of a rate review proceeding almost guarantees that its conclusions will be obsolete by the time they are reached. And the SEC's inability to enumerate standards to be applied in future proceedings gives us little hope that they will be any more expeditious.¹⁴

In the event, NYSE commissions became freely negotiable on 1 May 1975. However, the inability of the SEC to act in a decisive way, despite the fact that fixed commissions were widely seen as inefficient and market distorting, largely reflected institutional constraints on the Commission's leadership. *First*, it was generally acknowledged that the Commission and its staff were dominated by the legal profession with little or no background in economics or antitrust issues.¹⁵ As a consequence, the SEC did not have a framework or a theory around which it could anchor its regulation of the industry's participants and its self-regulatory organizations (SROs). Significantly, the SEC did not believe that it should play an important role in determining the way the securities

¹³ Robert Haack, "Competition and the Future of the New York Stock Exchange," 17 November 1970. Quoted in Seligman, 477.

¹⁴ Senate, Subcommittee on Securities, Securities Industry Study (Washington, D.C.: GPO, 1971) quoted in Seligman, The Transformation of Wall Street, 479.

¹⁵ Joel Seligman, The Transformation of Wall Street, 350.

industry organized itself. *Second*, the apparent values of the SEC leadership, and the high probability that they wished to optimize their own self-interest¹⁶ rather than the public interest seemed to have an important influence not only on its activities but also on its effectiveness.

It was widely believed within the SEC that its favorable reputation was, in part, a consequence of its not prescribing rate levels or industry structure, as did other then less-well regarded federal agencies, such as the Interstate Commerce Commission. If the SEC directly regulated the economics of the securities industry and thereby increased its ability to affect the industry's profitability, it was assumed it would risk the loss of considerable industry support and be subjected to far more frequent and intense political pressures. Rather than being an 'umpire' of securities industry disputes well regarded for its technical competence, the SEC would become a different agency. It would be vulnerable to charges of being an 'industry captive' if its leadership was quiescent, at loggerheads with the securities industry if its leadership was activist, and in either case, less likely to maintain its highly regarded reputation or such insulation from partisan politics as it did possess, regardless of its technical competence.¹⁷

From a behavioral perspective, we have here a classic example of the bureaucrat's objective function being driven by the desire to both promote the survival of his/her agency and to preserve its prestige.¹⁸ Indeed, the record suggests that these two motives, which appeared to be driving the SEC's leadership behavior during the protracted deliberations surrounding the "unfixing" of commission rates, ranked above such goals as serving the public interest and/or commitment to a specific program of action.¹⁹

Acheson and Chant refer to prestige as the ranking of the agency within the social hierarchy of government bureaus while the value of agency survival is seen from the perspective of individual self-interest.²⁰ It was well known that SEC personnel were able reap the "rents" of their accumulated experience at the Commission through highly

¹⁶ Anthony Downs, Inside Bureaucracy, 81.

¹⁷ Joel Seligman, The Transformation of Wall Street, 350.

¹⁸ Anthony Downs, Inside Bureaucracy, 9-10.

¹⁹ Anthony Downs, Inside Bureaucracy, 84-85.

remunerative post-SEC careers in the legal profession or investment banking industry.²¹ An agency's concern for survival can, as well, have an important impact upon its behavior:

First, a bureau will attempt to avoid conflict with groups that have the power to influence its status. Such an avoidance of conflict will increase the chances of the bureau's survival in its present form. Second, a bureau will be concerned with maintaining its autonomy. While increased autonomy may increase the possibility of conflict by making responsibility for failure more difficult to avoid, autonomy can also increase security by increasing the bureau's ability to deal with those situations of conflict that do arise.²²

The SEC was certainly not successful in managing the conflict during the ordeal of unfixing commissions -- although that was one of its goals. Indeed, the SEC hesitated to act on the issues surrounding the liberalization of commissions in the absence of formal agreement from and consensus by the NYSE and its members regarding the path they wished the regulatory authorities to follow. This process was compounded by the SEC's neglect of a formal philosophy surrounding the regulation of the investment banking industry and the fact that the industry was not a monolithic group. Hence, for a long time the SEC was unable to reach a consensus on how to approach commission rates. The status quo was the objective of the regulators. Rather than being autonomous, the SEC appeared to be captured by the securities industry -- predisposed "to make decisions and take actions consistent with the preferences of the regulated industry"²³ -- despite its goal of autonomy.

The Department of Justice, on the other hand was guided by the precepts of the antitrust laws, as was the US Congress, in demanding liberalization of the constraining rules of the NYSE. Ultimately, it was the power of the US Administration and the

²⁰ Keith Acheson and John F. Chant, "Bureaucratic Theory and the Choice of Central Bank Goals: The Case of the Bank of Canada," in Central Bankers, Bureaucratic Incentives, and Monetary Policy, ed. E.F. Toma and M. Toma (Dordrecht: Kluwer Academic Publishers, 1986).

²¹ Barry M. Mitnick, The Political Economy of Regulation, 226.

²² Keith Acheson and John F. Chant, "Bureaucratic Theory and the Choice of Central Bank Goals: The Case of the Bank of Canada," 131.

²³ Barry M. Mitnick, The Political Economy of Regulation, 207.

Congress which prevailed over the SEC. They were pressured by the persistence of the powerful and wealthy institutional investors and the resourcefulness of the OTC market and the regional exchanges. It was only when the NYSE and its constituents recognized this dynamic was there a change in the industry's attitude toward liberalization. Even at this point, the industry's acquiescence was driven by a desire not so much for change, but to preserve whatever room was left to influence the scope and pace of change.

Provocative as this process was, it would be a phenomena to be repeated, in varying degrees, in both Canada and the UK, during the struggle to liberalize commissions, entry and ownership in *their* investment banking industries.

Unequivocally, this episode of "unfixing" NYSE commission rates can be linked to the idea of "interests" as an important phenomenon in the regulatory process -- the interests not only of those being regulated but also of those doing the regulating. It also provides a foundation for the intertwining of the theory of economics and politics in this field of regulatory policy. The questions that arise from the US experience of liberalizing the determination of NYSE commission rates are: "whose interests were being served by the fixing of commission rates?" and, "what role did the state play in accommodating these interests?" These questions are not profound in the current conjuncture, but they were when first posed by George Stigler some twenty years ago²⁴ and reviewed in Chapter Two. For Stigler, the key questions were "who will receive the benefits or burdens of regulation, what form regulation will take, and the effects of regulation upon the allocation of resources."²⁵ The answer provided by Stigler is that "regulation is acquired by the industry and is designed and operated primarily for its benefit."²⁶ Within that context Stigler dismissed the long held view that

the political process defies rational explanation: "politics" is an imponderable, a constantly and unpredictable shifting mixture of forces of

²⁴ George Stigler, "The Theory of Economic Regulation."

²⁵ George Stigler, "The Theory of Economic Regulation," 209.

²⁶ George Stigler, "The Theory of Economic Regulation," 209.

the most adverse nature, comprehending acts of great moral virtue and of the most vulgar venality.²⁷

Stigler assumed that the political system is rational and that policy outputs will reflect a market-type equilibrium as the political actors (private individuals, politicians and bureaucrats) respond to the systemic incentive structures characteristic of a free market exchange process. This rationality imposes a constraint on the actions of the individual actor and this constraint drives the actor to behave in a reasonably predictable fashion -- in its self-interest.²⁸ In the case of the "unfixing" of the NYSE commission rates, this market based theory of political choice suggests that the higher than necessary cost burden imposed on the institutional traders coupled with the accessibility of regional exchanges to these traders as well as the development of the over-the-counter market, contributed in an important way to the deregulation of the commission setting process.

Recalling that the SEC is an agency of the US federal government, and inasmuch as the SEC was the final arbiter of the commission setting decision, it was probably the case that the marginal costs to the agency, in terms of its lost political support from users of the services provided by the securities industry and the Congress (which passes judgement on the agencies budgetary requests) was greater than the marginal benefits associated with restricting the ability of market participants to negotiate the charges for transacting on the NYSE.²⁹ From the perspective of a public policy output, it cannot be argued that the bureaucrats at the SEC were acting rationally, in the context of the full-information maximum-likelihood model or what Lindblom characterizes as the "root"

²⁷ George Stigler, "The Theory of Economic Regulation," 210.

²⁸ Michael Trebilcock, The Political Economy of Economic Adjustment: The Case of Declining Sectors (Toronto: University of Toronto Press, 1986) contains a complete discussion of political rationality against the background of state intervention in market adjustment processes. This context mirrors regulatory processes if on the one hand they are seen as demand by an industry for protection (whether price, entry, etc.) or from the supplier's perspective as an exchange for votes or some other benefit. See also Terry Moe, The Organization of Interests (Chicago: University of Chicago Press, 1980), Chapter 1.

²⁹ Gregg A. Jarrell, "Change at the Exchange: The Causes and Effects of Deregulation," 284-285. The argument put forward by Jarrell suggests that the key factor driving the SEC to recommend an unfixing of commission rates was related to the extent of "wealth transfer from one group to another" -- which in turn gave rise to political support or opposition.

method,³⁰ but more from the vista of what Simon characterizes as a satisficing or bounded rationality purview.³¹ Indeed, evidence has already been presented that the SEC during this era did not have a clear vision of where it wanted to direct the securities industry because of the apparent absence of a clear regulatory paradigm within the bureaucracy. It was apparent, however, that the SEC leadership not only valued its independence from the general machinery of the US government and wished to preserve it, but also wanted to maintain the respect and support of the industry it was mandated to regulate. That was its objective during this period and from that view it can be claimed that the SEC acted rationally. Such behavior had been efficacious in the past.

Alternatively, it can be hypothesized that there was no relative autonomy of the regulators from those that were subject to the regulation that gave rise to the particular character of the public policy supply. That is, as much as regulators did not have a vision of the future, they were unable to see beyond the immediacy of the moment, dominated as it was by the short-term interests of the NYSE membership, to the exclusion of the "public interest." This prevented the regulators from making long term structural decisions which could be in the long-term interests of the NYSE membership. The short-term interests of the public officials themselves seemed to prevail.³² Indeed, in 1975 fully one third of the upper level civil servants of the SEC had prior employment in the securities industry (the largest share of nine US federal regulatory agencies examined) while 12 of 19 commissioners who left the employ of the SEC between 1961 and 1975 were

³⁰ Charles E. Lindblom, "The Science of Muddling Through," in Readings on Modern Organizations, ed. Amitai Etzioni (Englewood Cliffs: Prentice-Hall, Inc., 1969).

³¹ Herbert Simon, Administrative Behavior (New York: The Free Press, 1976), xxviii-xxxi.

³² Eric A. Nordlinger, On the Autonomy of the Democratic State (Cambridge, MA: Harvard University Press, 1981), 1-41 and Theda Skocpol, "Political Response to Capitalist Crisis: Neo-Marxist Theories of the State and the Case of the New Deal," Politics and Society 10, No. 2 (1980), 155-201. According to Nordlinger (p. 13) authoritative actions of the state do not have to relate to broadly based policies impinging positively or negatively on many individuals, but can be more narrowly based policies such as regulation. For Skocpol, the failure of the New Deal in the aftermath of the Great Depression occurred at the implementation stage because those designated to ensure the success of the associated social safety net policies were business people seconded from the private to the public sector, who were ideologically opposed to the character of Democratic politics during this era. There was no relative autonomy of the state.

subsequently directly or indirectly employed in the securities industry. SEC commissioners also had the shortest average tenure (2.75 years during fixed term appointments of five years) of the major regulatory agencies.³³ The senior bureaucrats in the SEC adopted a strongly utilitarian view of the world they were mandated to regulate.³⁴ The SEC's activities were designed to preserve the organization as an institution in the face of external threats to its standard operating procedures.

The Canadian Experience

The patterns of policy development respecting commission rates on the Toronto Stock Exchange³⁵ very nearly mirror those in New York. Brokerage commissions are regulated by a TSE bylaw (subject to review by the OSC) and brokers were not permitted to charge rates lower than noted in the bylaw, although of course they were permitted to charge higher rates.³⁶ However, by the mid-1970s the rates that were sanctioned by the TSE bylaws contained a tapered schedule.³⁷ That is to say, the permissible rates were lower on a per share basis on large trades (for institutions) than they were on small trades (for "retail" clients -- i.e., the small investors, mainly household sector participants in the equity market). The impetus for the introduction of the tapered schedule at this time was

³³ House of Representatives, Subcommittee on Oversight and Investigations, Committee on Interstate and Foreign Commerce. Regulatory Reform - Volume I: Quality of Regulators. 94th Congress, 1st Session (Washington, D.C.: U.S. GPO, November 6 and 7, 1975, 452-459.) Reported in Barry M. Mitnick, The Political Economy of Regulation, 225-230.

³⁴ James G. March and Johan P. Olsen, Rediscovering Institutions: The Organizational Basis of Politics (New York: The Free Press, 1989), 3.

³⁵ Developments on the Montreal Exchange (MSE) parallel those in Toronto, but the discussion will focus on the TSE.

³⁶ The OSC regulates the securities industry in Ontario. The primary purpose of the regulation is to ensure that investors have sufficient information on which to base investment decisions. To carry out these responsibilities the OSC ensures that individuals and firms selling securities are properly qualified to undertake such tasks. This is ensured to a registration process -- of both firms and individuals. The OSC also has regulatory authority over the TSE with respect to matters that are in the "public interest." The OSC also has the statutory authority to investigate complaints against those registered with the OSC. Implementation of regulations is undertaken by self-regulatory organizations (SROs) which in the case under consideration here it is the TSE.

³⁷ John D. Todd, Price Competition in the Canadian Securities Industry: A Test Case of Deregulation (Toronto: Ontario Economic Council, 1983), 14.

the earlier deregulation of commissions that had occurred in New York.³⁸ There was a need for Canadian brokers' rates to be competitive with those in New York in order to preserve the TSEs share of trading in those stocks which were cross-listed on the NYSE.³⁹ The public persona of the OSC was concerned with preserving a competitive and viable capital market in Toronto.⁴⁰

A little more than one year after the NYSE was pushed into liberalizing the commission rate determination process, and in reaction to it, the OSC conducted hearings into the same question (in July and October 1976). The OSC Chairman Arthur Pattillo was concerned that Canadian stock exchanges

continue to fix minimum commission rates without attracting attention under the Competition Act simply because these rate levels are subject to approval of the relevant provincial securities commission. So while the OSC and other commissions have hitherto limited themselves to approving or disapproving rate patterns fixed by the exchanges, they have a certain public responsibility to find out whether what's been happening in the US ought to be tried in Canada.⁴¹

The academic community also pressed the case for the deregulation of the commission structure⁴² -- arguing that industry competition, rationalization and efficiency would enhance the welfare of society, while on balance members of the industry were equally firm in opposing any policies which would alter the status quo. "Some of the bigger firms, who can rely on underwriting and other investment dealing functions to see them through, wouldn't mind being able to compete on rates. But some of the smaller firms, more, or wholly, reliant on agency revenue, fear they would be the ones who'd go to

³⁸ John D. Todd, Price Competition in the Canadian Securities Industry, 19.

³⁹ In mid-1975 the OSC suggested that "over 30% of the TSE business is interlisted securities, [and] it is possible that a totally negotiated rate structure in the United States can have a significant impact on the TSE. Ontario Securities Commission, "In the Matter of the Securities Act and In the Matter of Part XV of the By-Laws of the Toronto Stock Exchange," (July and October 1976) Bulletin of the Ontario Securities Commission (OSC Bulletin), November, 1976, 294.

⁴⁰ Ontario Securities Commission (July and October 1976), OSC Bulletin, November 1976, 295.

⁴¹ Editorial, "Much at Stake for all Investors," Financial Post, 2 August 1975, 1.

the wall.'⁴³ Ironically an industry whose business is rooted in the "market" feared competition.⁴⁴ Not surprisingly, the industry's "boilerplate" fears⁴⁵ closely mirrored those contained in the arguments used by US investment bankers when they opposed commission rate liberalization. They were of the view that deregulated commissions would:

- (i) raise investment transaction costs to the retail sector, thus encouraging such clients to deal with the large institutional investors (e.g., mutual funds), because this segment of the market would not have the bargaining power to lower their transaction costs;
- (ii) sharply reduce revenues thus lowering the quantity and quality of research upon which the firms depended to attract and maintain their client base. A number of submissions suggested that as much as one third of the membership of the TSE would go out of business as a consequence of commission rate deregulation and the attrition would be concentrated in those firms which stress the research function;
- (iii) increase institutional concentration in the market and thus reduce the market's liquidity and efficiency.⁴⁶

⁴² See Derthick and Quirk, *The Politics of Deregulation*. They explore the influence of and contribution by academics (mainly economists) in the US during the 1950s and 1960s with respect to the social benefits that would arise from a less intrusive state. In the 1970s Canadian academics had the benefit of these ideas, but their influence was very much more muted because conservative political ideologies held sway compared to the growing liberal tendencies in the US during the late 1960s and 1970s. A notable exception in this regard was the work in the late 1970s by Douglas G. Hartle, *Public Policy Decision Making and Regulation* (Toronto: Institute for Research on Public Policy, 1979). On the question of commissions per se see: M. Q. Connelly, "Fixed Versus Negotiated Commission Rates on the Toronto Stock Exchange," *Canadian Business Law Journal*, 2 (1977-78), 245-261; and Richard Claus van Banning, "Brokerage Commissions Charged by Toronto Stock Exchange Members: An economic analysis of the arguments for and against fixed commissions." Paper submitted for the Business Planning Cluster, at the Faculty of Law, University of Toronto, May 1977.

⁴³ Patrick Bloomfield, "Securities rate war possible," *Financial Post*, 29 November, 1975, 1.

⁴⁴ See Patrick Howe, "TSE plans to discuss whether fixed rates should be abolished," *Globe and Mail*, 2 December, 1975, B9 for a commentary on the industry's attitudes.

⁴⁵ These fears are the standard ones expressed by the industry whenever public policy begins to erode the price and entry protection that members had come to rely upon.

Interestingly, the institutional investors, while broadly in favor of lower commission rates, favored a rather slow approach to deregulated rates because they feared losing the benefits of the research produced by the brokerage houses, upon which they depended for managing their investment portfolios. In one sense this was a surprising reaction because the majority of the members of the investment industry opposing the deregulation of commission rates suggested that it was the institutional investors who would be the main beneficiaries of this policy change. The institutional investors seemed to press their case for support of fixed commissions under the guise of the public interest -- in that respect singing from the same song-book as the securities industry -- and many proposed the alternative of lower fixed commissions instead of unfixing them. The position of the institutions was also surprising, especially against the background of the pressure exerted by their American counterparts to deregulate commission rates in the US. With respect to this latter point, the position of the institutional investors may have partly reflected the fact that lower commission rates could be achieved on the US exchanges for cross-listed "blue-chip" Canadian stocks. As well, these market participants did not want to develop "in-house" infrastructures to carry out the research that was now obtained "free" from the securities industry. In any event, it is concluded the Canadian institutional investors pressed their case essentially to preserve the status quo for their own self-interest, despite the implications in their public pronouncements about wishing to advance the public interest.

An SEC analysis of the first four months of the liberalized commission determination regime in the US acknowledged that there had been a sharp decline in the net income of those investment dealers whose primary clients were the large institutional accounts. However, "the SEC concluded that the drop in institutional commissions was basically healthy and the overall financial condition of broker-dealers remained sound."⁴⁷ US industry representatives, on the other hand, characterized the negotiated commission

⁴⁶ Ontario Securities Commission, "Summary of Submissions to the Hearings on Commission Rates," August 1976; Toronto Stock Exchange, "Submission of the Toronto Stock Exchange to the Ontario Securities Commission on the Matter of Commission Rates," Toronto, June 18, 1976.

⁴⁷ Hyman Solomon, "Beware the Commission war carnage," *Financial Post*, 20-27 December, 1975, 15.

regime as a "ruinous price war," which prevented the securities industry from covering its costs. The industry tried to lobby the US regulatory authorities for the establishment of a floor under institutional commission rates but was unsuccessful.⁴⁸ It was during this period that the Chairman of the US Securities Industry Association offered to assist its Canadian counterpart. "If you guys can't head this off with your commission [the OSC] we'll come up to help you and testify before the Ontario Commission - if that's what you want."⁴⁹

In the event, the OSC supported the position of the industry despite the inherent contradiction in its reasoning:

...if one is satisfied that the industry is a necessary one, that its survival is essential, that the fixed rates are not a protective tariff, that the industry is subject to effective competition and that the rate structure does not give the industry or any segment of it what is perceived to be unreasonable profits, it can be concluded that fixed commission rates per se are not against the public interest. Such a rate structure should be perceived as fair by those whom the industry serves.⁵⁰

After considering all of the facts relating to competitive forces now in effect and appreciating that hard evidence in support of either fixed or negotiated commissions is limited, the majority of us have concluded that it would not be in the public interest at this time to direct the immediate introduction of negotiated rates in whole or in part. We have concluded that the Exchange and its members should be given a further opportunity to introduce a rate structure which would be perceived to be fair by the industry's clients, the general public and the commission.⁵¹

The opinion of the majority of Commissioners was, on this occasion, without analytic substance. As was the case with the SEC in the US, as it pondered the same issue.

⁴⁸ Hyman Solomon, "Beware...", 15.

⁴⁹ Timothy Pritchard, "Broker predicts 'disaster' under unfixed commission rates," The Globe and Mail, 4 June 1976, B6.

⁵⁰ Ontario Securities Commission (July and October 1976), OSC Bulletin, November 1976, 292.

⁵¹ Ontario Securities Commission (July and October 1976), OSC Bulletin, November 1976, 302.

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the OSC had no apparent analytical framework upon which it could rely for guidance for its regulatory decisions. It did not have a set of firmly founded "priors" on the role of the state in society, a methodology for examining the costs and benefits associated with its policy outputs, nor sufficient expertise to judge the merits of the worst case scenarios of deregulation put forward by the securities industry. More generally, the commission had no "philosophic guidelines"⁵² for formulating decisions around its regulatory mandate, to protect the investor, and which would be in the public interest. Indeed, two Commissioners noted that "Prudence and common sense dictate that those who have no experience or background in the industry must listen to and weigh very carefully"..."the considered opinion of those in the industry that such a move could have potentially serious adverse effects on the securities industry and hence on the Canadian capital market."⁵³ The OSC appeared to lack a public philosophy. The irony embedded in the majority opinion of the Commission is summarized in the following:

The tools and standards applied by established commissions in the rate fixing field, notably energy and communications, in dealing with publicly granted monopolies are inapplicable to a highly competitive and heterogeneous industry such as the securities industry. No two firms are precisely the same. The standards and qualities of service differ. The industry itself is subject...to strong competitive outside forces. The conclusions reached in any particular application must in some substantial measure be subjective because the kinds of hard evidence that a rate fixing board requires in dealing with the application of one natural gas company or one telephone company in a single area can never be available.⁵⁴

This is an argument for unfettered competition!

While the Commission professed to be committed to the public interest (which it is noteworthy was never defined by the Commissioners), the evidence it considered reflected the views of special interests -- the institutional investors and the dealers. The concerns

⁵² Nicholas Henry, Public Administration and Public Affairs, (Second Edition) (Engelwood Cliffs: Prentice-Hall, Inc., 19xx), 137.

⁵³ Observations from Beck and Johnston, 323.

⁵⁴ Ontario Securities Commission, OSC Bulletin, November 1976, 291-292.

about the welfare of the so-called "small investors" (i.e., the retail accounts) appears to have been a misplaced proxy for the public interest. The real public was the client base of the institutional investors -- for example, the policy holders of the insurance companies, the individual contributors to the numerous pension funds, and investors in mutual funds.

The OSC was interested in the survival of the Ontario securities industry without providing sufficient arguments against alternative industry structures to the status quo. The main fears of the industry were that the equity market would become more concentrated because many dealers would go out of business in a regime of negotiated commissions and individual investors would abandon the market in favor of institutional fund managers. The institutions would become too powerful in the marketplace. Its decision supplied public policies to the few, the costs of which were borne by the majority. The OSC acted in the interests not of the investor⁵⁵ for which its mandate is clear but in the interests of the regulated industry from whom the investor was to be protected.

Two OSC Commissioners, Beck and Johnston (B-J) took a more forward looking perspective in respect of negotiated commissions, than did the other Commissioners, by dissenting from the majority view.⁵⁶ Their opposition to the majority opinion was rooted in both a view of the role of the state and as a consequence an implicit public philosophy. The foundation of the B-J argument is that traditionally, in Canada, economic activity has favored free competition (except in the case of natural monopolies) and public provision of goods and services. Indeed, if competition as an idea was a widely accepted belief, the conundrum of the OSC acting contrary to the "paradigm" is even more paradoxical.

B-J were opposed to OSC (state) involvement in an ongoing rate determination regime for which it (as the primary regulating agency) was not well suited. The OSC did not have enough quantitative information available to it regarding the operations of the

⁵⁵ For a discussion of the mandate of the OSC see Ontario Securities Commission, "Staff Submission In the Matter of Part XV of the By-Laws of the Toronto Stock Exchange (Commission Rates)," November 1981. It is interesting to note that Stanley Beck, when he became Chairman of the OSC, was instrumental in securing the liberalization of entry and ownership in the Canadian investment dealer industry.

⁵⁶ Observations from Beck and Johnston, 304-324.

firms in the industry. This was especially true in respect of a generally accepted paradigm which would allow allocation of the industry's costs across its various activities -- a regulatory characteristic which is common to monopolistic industries such as communications and energy transmission industries. The securities business was an industry characterized by easy entry, by each entrant providing a rather different mix of services to its clients, and by demand that was driven by "animal spirits" rather than by necessity.

Thus, the dissenting Commissioners felt that it was not possible for the OSC to determine the proper level of fixed rates. Indeed, not one witness suggested "that the Canadian securities industry was one that from an economic point of view is suited for rate regulation...[and] it is doubtful if a witness with even a nodding acquaintance with the economics of rate regulation could be found to so testify."⁵⁷ The dissenters suggested that rate fixing may have already resulted in too many brokers for the volume of business transacted on the TSE. Therefore negotiated commissions would assist in rationalization of the industry, increase its efficiency, and result in lower revenues for the industry of some \$18 million. The lower income of the brokers would mirror the savings of individual and institutional investors.

The dissenting Commissioners suggested that it was not the liberalization of commission rate determination which would further concentrate the investment business in a few institutional and market intermediary participants. Public policy in Canada had already set the stage for the institutionalization of savings through manipulation of the income tax system. That was to say, tax expenditures in the form of registered retirement savings funds, registered pension funds, home ownership savings plans, etc., had already diminished the direct activity of the individual investor in the equity market and enhanced the role of the institutions.

Implicitly, the dissenting Commissioners criticized the majority decision based as it was on the incremental decision making model. Indeed, the Commission appeared to

⁵⁷ Observations from Beck and Johnston, 312.

fall into the trap envisioned by the most extreme critics of this process of public policy decision-making.

In the first place, decisions so reached would, of necessity, reflect the interests of the most powerful, since partisans invariably differ in their respective power positions; demands of the underprivileged and politically unorganized would be under-represented.

Secondly, incrementalism would tend to neglect *basic* societal innovations, as it focuses on the short run and seeks no more than limited variations from past policies.⁵⁸

Dror characterized incrementalism

as an ideological reinforcement of then pro-inertia and anti-innovation forces prevalent in all organizations.⁵⁹

That is, from the dissenters' perspective, it is not a reason to reject more radical adjustment regimes for the securities industry just because the consequences of the existing fixed price model are known and predictable, while the uncertain consequences of more comprehensive changes would make the industry vulnerable. The majority of commissioners, which opted for the status quo, did not suggest even one alternative that would lie along the continuum between the status quo and the radical change of negotiated commissions. The dissenters suggested what for them was a second best solution -- a new (lower) fixed rate schedule for a short time while the industry concurrently would prepare for a negotiated commission regime.⁶⁰

The decision by the OSC in 1976, to permit the continuation of fixed commission rates, was a politically efficient one. The pressure for deregulation was sufficiently muted⁶¹, and the influence of the securities industry sufficiently robust to further delay the

⁵⁸ Amitai Etzioni, "Mixed Scanning: A 'Third Approach To Decision-Making,'" Public Administration Review, 387.

⁵⁹ Yehezkel Dror, "Muddling Through - 'Science' or Inertia?" in Readings on Modern Organizations, ed. Amitai Etzioni (New York: Prentice-Hall, Inc., 1969), 169.

⁶⁰ Observations from Beck and Johnston, 324.

removal of the protection enjoyed by the industry. As well there were no serious external threats to the TSE and its members from important regional exchanges or indeed, foreign competitors. The competition from the US exchanges (especially the NYSE) was still not a serious menace and the globalization of financial markets had not progressed very significantly. Apparently, the welfare of the securities industry was not seen to be as vulnerable as it was in fact to be later on, and thus there was no compelling or transparent reason for the majority of OSC Commissioners to remove the protection for the industry. In the context of the overall political environment, the muted public debate around the issue of broker commissions was not directly linked to other public policy issues.

It is not surprising, then, that the OSC was able at this juncture to deflect what little pressure was being put on the regulators to liberalize the commission setting regime. It will be shown later, when the key issue of ownership restrictions was debated, how extensive the influence of the securities industry and its constituent association was.

Commissions Revisited

In 1981 the OSC revisited the issue of fixed commissions. It was clear why the OSC took this step. There was then some six years of accumulated experience regarding the deregulation of commission rates in the US which suggested that the system was working well in that country.^{62,63} the influence of public policy in the US to deregulate large segments of economic activity⁶⁴ was having an important influence on the public

⁶¹ In 1982, when the OSC brought down its decision on fixed commissions after revisiting the issue in 1981, it noted that there was "no strenuous public outcry" to change the fixed rate regime. Ontario Securities Commission, "In the Matter of the Securities Act and In the Matter of Part XV of the By-Laws of the Toronto Stock Exchange," (November and December 1981), in Todd, 90. Moreover, the matter was not raised in the Ontario legislature during 1975 or 1976.

⁶² Dennis Slocum, "TSEs support of the status quo of fixed rates opposed by at least one brokerage house," *The Globe and Mail*, 17 September 1981, B9.

⁶³ In June 1981 the President of the NYSE testified before a Congressional Subcommittee that intensified competition in the securities industry had provided an important stimulus for firms to expand the range of services offered to investors had to diversify their business activities. Noted in Ontario Securities Commission Staff Submission (1981), 24.

⁶⁴ Dennis Slocum, "TSE considers changes in commission rates," *Globe and Mail*, 25 March 1981, B2.

philosophy in Canada regarding the proper role of the state in essentially private economic transactions,⁶⁵ the securities industry itself was moving away from unanimous support of the TSEs position of maintaining the status quo,⁶⁶ and the OSC was of a view that the time was propitious for a reexamination of the public interest in respect of fixed commissions. Indeed, on this occasion the OSC seemed determined to over-turn its earlier decision. The hearings were influenced significantly, not only by the apparently heavy weight it assigned to the public interest, but also by the less than unanimous support for the status quo that had emerged over the preceding five years.

The Commission, however, did not define what it understood as the public interest. It can be implicitly assumed, however, that its earlier decision regarding fixed commissions did not reflect the public interest seen as the "government acting in accord with the actual values held by the majority."⁶⁷ The most that can be concluded about this second enquiry is that the Commission wished to widen the particular interests it would consider beyond the special interests of the broker community.⁶⁸ The reason the OSCs concept of the public interest is opaque, from an academic perspective, follows upon the earlier discussion of the absence of a formal framework for its regulation. That is to say, the OSCs regulatory objectives were not clear with respect to the structure and competitiveness of the securities industry, and that it now wished to act in the public interest was merely rhetoric. Past policy pronouncements perhaps could have been rationalized as in the public interest if the Commission admitted that its intent was to protect the securities industry from undue competition. There was some vague reference

⁶⁵ Douglas G. Hartle, Public Policy Decision Making and Regulation, xi.

⁶⁶ Dennis Slocum, "Midland Doherty back plan for flexible commission rates," Globe and Mail, 24 September 1981, B10.

Dennis Slocum, "Burns Fry Ltd. favors change to freed rates," Globe and Mail, 26 November 1981, B2.

⁶⁷ Barry M. Mitnick, The Political Economy of Regulation, 261.

⁶⁸ The National Anti-Poverty Association (NAPO) argued for abolition of fixed commissions and demanded meaningful competition in the securities industry. The NAPO argued in its brief to the OSC that many of its members received their primary income from funds managed by the institutional investors who would reap the benefits of a liberalized environment. See Dennis Slocum, "Low-income group is against bid by TSE to retain fixed-rate policy," Globe and Mail, 3 December 1981, B6.

in the Commission's 1976 decision regarding the capacity of the Canadian capital market to finance the country's financial requirements in a highly competitive securities industry. This conjecture was unsubstantiated.

Ultimately, the OSC accepted the views of the Director of Investigation and Research, Combines Investigation Act, that "price fixing is thought to be against the public interest. Competition should only be displaced in the exceptional case and that as a matter of policy, people should be able to compete." This presumption in favor of competition finds legislative expression in the Combines Investigation Act, which outlaws various anti-competitive types of behavior. In large measure, the Act limits the use of regulation to the control of situations in which the competitive mechanism can be shown to be inoperative.⁶⁹

In the event, the OSC was unconvinced by the argumentation of the securities industry that the public interest was being served by fixed commissions. The case put forward by the TSE (representing the industry) suggested that:

- (a) fixed commissions had to be maintained in order to ensure that an adequate level of research could be undertaken which would facilitate business development for the TSEs membership;
- (b) if commissions were unfixed the resulting price equilibrium would not be the perfectly competitive level because there were too many market imperfections -- such as the market power of the institutional investors, the resulting concentration of the securities industry, and the volatility of the industry's revenues;
- (c) there would be hardship for many of the firms in the industry and individuals working in the industry;
- (d) fixed rates were required to preserve "liquidity" in the Canadian capital market.⁷⁰

⁶⁹ Ontario Securities Commission, In the Matter of the Securities Act, R.S.O. 1980, Chapter 466 and In the Matter of Part XV and Sections 22.93 to 22.99 of the General By-Law of the Toronto Stock Exchange, from John D. Todd, Price Competition in the Canadian Securities Industry, 91-2.

⁷⁰ Toronto Stock Exchange, Submission to the Ontario Securities Commission Respecting the Unfixing of Commission Rates (Toronto: Privately Printed, 1981).

It is the position of the Exchange that no compelling reason has been made to exchange the present system, which is known to work effectively and to serve the public interest, for an unknown set of circumstances offering theoretical benefits, and the risk of potential detriment for the Canadian markets.⁷¹

Like much of the argumentation put forward by the industry in the past -- and to be repeated in the future -- it was self-serving. The industry failed in its evidence to indicate that the experience of the unfixing of commissions in the US did not support the TSE scenario. Moreover, the OSC was not convinced of the industry's position.

While the OSC in the past has attempted in the public interest to determine whether particular commission rate structures were fair to all classes of investors and, following the 1977 hearing accepted a particular rate structure...as being fair and not contrary to the public interest, the subsequent changes in the securities industry, and its associated activities...have made it increasingly impractical, inappropriate, if not impossible, to determine what is or is not a fair commission rate structure. Accordingly, we unanimously adopt the position taken by the minority at the 1976 hearing...concerning the difficulty in appropriate and fair rate fixing in the securities industry.

We have concluded, on all evidence, that we can no longer continue to sanction a practice, no matter how long it has been in existence, which is contrary to the aspect of the public interest identified in the...Combines Investigation Act.⁷²

Looking through the "public interest" rhetoric, the genuine rationale for the OSCs concerns about fixed commissions appears to relate to the competitive position of the TSE relative to the US exchanges. Canadian "...business flowed to the U.S. as a result of May Day -- May 1, 1975 -- on the New York Stock Exchange, which freed up and reduced U.S. commissions."⁷³ "The move to deregulate commissions in Ontario 'is designed to bring commission dollars lost to U.S. brokers back to Canada,' said Dominic Pitto, a Trader for

⁷¹ Toronto Stock Exchange, Submission (1981), 4.

⁷² Ontario. Ontario Securities Commission. In the Matter of, from Todd, 95-96.

⁷³ "Ontario eyes rate deregulation," Pensions & Investment Age, 17 August 1981, 14.

Toronto Investment Management Co.”^{74,75} Similarly, the US regulatory authorities were concerned about the competitive position of the NYSE relative to the regional exchanges when they acted to deregulate commissions on the NYSE.

On 25 June 1982 the OSC ruled that the TSE had to repeal those of its By-Laws which sanctioned fixed commissions effective 1 April 1983. Thus in Canada, as in the US, the regulatory authorities acted in the long run interests of the securities industry, despite the fact that short-term adjustments could be costly.

***The Aftermath of Commission Liberalization:
The Discount Brokerage Debate in Canada***

An important event associated with the blurring of the four pillars of the Canadian financial system occurred in the aftermath of the OSC decision to liberalize broker commissions. In April 1983 the Toronto-Dominion (TD) Bank introduced a new investor facility -- the Greenline Investor Service (GLIS) -- which offered the investor access to brokerage execution services at a discount. The TD claimed that the authority to engage in the discount brokerage business was contained in Section 190(4)(b) and (a) of the Bank Act which states that a bank may⁷⁶

act as agent of a vendor or purchaser of equity securities if the sale or purchase is effected by a broker or dealer...who is not a bank or an employee of a bank and who is authorized by law to engage in such transactions with members of the public.⁷⁷

⁷⁴ “Ontario eyes rate deregulation,” Pensions & Investment Age, 17 August 1981, 14.

⁷⁵ The share of Canadian interlisted equities traded on US exchanges rose steadily between 1975 and 1980. See Toronto Stock Exchange, “Submission to the Ontario Securities Commission Respecting the Unfixing of Commission Rates,” 27.

⁷⁶ Ontario Securities Commission, “Report on the Implications for the Canadian Capital Markets of the Provision by Financial Institutions of Access to Discount Brokerage Services,” OSC Bulletin (Special Supplement), (Toronto: Dataline Inc., October 1983), 1.

⁷⁷ Bank Act, 1985 Office Consolidation (Ottawa: Minister of Supply and Services, November 1989).

The Bank also argued that it was "relying upon an exemption from registration"⁷⁸ in the Securities Act"⁷⁹ contained in Section 34(1)11:

Subject to the regulations, registration is not required in respect of the following trades:

11. The execution of an unsolicited order to purchase or sell through a registered dealer by a bank to which the *Bank Act* (Canada) applies or a trust company registered under the *Loan and Trust Corporations Act* as agent for a person or company and the trade by such person or company in placing the unsolicited order with the bank or trust company.⁸⁰

The TD Bank proposed to offer the discount brokerage service in conjunction with the discount broker, Equity Trading Inc. They wished to direct the service to those investors who make their own investment decisions. In order to reach this designated group the TD bank developed a sales campaign which comprised mailing information material to the bank's shareholders and banking clients, and placement of advertisements in the print media.⁸¹

Following the start-up of the aforementioned publicity campaign the OSC "was informally requested by representatives of major securities firms to intervene on the basis that GLIS threatened the viability of existing brokers and could lead to bank domination of the brokerage business."⁸² Those opposed to the GLIS put forward six fundamental arguments against allowing it permission to operate⁸³:

⁷⁸ The Ontario Securities Act requires all dealers in securities to be registered unless an exemption is available from the registration requirements.

⁷⁹ Ontario Securities Commission, "Report on the Implications for the Canadian Capital Markets...", 5.

⁸⁰ Ontario Securities Act and Regulations, 1989 (Don Mills, Ontario: Richard De Boo Publishers, 1989).

⁸¹ Ontario Securities Commission, "Report on the Implications for the Canadian Capital Markets...", 4.

⁸² Ontario Securities Commission, "Report on the Implications for the Canadian Capital Markets...", 4.

- (a) the GLIS would violate the long standing separation of functions (the four pillars concept) among Canadian financial institutions;
- (b) the TDs proposed marketing scheme does not fit the "unsolicited order" criterion for exemption from registration with the OSC;
- (c) competition in the securities industry would be diluted as a consequence of the power of the banks as measured both by their branch networks and capitalization -- which swamps the comparable resources available to the investment dealers;
- (d) the potential for conflicts of interest would be enhanced;
- (e) a regulatory void would be created because dissatisfied investors could not appeal to the OSC for help because the TD - GLIS is exempt from registration⁸⁴ and therefore not subject to OSC scrutiny and bank regulators are not sufficiently experienced with the securities business to deal with such issues; and finally,
- (f) there would be a jurisdictional problem in any event because the provincial securities regulatory authorities would be supervising federally incorporated and regulated institutions.⁸⁵

⁸³ Director of Research and Investigations, Combines Investigation Act, "Discount Brokerage and the Role of Financial Institutions: Argument of the Director," September 1983.

Lloyd S.D. Fogler, "Discount Brokerage and the Role of Financial Institutions: Argument on Behalf of First Marathon Securities Limited," September 1983.

Joint Industry Committee, "On the Role of Financial Institutions in the Canadian Securities Industry," September 1983.

McCarthy & McCarthy, "Submissions of the Toronto-Dominion Bank to the Ontario Securities Commission respecting its Open Meetings and Hearings," June 1983.

McCarthy & McCarthy, "Discount Brokerage and the Role of Financial Institutions: Submissions of the Toronto-Dominion Bank on Public Policy Issues," June 1983.

Ontario Securities Commission, "Discount Brokerage and the Role of Financial Institutions: Submission of the Staff," September 26, 1983.

⁸⁴ Implicitly a failure of the suitability rule means that the requirement that every broker who sells or purchases a financial instrument on behalf of a client will not make enquiries regarding the "suitability" of the proposed transaction given the general investment needs and objectives of each client. The enquiry was mandatory in the case of full service brokers, but discount brokers provide only a buy and sell service.

The OSC found that the arguments put forward by the industry were not sufficiently persuasive. In this instance, however, the Commission invoked a more rigorous framework within which this type of decision would be taken than was the case previously.

The commission determined that the test it should apply in considering the implications of discount access services should be based on what is perhaps the fundamental principle of any free society: namely, the presumption that any action is permissible unless it can be demonstrated to be contrary to the public interest...The use of this test reflects the Commission's belief that free market forces should generally determine the availability of a service and that the four pillar concept is an exception from this view dictated by particular circumstances.

The Commission was not therefore concerned with protecting one segment of our financial system from another as a matter of principal. Rather, it sought to determine whether any breaking down of the separation of the investment banking and commercial banking segments of the system resulting from discount access services would prejudice the healthy functioning of the capital markets in Canada.⁸⁶

This more rigorous test applied by the Commission, rooted in the traditional liberal (neo-conservative) ideology which was both prominent and fashionable at this time in the major industrial democracies, was augmented by yet another test: whether the proposed GLIS impinged on the core function of the securities industry⁸⁷ -- defined as underwriting -- in a way which was detrimental to the public interest. In the event, the OSC determined that the

⁸⁵ Thomas J. Courchene, "Financial Markets and the Division of Powers," Photocopied, March 1989, 19. Chapter of a larger study prepared for the Royal Commission on the Economic Union and Development Prospects for Canada.

⁸⁶ Ontario Securities Commission, "Report on the Implications for Canada's Capital Markets...", 16-17.

⁸⁷ Ontario Securities Commission, "Report on the Implications for Canada's Capital Markets...", 26-29.

Discount brokerage is only related very indirectly to the core function of the securities industry. It is not an integral part of the new issue process. It is related indirectly in the sense that it contributes to the liquidity of the secondary market which is essential to the new issue business. On the other hand full service brokerage is more directly related to this business because the full service broker is an important part of the distribution network relied upon by the securities dealer engaged in new issue financing...Accordingly, whether discount brokerage is provided by independent discount brokers or financial institutions with access to discount brokerage services, the impact upon the ability of the securities industry to perform the new issue function will be minimal.⁸⁸

Ultimately the OSC gave a recommendation to the government to permit financial institutions to offer a discount brokerage service. This would be achieved by amending the Ontario Securities Act so that registration would be necessary for any financial institution which engages in buying and selling, even if the service is passive and even if the marketing of the service is limited to advertising its availability.⁸⁹ This was the beginning of the blurring of the four pillars in Canada, despite the OSC's argument in its GLIS judgement that it was not.

for the banks to become involved directly in the distribution of new corporate securities in any meaningful way would require significant amendments to the Bank Act and would require the Commission to grant to the banks an appropriate registration. Both steps would require a fundamental change in public policy which would in all likelihood have the effect of merging the securities industry segment of our financial system with the banking segment.

Obviously such a change is not public policy in Canada today.⁹⁰

⁸⁸ Ontario Securities Commission, "Report on the Implications for Canada's Capital Markets. .," 30-31.

⁸⁹ Ontario Securities Commission, "Report on the Implications for Canada's Capital Markets....," 59.

⁹⁰ Ontario Securities Commission, "Report on the Implications for Canada's Capital Markets....," 51.

Thus, the policy verdict of the OSC was explained away by the decision-makers by using the precepts of the incremental model. In retrospect, however, the influence of the chartered banks in the investment dealer industry became profound. This underscores the idea that the OSC continued the decision-making traditions of the previous decade -- supplying regulatory policies in the absence of a regulatory philosophy. Policy fashion, sprinkled with a dose of liberal ideology, was the driving force behind this decision to allow the banks to participate fully in the discount brokerage. The policy record suggests that the OSC did not have a "model" to help them consider the future organization of the securities industry and thus could not argue that the decision was in the public interest. Indeed, according to the Director of Research and Investigation

The introduction of GLIS may initiate a trend towards a total restructuring of the financial services sector without the necessary regulatory structures being first in place to cope with functional integration....[A]llowing GLIS to go ahead...would introduce a potentially dangerous precedent. GLIS should not be permitted to proceed unless there is consensus among regulatory and political authorities that it is in the public interest...Canadian regulators should resist the trend to integration until sufficient cooperation among the various regulators of the financial services sector can be achieved either to maintain functional separation or, if functional integration is considered to be either inevitable or desirable, to maintain control of the transition.⁹¹

The Staff of the OSC disagreed with the Director and noted that "GLIS has not been demonstrated to be contrary to the public interest".⁹² By the Staff's own admission, its arguments were based on an analysis of a public policy typology developed by the US Securities Industry Association. This typology was essentially a restatement of the economists' rational model, incorporating such factors as market efficiency, innovation, competition, concentration of power, and investor protection.

⁹¹ Argument of the Director of Research and Investigations, in "Discount Brokerage and the Role of Financial Institutions," September 1983, 4-6.

⁹² Ontario Securities Commission, "Discount Brokerage and the Role of Financial Institutions: Submission of the Staff," September 26, 1983, 30.

Also of interest, however, is the fact that the Commission, in two consecutive overarching decisions, did not act in the short-run interests of the securities industry. The momentum associated with policy fashion, in a comparative context, inadvertently pushed public policy in Ontario toward strengthening the longer-run interests of the industry and the financial markets in Toronto. As well, this decision was important in giving rise to the structural changes which were to evolve not many years later.

The UK Experience

The dynamics underlying the deregulation of the financial services industry in the UK, which materialized in the mid-1980s, like the experiences in the US and Canada, were long and tortuous. As in these latter countries, the roots of the liberalization phenomenon were in the fixed commissions on transactions in the London financial market, which were given legitimacy by both the London Stock Exchange (LSE), and the rules for membership in the Exchange itself. Furthermore, there were a number of cross-currents at work in the UK that were also present in the US and Canada.

First, the basic push for a more liberalized environment in which members of the LSE would carry on their business came from within the state bureaucracy (the Office of Fair Trading in the Department of the Secretary of State). It will be recalled that in the US it was the Antitrust Division of the Justice Department that ultimately carried the day in that country with respect to the liberalization of the commission determination process, and the reluctant OSC in Canada. *Second*, the influence of the political ideology of the Thatcher regime, which was in general opposed to state intervention or control of nearly any private sector activity, encompassed the activities of the LSE in its liberalization and privatization net. In the US, there was, during the Ford and Carter Administrations an ideological thrust towards deregulation, while in Canada, during the fading years of the final Trudeau administration, there was increasing disillusionment with the failure of interventionist-type state policies. *Third*, and uniquely British, was the fact that there were a number of scandals in the City⁹³ which called into question the basic character of its prudential supervision. While policy considerations related to this latter issue could be

⁹³ The financial district in London is referred to as the City.

seen as separate from the questions surrounding competitiveness in the London market, in the event the two issues were so closely linked that the "whole" process of structural change and freer market activity (liberalization) became known as the "Big Bang."

In Canada, in this regard, the deregulation of ownership of the securities industry was largely debated outside the boundaries of prudential supervision issues but structural changes among the other financial intermediaries have encompassed the adequacy of supervision question.⁹⁴ In recent years, in Canada, following the collapse of Osler there has been increasing concern in the securities industry about its capacity to protect investors -- particularly the "small" retail clients. In this regard prudential surveillance has been upgraded and the Investor Protection Fund has been restructured and strengthened.

The pressure for reform of the securities markets and institutions in London came from market participants themselves. As was the case in the US and Canada, institutional investors increasingly came to the view that the costs of transacting on the LSE were too high relative to other exchanges in the major financial markets -- especially in New York.⁹⁵ In the late 1970s, following the abolition of exchange controls in the UK, the indigenous firms began to lose their share of the market -- not only in the equity markets where institutional traders began to short circuit the LSE, but also in the Eurobond markets which traditionally had been rooted in London's securities houses -- to the London and off shore offices of foreign owned securities firms.⁹⁶ It will be recalled that it was the institutional investors in the US and Canada, who initially brought pressure to bear on their authorities to allow free bargaining for fees respecting transactions on stock exchanges.

⁹⁴ See Department of Finance, Reform of Federal Financial Institutions Legislation: Overview of Legislative Proposals, Fall 1990, for a general discussion. The new legislation incorporates specific provisions with respect to self-dealing, information disclosure, role of directors and conflicts of interest, in addition to provisions respecting ownership.

⁹⁵ The industry itself was concerned about the adequacy of its capital in the face of lumpy (block) trading by institutions. In a poor market environment (with institutions "selling" the resource of the market intermediaries could be threatened or minimally called into question.

⁹⁶ Maximilian Hall, The City Revolution: Causes and Consequences (London: The MacMillan Press Ltd., 1987), 1.

For the Thatcher administration, the elimination of foreign exchange controls was seen to be a demonstration of the government's commitment to freer market practices, not only in the securities field, but also in the other professions (e.g., doctors, lawyers, opticians, etc.) which increasingly were being criticized by interest groups for their licensing arrangements which had the effect of restricting competition and raising service fees above a fair market level.⁹⁷ The pressure for change was further enhanced some four years after the elimination of foreign exchange controls following a study by the Bank of England⁹⁸ of the investment behavior of institutional investors. It indicated that British investment bankers were losing market share of the securities business to offshore firms. The Bank of England became concerned that

without major reform, Britain's national Stock Exchange could become more isolated and be by-passed in an emerging global securities marketplace, where it was currently little fitted to handle future explosion in international share dealing. And the Exchange's closed-entry system -- had no foreign firms and had admitted almost no new British ones for many years -- was looking ever more anomalous.⁹⁹

It will be recalled that the protectionist, self-interest seeking behavior of securities firms and Stock Exchanges, in both the US and Canada, was a major obstacle to the liberalization of commissions on the major stock exchanges in those two countries. It was not until the very viability of the firms and major exchanges in Canada and the US came into question was there a significant move towards reform.¹⁰⁰ However, the restructuring of the financial system in the UK, as a consequence of the freeing of LSE commissions, was far more profound than had occurred in the US and in Canada. Indeed, the UK

⁹⁷ Adrian Hamilton, The Financial Revolution: The Big Bang and the Explosion of the World's Money Markets (Harmondsworth, Middlesex: Viking Penguin Books Inc., 1984), 130, 132.

⁹⁸ Adrian Hamilton, The Financial Revolution, 130.

⁹⁹ Margaret Reid, All Change in the City: The Revolution in Britain's Financial Sector (London: MacMillan Press Ltd., 1988), 45.

¹⁰⁰ It will be seen below that the liberalization of ownership restrictions of Canadian securities firms in part reflected similar behavior on the part of the principle actors over a period spanning at least two decades. As will be demonstrated, in the final analysis, elected and appointed officials prevailed -- but not until the industry and its representatives had fought a long and hard battle for continued protection from competitive pressures.

authorities and the British industry itself were surprised at its far reaching effects. "Neither Cecil Parkinson nor Nicholas Goodison appears to have appreciated...just how far beyond the walls of the Stock Exchange the combination of commission abolition and freedom of Stock Exchange entry would take the change."¹⁰¹

The process of reforming the City was a complicated one. As noted above, institutional investors were unhappy with the commission structure on the LSE. The process began in early 1979, when the Director General of Fair Trading referred the LSE rule book to the Restrictive Practices Court. The government wanted the Exchange to show why its seemingly restrictive practices were in the public interest. In addition to the fixed commission issue, the government was also anxious about a number of other LSE traditions that had served to constrain competition in financial markets.¹⁰²

- the 10 percent limitation on industry "outsider" ownership of member firms of the LSE;¹⁰³
- the mandated "single-capacity" dealing which entailed a separation between brokers (who deal directly with the investors and whose income is based on the commissions charged for transactions) and the jobbers (who deal directly in the market for their own account -- supplying products to the brokers -- and earn their income from the bid-offer dealing spreads in the market). In other major markets the broker-jobber function is combined in one firm -- known as dual capacity.

...quite early on, advisers to the Exchange began to come to the conclusion that the chances of winning on the fixed commission structure alone were

¹⁰¹ Adrian Hamilton, *The Financial Revolution*, 134. Parkinson was the Secretary of State for the Department of Trade and Industry where the Office of Fair Trading resided; Goodison was Chairman of the Stock Exchange Council.

¹⁰² Maximilian Hall, *The City Revolution*, 12-13 and Cento Veljanovski, "Introduction," in *Financial Regulation - or Over-Regulation?* ed. Arthur Seldon (London: Institute of Economic Affairs, 1988), 2.

¹⁰³ Reflecting the inexorability of change in the City, the LSE Council, in May 1982, decided that it would permit non-industry equity participation in the member firms; the ceiling on individual or institutional ownership was set at 29.9 percent. Maximilian Hall, *The City Revolution*, 12, and W.A. Thomas, *The Big Bang* (Oxford: Philip Allen Publishers Limited, 1986), 12.

poor -- that it would be almost a miracle...How, after all, could one justify this fixed-charge practice, when the whole restrictive trade practices law was aimed at furthering a freer market?¹⁰⁴

In the event, the Exchange decided to add to its defence of the Rule Book the likely demise of "single-capacity" which, it would argue, works against both conflicts of interest between the broker and the client and the public interest.¹⁰⁵ Generally the LSE saw a number of objectionable consequences of single-capacity. For example there would be a

fragmentation of trading activity. Price information would be incomplete, market-makers would be deprived of a substantial volume of business, and the marketability of securities would deteriorate -- since a jobber would not be ready to buy or sell in a reasonable amount at a price reflecting all trading activity; prices would be determined only in partial markets.¹⁰⁶

...From the standpoint of investor protection, the fear was expressed that detection of collusion and the creation of false markets would be more difficult than under single capacity, since jobbers were able to provide information on virtually all market transactions in a security. On the broking side, firms would be able to venture into dealing where they would be undertaking much more risky business. By implication this would render them less stable, particularly if they were undercapitalized and short of dealing expertise.¹⁰⁷

...In this very uncertain environment, it was thought that some firms would fail or go out of business. Others would see advantages in carrying on business outside the Stock Exchange, since they would shed some costs and lessen the regulatory controls they had to observe. Market membership would fall, leading to the dominance of a few large firms, while the volume

¹⁰⁴ Maximilian Hall, The City Revolution, 29.

¹⁰⁵ The single capacity system would likely collapse into a dual capacity system because the brokers, whose earnings are based on commissions, would, in the face of the elimination of fixed commissions look to trading profits to augment their income. This would, in turn, impinge on the business of the jobbers who would try and attract the business of investors. "All the case rested on was the moral rectitude of single capacity" according to a City banker (quote from Maximilian Hall, The City Revolution 30).

¹⁰⁶ W.A. Thomas, The Big Bang, 41.

¹⁰⁷ W.A. Thomas, The Big Bang, 41.

of business on the market would decline and gradually become less representative of the trade in shares...All of this would rebound adversely on the new issue market and the capacity to meet the needs of industry and the public sector.¹⁰⁸

It was with the full realization of the implications of these traditional, if not mythical, implications of enhanced competition that the industry opposed the government's initiatives as contrary to the public interest! The government also had its own interests in mind, in addition to those of the public, when it challenged the LSEs fixed commission regime. That is to say, the UK government was still running a substantial fiscal deficit at the time which was further exacerbated by the high new issuance costs imposed on the public sector borrowing requirement by the securities industry as a consequence of the high commission rates.¹⁰⁹ The UK Treasury was of the view that there were economies of scale in the issuance of gilt stock -- especially since the largest purchasers were institutions which typically purchased large blocks of gilts at each transaction. The Treasury wanted to share in those economies of scale with the securities industry.

The OFT case was in the making for some six years and the LSE, during this same period, was trying to keep the case out of the courts. Change in the City had become paralyzed -- which disadvantaged many firms involved in international trade in securities - although for many brokers whose very existence was threatened by change, the delays in adjustment associated with the Court challenge were found to be comforting.¹¹⁰ The government itself was also tiring of the inordinate delays, the consequences of which threatened the viability of the City as a financial center.¹¹¹ The government was also sensitive to the rapidly escalating legal costs associated with bringing the case to the

¹⁰⁸ W.A. Thomas, *The Big Bang*, 42.

¹⁰⁹ Adrian Hamilton, *The Financial Revolution*, 132 and Margaret Reid, *All Change in the City*, 25. Gilt related revenues amounted to some 30 percent of all commission revenues in the early 1980s compared to about 10 percent in 1986.

¹¹⁰ Margaret Reid, *All Change in the City*, 45.

¹¹¹ Keep in mind that the change that occurred in the City had ripple effects that went beyond the mere removal of minimum commissions.

courts. Thus in the summer of 1983 the Secretary of State (Parkinson) and the Chairman of the Stock Exchange Council (Goodison) reached an agreement that would remove the government's challenge to the LSEs rule book from the ambit of the Restrictive Trade Practices Act. In exchange, the LSE Council undertook to remove the rules which fixed minimum commissions on Exchange transactions; to eliminate the barriers to entry into the industry and thus permit nonmembers to serve in non-executive director capacities of LSE member firms; and, to permit lay members to be selected to sit the Stock Exchange Council (with the approval of the Bank of England).¹¹²

The factors which lay behind the decision of the UK government to remove the challenge to the LSEs rules from the courts to the traditional "back room" bargaining so common in these matters are not clear. The official view, provided by the Secretary of State to the House of Commons on July 27, 1983 suggested that the government had "felt for some time that the court proceedings were not perhaps the best way to deal with the matter of Stock Exchange reform."¹¹³ That was to say

it was a piece of firm decision-making, which had forced on the City change that would otherwise have had to wait years for a court judgement and almost certain appeals to higher courts.¹¹⁴

Needless to say, the OFT having lost the battle of the bureaucrats within the machinery of government,¹¹⁵ disagreed with this assessment suggesting that "the Stock Exchange would have done nothing without the threat of legal action."¹¹⁶ Indeed, the OFT was not given a role to play in the implementation of the Accord between the LSE and the Secretary of State. Its implementation and related matters were left to be monitored by the

¹¹² W.A. Thomas, The Big Bang, 48.

¹¹³ W.A. Thomas, The Big Bang, 47.

¹¹⁴ Adrian Hamilton, The Financial Revolution, 134.

¹¹⁵ The Bank of England was of the view that there was a need to remove the challenge to the LSEs rules from the Restrictive Practices Court because the City was rapidly being challenged by the powerful financial centers of New York and Tokyo (Margaret Reid, All Change in the City, 43). Indeed, the Office of Fair Trading had been left out of all negotiations surrounding the deal between the government and the LSE to remove the case from the courts (Reid, 49).

¹¹⁶ Adrian Hamilton, The Financial Revolution, 134.

Bank of England and the Department of Trade and Industry.¹¹⁷ Part of the reason that the OFT was omitted from the implementation bureaucracy may have been related to the fact that the Accord allowed for a three year phase-in of the provisions agreed upon, and moreover was silent on the issue of single capacity. In the case of the latter point, the OFT was known to be of the view that the government's decision was a major capitulation to the securities industry because the provision was itself a substantive restriction to entry to and competition within the industry.

Finally, it has been hypothesized that the Thatcher government wished to move quickly on the matter of the court challenge because a protracted period of uncertainty surrounding the practices of the City, could serve to undermine or at least threaten the success of the government's political agenda. That is to say, "the government was anxious not to disrupt the projected sales of shares in its various privatization plans. For the immediate future it was important to maintain the *status quo* until most of these had been accomplished."¹¹⁸

Concluding Analysis

This review of the policy decisions surrounding broker commissions across the three countries was intended to illustrate the similarities of the state - securities industry relations. We have seen that cross-border linkages have arisen because of the globalization of financial markets. This phenomenon exerted pressure on the securities industry to adopt practices which in the short run had the effect of minimizing its income flow -- although the resulting structural changes may have been in the long-term interests of the industry. The pressure for change initially flowed from the clients of the industry -- particularly the institutional investors who had come to be the most important equity (and bond) investors. This pressure was manifested in institutional trading on competing exchanges either off-shore or in other regions of the countries which put the primary national markets under stress and brought into question their ability to survive.

¹¹⁷ W.A. Thomas, *The Big Bang*, 49.

¹¹⁸ W.A. Thomas, *The Big Bang*, 48.

We have also witnessed similarities in the behavior of the primary regulators of the securities industry when they were confronted with the initial demands for regulatory change. That is to say, the primary regulators invariably acted to slow the process of change in the face of essentially similar arguments of the industry in each of the three countries. (Indeed, the industry leaders in each of the countries attempted to bolster the arguments of their counterparts in the other countries when each confronted its regulator.) Initially, however, the regulators could be seen to be acting not only in their own interests, in the US, UK and in Canada, but also in the interests of the securities industry. Moreover, the structural relationship between the state and the industry, in part, facilitated the establishment of the barriers to competition which the industry enjoyed.

Structural changes ultimately were realized when the viability of the domestic or national market came under enormous competitive pressures such that its practicability as an effective market was called into question. The ultimate capitulation of the primary regulators was preceded by the "rational-economic" arguments of a secondary bureaucracy which has as its mandate to ensure that anti-competitive laws and principles are not violated. An additional, but important, influence on change in this period was the shifting political ideologies in the three countries, most strongly in the US and UK, which came to question the intrusive role of the state in what were essentially private market transactions. Thus neo-conservative "policy fashion" worked to accelerate the policy of structural adjustment in the securities industry.

When the liberalization of commissions was ultimately realized in each of the three countries, the state was acting to preserve the viability of both a national securities market and industry while concurrently reaping the political benefits that would flow from such a decision.

In the context of these developments, we have demonstrated the existence of linkages, across nations, of the policies associated with regulating the investment dealer industry and the consequent similarities in the patterns of policy evolution in the three countries. We have also demonstrated the importance of "interests" in this policy process and as a result portrayed the generalities of the "persona" of the securities industry which by its nature encompasses frequent and unrestricted interaction with the state.

More particularly, in Canada, for example, the leaders of the individual securities firms and the executive of the Investment Dealers Association (IDA),¹¹⁹ with which most firms are affiliated, are well connected to elected officials and senior bureaucrats in the economic portfolios, including the central bank. They meet with these officials on a regular basis to exchange views not only on current economic and financial conditions and policy but on specific policy outputs as they affect the securities industry. On the supervisory side, "The IDA maintains continuous contact with provincial securities commissions with a view to streamlining self-regulation procedures."¹²⁰

The bottom line of this analysis is that close concertation characterized the relationship between the state and the industry, which in time colors the lens through which the state looks at the industry.

¹¹⁹ The IDA, an Self Regulatory Organization (SRO), is also well connected to the leaders of the OSC from whom the SRO authority is delegated.

¹²⁰ The Canadian Securities Institute, The Canadian Securities Course (Toronto: Privately Published, 1985), 232.

CHAPTER FOUR

COMPLETING THE ANALYTICAL FRAMEWORK

Introduction

The chapter has two purposes: *first*, to conclude the literature review in order to highlight the additional scholarly work which will assist in validating the qualitative character of the dissertation's framework; and *second*, to set out the broad framework for analyzing the political decision to liberalize entry and ownership in the Canadian investment dealer industry -- which is the focus of the second part of this dissertation.

The two step process which has been used to complete the literature survey and set out the analytical framework was necessary so that the reader could become familiar with the "traditional" relationship between the state and the securities industry. This in turn will facilitate the understanding of the empirical journey upon which we embark in the second half of the dissertation.

The "empirical" analysis which follows in Part Two is an outgrowth of the preceding chapter, and thus continues the examination of a policy field over time and space. Looking at the policy field over time reveals the emergence of patterns which influence the development of policies, and the decision processes surrounding them, in respect of the securities industry. Looking at the decision over space highlights the early and persistent tension between the key policy actors in Ontario and Quebec. The influence of the federal authorities will become apparent near the end of the episode. Indeed, the emergence of the most prominent patterns in time and space shaped the choice of variables that have governed the explanation of liberalization in the Canadian securities industry.

While the focus of the main analysis is Canada, the preceding chapters, especially the one just completed, indicate that the events and subject matter to be examined must be seen from a comparative perspective. The developments in Canada are both the mirror image of the changes that had occurred earlier in some countries and foreshadow changes which would occur later in others. Because of the federal nature of the Canadian state, and the division of powers between the federal and provincial governments in the area of banking and investment banking, we cannot speak of the policy output in the financial field as emanating from a monolithic actor. Thus, examination of the Canadian case adds a dimension of federalism that would not be as important for most other countries in the OECD area, save the United States.

The financial industry generally, and the securities industry in particular, have not been studied in a scholarly manner in Canada, from this perspective. The little scholarly work that does exist is largely prescriptive and seen from the perspective of both market efficiency and from some notion of the public interest which is rooted in traditional welfare economics. Courchene's work does recognize Stigler's contribution to the ideas surrounding regulation -- but the scope of his work is very much narrower than what is being pursued here.¹ Coleman's work, discussed in the following section, addresses the structural relationship between the securities industry and the state.² Pauly's work³ focuses on the banking industry in the advanced capitalist countries on the Pacific Rim, including Canada. His work examines and explains the convergence to a regulatory standard in a number of regimes and concludes that much of the impetus for change in the banking industry was related to the advocacy activities of foreign banks. The bottom line

¹ See Tom Courchene, "A Really Secure Industry or A Real Securities Industry," Centre for the Study of Canadian Economic Policy, Working Paper No. 84-01, A Submission to the Ontario Securities Commission in respect of its Securities Industry Review, November 18, 1984; and "Crumbling Pillars: Cavalier Destruction or Cavalier Demolition?" Conference on Deregulation and Reregulation, Lethbridge, Alberta, September 1989.

² William D. Coleman, "Self-Regulation in the Canadian Securities Industry: A Study of the Investment Dealers Association of Canada," *Canadian Public Administration*, Winter 1989.

³ Louis W. Pauly, *Opening Financial Markets: Banking Politics on the Pacific Rim* (Ithaca, New York: Cornell University Press, 1988).

of all of these Canadian studies is that they do not examine the detailed character of financial regulation decision-making in this country nor the decisions themselves.

This dissertation sets out a framework for analyzing the decisions in light of three streams of literature: the political economy of regulation, interests and the public interest, and the comparative analyses of the financial services industry. The politics of policy fashion and ideas, and of inter-provincial competition (competitive federalism) in the supply of public policy also play a role in understanding the final decision to liberalize the Canadian securities industry. This literature will be reviewed before the analytical framework is completed.

This dissertation does not propose a new theory -- because it is clear that a general theory of regulation cannot be derived from an industry study. But a comprehensive and transparent framework for analyzing regulatory policy in the Canadian financial services area is developed.

The State-Industry Relationship Again: The Roots of the Analysis

The relationship between the securities industry elites and the bureaucratic and political establishments is especially close compared to the relationships between other pressure groups and the state. The close relationship arises not necessarily from so-called "lobbying" encounters between the state and industry elites (although that does occur), but more from the day-to-day business interaction of representatives of the two organizations. This results in the development of an ongoing partnership between them. In the US, for example,

Some critics...question the Treasury's close relationship with...the Public Securities Association. Its members, which include the big bond-trading houses, consult with the Treasury on the structure and scheduling of new issues.⁴

⁴ Diana B. Henriques, "Free-Wheeling Treasuries Market Is at Turning Point With Congress, The New York Times, 3 September, 1991, D?.

Thus, in matters of finance, governments need the members of the financial services industry as much as they need the government officials. Government finance is a "high profile" activity. The relative cost of any government financing operation to that of another government (i.e., the interest rate spread between two sovereign borrowers) is a reflection of the political credibility of the borrowing entity itself, as is the successful distribution of a borrowing operation. Governments rely heavily on the advice they receive from the investment dealer community to help preserve their credit standing. Discussions associated with a government financing operation, which is facilitated by a syndicate of investment dealers, necessarily involves intimate and detailed discussions between the leaders of the borrower's syndicate and senior appointed and elected officials.

In Canada, at both the federal and provincial levels, it is not unusual for ministers of finance and senior appointed officials to meet with their borrowing syndicates immediately after the tabling of a budget, to discuss a borrowing timetable to meet its cash requirements. These consultations are typically characterized as "road shows," and are designed to "assure" the financial communities of North America, Europe and Japan of the credibility of their governments' financial policies.

These contacts have created a structural relationship between the securities industry and the state. These relationships eventually influence the attitude of the state towards the industry. For example, the following initial assessment, in the aftermath of the Salomon Brothers violation of the US Treasury's bond auction rules, is a typical but rather crude reflection of the widely accepted interpretation of the relationship between the state and the industry:

Despite Salomon Brothers Inc.'s admission that it violated government-bond bidding rules, the securities firm isn't likely to be barred or suspended from Treasury auctions, government officials say. The reason: Salomon is such a big player that the government can't afford to keep it out.

The mammoth \$2.2 trillion Treasury securities market has been among the most lightly regulated U.S. securities markets. Government regulators have been reluctant to impose much control on government-bond dealers because they need them to finance the huge national debt.

And major bond dealers long have played on these fears, warning Washington that tougher regulation will only drive up the government's borrowing costs.⁵

These relationships are comparable in Canada (where the regulation is also "light") and go back as far as World War I, but the very close reliance of the federal government on the Investment Dealers dates from the 1930s when the IDA was asked to formally organize itself to provide advice to the government.⁶

William Coleman has developed a typology⁷ to link the securities industry and the state. The typology is used to model the enhanced participation of the IDA in the management of both securities legislation and its members' professional behavior, in the context of its responsibilities as an Self Regulatory Organization (SRO). Much like Pross' model⁸ of interest group maturation, Coleman develops a continuum along which the IDA evolved into a full fledged SRO policy-maker as opposed to the more traditional policy advocate role usually associated with trade associations.

The policy network (or community as Pross called it) moved along the developmental continuum from pure policy advocacy (characterized as pressure pluralism), through a dependency relationship of the state on the industry (clientele pluralism) to a concertation network where

a single association represents a sector and participates with a corresponding state agency in the formulation and implementation of policy. The state agency has considerable capacity in its own right, being

⁵ Kevin G. Salwen, David W. Wessel, and Tom Herman, "Salomon Brothers Unlikely to Be Barred," The Wall Street Journal, 13 August 1991, C1. In the event Solomon was penalized by the Treasury and the Federal Reserve Bank of New York -- though not very severely. As well, the auction techniques for US Government security issues was altered.

⁶ Investment Dealers Association, "Memorandum regarding the Meeting between representatives of the Investment Dealers Association of Canada and the Hon. Mr. Dunning, Dominion Minister of Finance and Mr. W.C. Clark, Deputy Minister of Finance in Ottawa, IDA Bulletin, February 1936.

⁷ William D. Coleman, "Self-Regulation in the Canadian Securities Industry: A Study of the Investment Dealers Association of Canada."

⁸ Paul Pross, Group Politics and Public Policy, Part II.

autonomous and able to concentrate power for coordinated decision-making. Sectoral interests match the state's strength by drawing on an inclusive, hierarchical associational system capable of engaging in longer-term policy deliberations while maintaining members support.⁹

While Coleman's typology is interesting, its primary use is to explain the reasons for the involvement of the IDA as a SRO in the prudential supervision of the securities industry. From the perspective of this dissertation it confirms the existence of the earlier noted structural relationship between the state and the industry. However, the typology provides limited guidance about the rationale for the character of the SROs policy output. Indeed, given the objectives of this project, it is clear that Coleman's model does not have the capacity to provide an analytical framework to explain the state's action to protect the interests of the securities industry over time. Moreover, contrary to what would have been predicted by the Coleman typology -- activities or advice designed to protect the "public interest" rather than the particularistic interests of the industry -- the IDA played the role of a "traditional" pressure group and the policy advocate, as would have been predicted by the Pross model.

Having said all that, this dissertation does, after-all, incorporate in its analysis of the decision-making process elements from the perspective of both the policy community and policy network literature. Early on, and continuing through much of the period considered in this project, the relationship between the OSC and the securities industry can be seen from the perspective of clientele pluralism. Moreover, the distinction between this latter concept and the one of "capture" is not very transparent. Indeed, a distinction between capture and clientele pluralism is not substantive from the perspective of this undertaking.

The structure of the relationship between the state and the securities industry is one of dependence. Coleman suggests that clientele pluralism results in a network characterized as a period during which "state officials are unable to differentiate themselves from organized interests. They become dependent on interest associations to

⁹ William D. Coleman, "Self-Regulation in the Canadian Securities Industry: A Study of the Investment Dealers Association of Canada," 505-6.

supply information and expertise and to ensure member compliance and offer them an opportunity to participate in the policy process in exchange."¹⁰ Subsequently, as the policy dilemma evolved, the policy community extended beyond the OSC and the members of the industry, to include users of capital and of the services provided by the securities industry, other members of the financial services industry, other provincial regulators, and finally the federal government's interested bureaucracy.

Perhaps more relevant are the lessons to be gleaned from Michael Moran's examination of the liberalization of financial markets in the UK in the early 1970s.¹¹ In brief, the changes (known as Competition and Credit Control) were implemented by the UK Treasury and the Bank of England to permit a more competitive and market oriented process of credit allocation in the British economy. Prior to the changes, the credit distribution process across the economy was rooted in the moral suasion of the central bank. That moral suasion was successful for so long in the UK can be attributed to the strong perceptions of the Bank's legitimacy by members of the banking community and to the associated robust structural/institutional linkages between the Bank and the private bankers.

From the perspective of this dissertation, what is of interest in Moran's analysis is not so much the character of these changes which were introduced to the London financial market, but the identification of the underlying forces (the linkages between the key public and private sector decision-makers) that gave rise to the changes. The forces upon which Moran draws are rooted in both complexity -- intellectual, social and administrative -- and philosophy of governance -- esoteric and exoteric politics.

On the conceptual notion of complexity, Moran accepts Simon's prescription that full rationality of public policy-makers is not achievable because the intellectual capacity of humans is limited. This limitation, coupled with the complexity introduced by the

¹⁰ William Coleman and Grace Skogstad, 'Policy Communities and Policy Networks,' in Policy Communities and Public Policy in Canada (Mississauga: Copp Clark Pitman Ltd., 1990), 27.

¹¹ Michael Moran, The Politics of Banking: The Strange Case of Competition and Credit Control (London: Macmillan Press, 1984).

natural tendencies for individuals to engage in self-interest seeking behavior (human inventiveness) creates further uncertainty for public policy-makers. The process of harnessing this latter uncertainty -- social complexity -- gives rise to the bureaucratic growth which is required to deal with problems of social control. The growth of the bureaucracy in turn causes administrative complexity.

During the years prior to the introduction of Competition and Credit Control, in the absence of complexity, the state (in this case the UK Treasury and the Bank of England) was able to engage in esoteric politics -- informal and private interaction with the financial sector (the so-called "wink-and-nod method" of governance) to achieve monetary policy related objectives. However, in the face of complexity, which was manifest in the financial system by the key private players working to "get around" the discretionary rules supplied by the bureaucrats in the Treasury and central bank, a more formal (open and partisan) framework was required to keep the players in line with the wishes of the public policy-makers. This latter phenomenon is characterized as exoteric politics.

The practice of esoteric politics within the UK financial system was possible

because of the unusual social cohesion of the banking elite, and because the Bank of England exploited that cohesion to protect the system from exoteric influences. To sustain esoteric politics for so long was an extraordinary achievement in a society where elites of birth and kinship were under attack, where bureaucratic organization was spreading rapidly, and where partisan political argument was engaging in an increasingly wide range of issues. By the end of the 1960s the esoteric system was finally showing signs of stress. Competition and Credit Control was a response to that stress. The problems caused by implementing Competition and Credit Control further weakened esoteric politics and made the politics of money and banking even more exoteric in character.¹²

This distinction between esoteric and exoteric politics as applied to a financial system characterized by advancing complexity is an alternative, and helpful way, of accounting for the liberalization phenomenon that occurred in the Canadian securities

¹² Michael Moran, The Politics of Banking, 27-28.

industry almost a decade later. That is to say, the pressures of domestic competition, international globalization, self-interest seeking behavior by special interests and competitive federalism are explanatory variables that can be cloaked in Moran's notion of "complexity." More particularly, as globalization became an increasingly important factor impinging on the fortunes of the financial system during the 1970s and early 80s, a political dynamic was put in place which ultimately gave rise to changes in the structure of the securities industry. The special relationship between the industry and the state appeared to be altered from a situation of apparent capture to one of more formal rules where there is less room for discretionary decision-making by regulators and politicians. In Moran's analytical framework there was a movement along the esoteric - exoteric continuum during the period when the impulses of globalization were being transmitted.

Overarching the issues of complexity and governance, Moran searches for the origins of policy change. He suggested that policy is the product of:

- the rise and fall of fashion among those who make decisions;
- enquiry carried out by professional academics;
- party competition in a system of adversary politics;
- the demands of powerful economic interests;
- the workings of what Allison and Halperin call 'bureaucratic politics.'¹³

Moran does not ascribe much weight to the explanatory power of policy fashion, the influence of academics or the system of adversary politics, to policy change. Indeed, he tends to rely more on the potency of interests and bureaucratic politics to account for the changes in the UK's financial market structure in the early 1970s. Although the first three explanations are always in the background of Moran's typology, it is the case that the state ultimately succumbed to the requirements of the private banking system. For Moran, this simply reflects the influence of financial interests but not "capture." That the Bank of

¹³ Michael Moran, *The Politics of Banking*, 29.

England supported these changes was attributed to the fact that esoteric politics was not working effectively, and if the Bank did not change its operating procedures for monetary policy implementation, it would lose its influence on macroeconomic policy-making in the British machinery of government to the Treasury -- a central agency which was already breathing down its neck.

The lessons from Moran's analysis are helpful in highlighting and sometimes validating the arguments on which this dissertation anchored. *First*, the influence of both policy fashion and academics seems to be undervalued by Moran -- factors which illuminate our understanding of regulatory change in Canada. According to Moran, "Academics dislike accounts of change which are phrased in terms of fashion"¹⁴ because it seems to locate policy "outside the area of political analysis altogether."¹⁵ Moran, in down-playing the explanatory power of the "fashion" argument, gives inadequate recognition to the influence of competition from offshore markets and to the threat to the London market of continued bureaucratic intrusion into the credit allocation process. Thus, if London institutions were unable to "keep-up" with other financial centers its very viability as an international market would be compromised. Indeed, it is factors emanating from "fashion" (or spread of ideas) on the international scene that gave rise to changes in financial regulation policy across a number of OECD countries -- and was important in Canada.

Moran also questions the notion that academics had convinced the policy-makers in the UK of the need for financial sector reform. However, I think here as well Moran understates the influence of academic ideas. The UK authorities, constrained as they were by more competitive financial markets off-shore and a limited menu of alternative policy control regimes, opted for measures that were both fashionable and prescribed by academics. As already outlined, financial deregulation as a political phenomenon was unquestionably given its stimulus by academics -- especially from the US scholarly community.

¹⁴ Michael Moran, *The Politics of Banking*, 34.

¹⁵ Patrick Dunleavy, *Urban Political Analysis: The Politics of Collective Consumption* (London: Macmillan, 1980), 99. Quoted in Michael Moran, *The Politics of Banking*, 34.

Second, on the question of capture, Moran seems to ignore the relationship between the theoretical construct and the enduring structural relationship between the banking elite and the state. Recalling Mitnick's "capture" typology, based as it is on the transmission of 'information' between the state and the objects of regulation (or in this case instruments for the implementation of monetary policy) there is a strong desire for authorities to create an environment which will achieve their objectives. In the absence of a well functioning banking system the policies of the central bank would be compromised. Moran's analysis seems to impose too many restrictions on the meaning of "capture." The success of monetary policy required the cooperation of the banking system just as a vibrant financial market later on required a relatively liberalized securities industry.

The bottom line of Moran's analysis vis-a-vis its relevance for this dissertation is: interests are important in public policy decision-making -- interests of both public and private sector actors; and, the special linkages between the bureaucrats and financial and industry elites are important in formulating the character of public policy supply.

Interstate Relationships: Competitive Federalism

Inasmuch as a good deal of the process of policy change in the area of financial regulation involved skirmishes between Ontario and Quebec, a small important body of literature which has had an importance influence on this project is the ideas surrounding competitive federalism. Competitive federalism in its simplest terms can be seen as competition between governments of the federation in the supply of public policy. However, the dominant scholarly formulations of federalism in Canada revolve around the concept of cooperative federalism or executive federalism.

The benefits of competitive federalism have been advocated most recently by Albert Breton in his supplementary statement to the Royal Commission on the Economic Union and Development Prospects for Canada.¹⁶ The concept of executive federalism was formed by Donald Smiley in the 1960s as an alternative to cooperative federalism which

¹⁶ Albert Breton, "Supplementary Statement," Report of the Royal Commission on the Economic Union and Development Prospects for Canada (Ottawa: Canadian Government Publishing Centre, 1985), 486-526.

was developed in the US in the 1930s.¹⁷ Smiley views Canadians as living "under a system of government which is executive dominated and within which a large number of important public issues are debated and resolved through the ongoing interactions among governments."¹⁸ The problem with Canadian federalism, according to Smiley, is that there is no "institutional machinery" to resolve policy disputes at the intergovernmental level.¹⁹ From Breton's perspective the cooperative federalism envisaged by cooperative federalists

...does not necessarily eliminate federalist competition, but by moving it into executive and bureaucratic offices and corridors, it mutes its public manifestations and effectiveness. The heart of co-operative federalism is secret deals, not the stuff on which a lively democracy thrives!

...Those who seek co-operative federalism and labour for its realization, seek and labour for a unitary state, disguised in the trappings of federalism, but from which competition would have been reduced or even eliminated.²⁰

Breton's alternative to cooperative/executive federalism is competition; and for purposes of this project the relevant concept for inter-provincial dealings is "horizontal competition." Indeed, for Breton the presence of "efficient" competition among governments will be socially beneficial -- "measured" by using some construct such as the social welfare function. Moreover, it is probably fair to say that since Tiebout's paper in 1956, the benefits of intergovernmental competition have never been seriously questioned.²¹ Breton's theorizing about the concept competitive federalism can be located within the economists public choice paradigm. Here, the overarching contribution which the state can make to a well functioning decentralized federal economy is efficiency and equity. At

¹⁷ Garth Stevenson, "Origins of Co-operative Federalism," 7; and, Richard Simeon, "We are all Smiley's People: Some Observations on Donald Smiley and the Study of Federalism," 412-413, in Federal and Political Community: Essays in Honour of Donald Smiley ed. David P. Sugarman and Reg Whitaker, (Peterborough: Broadview Press, 1989).

¹⁸ Donald V. Smiley, The Federal Condition in Canada (Toronto: McGraw-Hill Ryerson, 1987), 83.

¹⁹ Donald V. Smiley, The Federal Condition in Canada, 85

²⁰ Albert Breton, "Supplementary Statement," 494-495

²¹ Charles M. Tiebout, "A Pure Theory of Local Expenditures," Journal of Political Economy, October 1956, 416-424.

a minimum, to satisfy the efficiency requirement there must be "free trade" -- the unobstructed flow of goods, services and capital -- within the boundaries of the nation state.²²

In Breton's discussion, for efficient horizontal competition to be realized it is not necessary for the competing units to be of equal size -- but one province or state cannot dominate the other continually. The second requirement is that there should be no externalities (positive or negative) that are not borne by the government or citizens of the province supplying the public policy.

With respect to the liberalization of entry and ownership rules in the securities industry, Breton's concern about the "size" of the political entities is not really relevant because the main "competitors" in this skirmish were Quebec and Ontario. The federal government was on the sidelines for much of the time. However, with respect to the second condition, for a long period Ontario's rather inflexible position on liberalization of the investment dealer industry had unquestioned negative externalities for the rest of the country, but they were not always apparent. That is to say, the stifling of competition within the securities industry would have had the undesirable effect of reducing financial market efficiency generally, inhibiting investment in computer technology, reducing the scope for innovative financial engineering, and ultimately increasing the cost of raising capital for everyone in the country. Thus for Breton, the presence of these "uncompensated" externalities would render the competition among Quebec and Ontario as inefficient. Indeed, to use Smiley's vision, some institutional mechanism to resolve the differences would have been preferable, because the course that was followed was probably not very cost effective.

Courchene, on the other hand, uses the harmonization of regulations surrounding the securities markets -- among the provinces -- as "a sphere of economic activity where they appear to have performed quite admirably."²³ More generally, however, Breton's efficiency requirements would not be satisfied in the context of Courchene's argumentation. Indeed, Courchene suggests that

²² Robin Boadway, *The Constitutional Division of Powers An Economic Perspective* (Ottawa: Economic Council of Canada, 1992), 23.

²³ Tom Courchene, *Economic Management and the Division of Powers* (Toronto: University of Toronto Press, 1986), 165

there are powerful forces at work in the system to ensure some considerable degree of harmonization. For example, the TSE is by far the largest stock exchange in the country. Hence the decisions of the TSE and the OSC will naturally have an important (inordinate?) influence on the regulations in other provinces, particularly the smaller ones. The options for the smaller provinces are limited: if they want to have a different set of regulations with respect to disclosure, they will have to build up a qualified staff of experts to deal with the differences in the regulatory system. For most provinces, these extra costs do not warrant moving away from Ontario legislation.²⁴

In Breton's terms this would be inefficient competition and therefore not socially desirable. In fairness to Courchene he recognizes that decisions and actions by provinces are not always taken from the national social welfare perspective.

On occasion parochial interests have even become dominant to the detriment of the efficient functioning of the market. The prime example is the implementation of a policy in 1969 by the Quebec securities Commission requiring orders received in Quebec to be filled on the Montreal or Canadian stock exchanges; the application of the policy as a basis for disciplining a registrant for executing a Quebec order on the Toronto Stock Exchange resulted in a retaliatory amendment to the Toronto Exchange's by-laws precluding arbitrage transactions by its members with the Quebec exchanges and thus served to some extent to balkanize the Canadian market.²⁵

In this connection, in this work for the Macdonald Royal Commission, Courchene did not relate the consequences of his analysis of the entry and ownership issues, and his personal involvement in the deliberations which ultimately gave rise to the liberalization decision in Ontario.²⁶ Indeed, in this latter work Courchene located responsibility for the protective provisions in the Ontario investment and ownership rules in the lap of the industry -- with no particular assignment of liability to the Ontario Government or the OSC. However, Courchene's bottom line was that "It would appear that an umbrella orga-

²⁴ Tom Courchene, *Economic Management and the Division of Powers*, 165.

²⁵ Philip Anisman and Peter Hogg, "Constitutional Aspects of Federal Securities Legislation." In *Proposals for a Securities Market Law for Canada*, Volume 3, 142. Quoted by Courchene, *Economic Management and the Division of Powers*, 166.

²⁶ See Tom Courchene, "A Really Secure Industry or A Real Securities Industry."

nization like a Canadian SEC (to which all exchanges would report) would tend to if anything to strive for uniformity and inhibit innovation by individual exchanges"²⁷ did reflect Smiley's earlier ideas.

In addition, Alan Cairns suggested as early as 1979 that federalism in Canada included "the coexistence of powerful *dirigiste* governments at both levels. As a result... the ratio of cooperative to competitive tendencies has shifted to the detriment of the former, and the stakes of competition have increased."²⁸ Indeed he was about as critical of intergovernmental relations in Canada as was Breton. In many respects Cairns opposed the growth of governments, associated as it was with province building, unrestrained by constitutional or federalist precepts. More simply, as Breton would have characterized the scene, the competition amongst governments of the federation was inefficient. Cairns noted in part that

The contribution possible under classical federalism to simplifying the managerial task of governments disappears under a system of big *dirigiste* governments at both levels. Like lumbering mastodons in tireless competition these governments are possessed of an infinity of weapons capable of wreaking deliberate and inadvertent harm on each other, but incapable of delivering a knockout blow.

The federalism of contemporary big government at both levels can best be understood in terms of the tendency of each government to seek to minimize the policy contradictions in its own jurisdiction and reduce the environmental uncertainty emanating from the conduct of other governments. Hundreds of officials at both levels are employed in this enterprise. Each government, in brief, strains, to exaggerate somewhat to attain and exercise powers of a unitary state. This tendency is unavoidable as long as each government views the conduct of the other governments as threatening to its own pursuits.

It is logically impossible for each government simultaneously to succeed in controlling the environmental uncertainties caused by its rivals. The effort to do so produces struggles between governments and innumerable 'cooperative' ventures which are serious failures.²⁹

²⁷ Tom Courchene, *Economic Management and the Division of Powers*, 167.

²⁸ Alan Cairns, "The Other Crisis of Canadian Federalism," *Canadian Public Administration*, Summer 1979, 178.

Cairns was equally pessimistic in his presidential address to the Canadian Political Science Association when he proclaimed that

The presence in the Canadian federal system of eleven governments, each honeycombed with bureaucratic interests and desires...helps explain the expansion of each level of government, the frequent competition and duplication of activity between governments, and the growing impact of government on society.³⁰

From the public choice perspective, the overlap and duplication of powers within a federal system "facilitate the signalling of citizen-consumer preferences about the mix of goods and services they wish to see provided by the government...[and]...also afford wider opportunities for internalising any negative interdependencies between individuals and/or organisations (public and private) and for seeking remedies for the incurring of consumption costs"³¹-- just as does the price system

These are interesting and relevant observations from both Cairns and Sproule-Jones which will assist us in understanding how and why the liberalization of the securities industry regulatory environment evolved as it did. It will be seen that competition, between Quebec, as nation-builder, and Ontario, as a preserver of the status quo, (attempting to maintain what it had earlier captured from Quebec), gave rise to the re-emerging policy deliberations surrounding the liberalization of the industry. The benefits of the process would be narrowly based among the members of the investment dealer industry and its costs widely dispersed among the users of capital including the governments themselves. One of Courchene's conclusions in his work for the Macdonald Royal Commission was that "The competition between jurisdictions at the provincial level likely implies that, in certain areas at least, the most lenient jurisdiction will set the

²⁹ Alan Cairns, "The Other Crisis of Canadian Federalism," 191-192.

³⁰ Alan Cairns, "The Government's and Societies of Canadian Federalism," Canadian Journal of Political Science, December 1977, 704.

³¹ M.H. Sproule-Jones, Public Choice and Federalism in Australia and Canada (Canberra: The Australian National University, Centre for research on Federal Financial Relations, Research Monograph No. 11), 42.

standard which other jurisdictions may be forced to meet."³² This will be seen as a prescient statement.

The Influence of Ideas

The arguments that have been made, and will continue to be made, are that the environment surrounding the securities industry, internationally, has changed. This itself has been an impetus for change in the indigenous industry -- but was resisted. It will be seen that economic change was an element in causing the change.³³ The lengthy process required to achieve it was in large part related to the fact that there was really no champion for change in Canada until well into the 1980s. Thus, while the ideas regarding liberalization of the securities industry were well enunciated and the economic conjuncture clear, the self-interest seeking behavior of the industry and the weakness of the dominant regulator -- having been captured by the industry -- prevented change from occurring quickly. Lewis explains that

People create political structure. They also receive it from the past. The received value mix that is political structure exists in persons and institutions. The received value mix of contemporary persons and institutions consists of the laws, customs, beliefs, and desires that have animated, regulated and directed agencies of the state and their constituent and clientele networks in the past.³⁴

The industry had power therefore because of its relationship -- both formal and/or informal -- with the OSC and other important policy actors at numerous levels in both the provincial and federal governments which gave it legitimacy.³⁵

³² Tom Courchene, Economic Management and the Division of Powers, 181.

³³ Paul J. Quirk, "In Defense of the Politics of Change," Journal of Politics, Volume 50, 1988, 31-41. See also Martha Derthick and Paul Quirk, The Politics of Deregulation.

³⁴ Eugene Lewis, "Public Entrepreneurship and the Teleology of Technology," Administration and Society, May 1988, 120.

³⁵ Eugene Lewis, Public Entrepreneurship: Toward a Theory of Bureaucratic Political Power (Bloomington: Indiana University Press, 1980), 2.

Change can also be seen from the perspective of those who have the power to make change. Their belief systems, their sense of history, their self-interest or indeed of what is right from a social welfare perspective. These characteristics were important through the long process which finally gave rise to the policy change in Canada. The ultimate policy change could be seen as a consequence of the influence of public policy entrepreneurs -- a minister of financial institutions in Ontario, a minister of state in the federal government, and chairmen of the QSC and OSC.

A public entrepreneur may be defined as a person who creates or profoundly elaborates a public organization so as to alter greatly the existing pattern of allocation of scarce resources. Such persons arise and succeed in organizational and political milieus which contain contradictory mixes of values from the past. Public entrepreneurs characteristically exploit such contradictions.³⁶

There are really two forces that emanate from Lewis' interpretation of the entrepreneur as it relates to the liberalization of the securities industry. *First* there was the lengthy debate among the key actors involved which persisted over a period of a decade and a half. The debate was at times very vigorous, but perhaps more importantly the ideas imbedded in the debate-- and its length -- may have become themselves a vehicle for change. Hood makes this point quite clearly.

...it often happens that we change the world in the very process of observation or explanation. Indeed, such self-fulfilling or self-defeating processes are pervasive in social science, and most of all in economics. Here the argument would be that the "Chicago" explanation of how regulation worked was (paradoxically) self-defeating because the theory was fed back into policy design. The claims of economics professors about "welfare losses" caused by regulation and their ideas about regulatory design turned out to be more powerful than the supposedly "iron laws" of self-interest in politics on which their theories were built.³⁷

³⁶ Eugene Lewis, Public Entrepreneurship: Toward a Theory of Bureaucratic Political Power, 9.

³⁷ C.C. Hood, Explaining Policy Reversals (Buckingham: Open University Press, 1994), 28.

Second, the optimum time for the ideas of liberalization in the securities industry to take hold within "official" circles occurred on the occasion of the appointment of a new chairman of the OSC -- and especially because it came on the heels of a change in the provincial party governing the province. An enduring feature of the liberalization debate, occurring against the background of an economic conjuncture that had changed dramatically from the period when restrictive rules were first put into place, set the stage for a public entrepreneur to "run with the ball." This occurred because the new governing party in Ontario and a new chairman of the OSC were sufficiently autonomous from the old structures which had served to validate and solidify the restrictive apparatus. The ideas of liberalization in the securities industry had been around for a long time and when the decision to liberalize was finally taken in 1986 there was little in the way of political costs that would have to be borne.

Finally, Moran aside, there is the influence of ideas on policy change. Changes in regulatory structure occurred in the UK, the US, in a number of other OECD countries and in Ontario and Quebec, for example. And we will see that the stimulus for change can come from many sources. Indeed, even Moran admitted that "When like-minded people constantly communicate privately and informally, and read the same reports and journals, they reproduce exactly the social conditions which make the spread of fashion likely."³⁸ This is certainly a reasonable depiction of behavior of participants in the financial services industry.

Furthermore, both Moran, and Derthick and Quirk admit to the power and influence of economists in bringing the more general deregulation phenomenon to the political agenda of the industrialized societies. The latter were more equivocal than Moran. They were "convinced" that if not for the critique of government regulation, regulatory reform -- in the United States at least -- would not have been realized.³⁹

Important institutional intermediaries engaged in the process of transmitting regulatory reform ideas globally were the major international institutions concerned with

³⁸ Michael Moran, *The Politics of Banking*, 35.

³⁹ Martha Derthick and Paul Quirk, *The Politics of Deregulation*, 36.

economic performance among their member countries. Such institutions are the International Monetary Fund (IMF), the World Bank (IBRD), the Bank for International Settlements (BIS), and the OECD. It was in the closed councils of these institutions where powerful bureaucrats and elected officials debated the merits of ideas -- in this case regulatory ideas -- and brought these ideas back to their capitals for further exploration. The OECD was especially active in this area.

The main body of the OECD concerned with official regulations or administrative practices which act as an impediment to domestic financial market efficiency and with the removal of obstacles to the globalization of financial markets is the Committee on Financial Markets (CFM). The CFM Secretariat is a component of the OECD's Financial and Fiscal Affairs Division whose mandate

Broadly speaking...is to foster free international flows of payments, services and capital, globally and with particular attention to some service industries, and to maintenance of a competitive climate.

The Organisation has taken over from the OEEC the two codes for the liberalization of capital Movements and of Current Invisible Operations, the aim of which is to ensure the highest attainable degree of freedom for transactions and transfers between Member countries in the fields of capital movements and current operations. The Organization is engaged also in co-operative activities designed to improve the capital markets of Member countries, with a view to increasing the availability of savings for investment and promoting balance of payments equilibrium.⁴⁰

This Committee began its deliberations in the early 1970s and since then has investigated and commented on relevant public policies and cajoled its member countries on a diverse number of issues.

Among the CFM's activities which were important agents of change in the financial market and intermediary regulation were the following:

⁴⁰ OECD, OECD: History, Aims, Structure (Paris: OECD Publication Service, June 1973), 17-18.

- an examination domestic policies toward the international bond market and the international activities of mutual funds (in 1970)⁴¹;
- recommendations regarding standard rules for the operations of mutual funds designed to protect investors and to eliminate unnecessary regulations which interfere with their operations; and, an enquiry into the admission of securities to stock exchanges (in 1971)⁴²;
- consideration of the likely impact on the capital market of the removal of the Interest Equalization Tax and measures in the US to limit the export of funds to finance direct investment abroad; an inquiry into the policies of member countries towards the issue and placing of international bonds; discussion of recommendations for change in the US financial system which were sent to the Congress; consideration of proposals by the UK parliamentary committee for changes to the structure and functioning of the British Savings Movement; preparation of draft recommendations on restrictions on investment in unlisted securities, disclosure requirements for publicly offered securities, and public offer and stock exchange listing of foreign securities (in 1973)⁴³;
- with the BIS, the European Commission (ECC), the IMF and the CFM, there was an examination of the function and role of the Euro-markets and the national regulatory systems affecting them (in 1975)⁴⁴;
- work was started on an examination of interest-rate margins and the cost of intermediation of bank credit, which is relevant for guiding policies towards more efficient management of member countries' financial systems; began discussions on the implementation of proposals of the US Treasury Secretary to identify the various impediments to international flows of portfolio capital (in 1975)⁴⁵;

⁴¹ OECD, Activities of the OECD in 1970: Report by the Secretary General, (Paris: OECD Publication Service, 1971), 24.

⁴² OECD, Activities of the OECD in 1971: Report by the Secretary General, (Paris: OECD Publication Service, 1972), 26.

⁴³ OECD, Activities of the OECD in 1973: Report by the Secretary General, (Paris: OECD Publication Service, 1974), 22.

⁴⁴ OECD, Activities of the OECD in 1975: Report by the Secretary General, (Paris: OECD Publication Service, 1976), 23.

- examination of obstacles to international movements of portfolio capital, of regulations affecting international portfolio investments of institutional investors in member countries and of obstacles to placing international bonds in member countries (in 1976)⁴⁶;
- examination of regulations affecting international operations of banks and non-banks in members' countries (in 1979)⁴⁷;
- examination of structural changes in the banking business and related issues of regulation (in 1980)⁴⁸;
- comprehensive examination of regulations affecting the international trade in services and a review of obstacles in the field of international trade in banking services (in 1982)⁴⁹;
- identification and analysis of obstacles to international financial investment and securities operations; reviewed member countries' financial reform activities (in 1985)⁵⁰;
- Financial market reforms were at the heart of the CFMs discussion in 1986 as many member countries pursued strong policies to improve the functioning and supervision of national financial institutions and markets and to strengthen their international competitiveness in the face of ever-intensifying internationalization of financial markets. With technological change affecting not only payments systems but also securities-related activities, there was a strong trend towards globalization of securities

⁴⁵ OECD, Activities of the OECD in 1976: Report by the Secretary General, (Paris: OECD Publication Service, 1977), 26.

⁴⁶ OECD, Activities of the OECD in 1977: Report by the Secretary General, (Paris: OECD Publication Service, 1978), 26.

⁴⁷ OECD, Activities of the OECD in 1979: Report by the Secretary General, (Paris: OECD Publication Service, 1980), 32.

⁴⁸ OECD, Activities of the OECD in 1980: Report by the Secretary General, (Paris: OECD Publication Service, 1981), 26.

⁴⁹ OECD, Activities of the OECD in 1982: Report by the Secretary General, (Paris: OECD Publication Service, 1982), 31.

⁵⁰ OECD, Activities of the OECD in 1985: Report by the Secretary General, (Paris: OECD Publication Service, 1986), 21

markets. The CFM made a major contribution to the OECDs overall program on trade in services by completing its study on obstacles to the international trade in securities-related financial services.⁵¹

The influence of the OECD in general, and of the CFM in particular, while important, should not be over-stated. It should be re-emphasized that the organization acts as an intermediary or conduit for ideas to infiltrate the relevant policy and decision-making bodies of the member countries. It is typically the case that the OECD Secretariat, in monitoring the structures, openness, and the regulatory apparatus of the financial systems of the member countries, will raise for discussion at one of the regular thrice yearly meetings of the CFM a particular policy change in member countries. As the particular policy change becomes "fashionable," spreading to a number of countries, the CFM would typically undertake to map out the particular policy field among all of the OECD countries. Member countries would be called upon to explain their policy stance on the issue(s) in question.

The pressure on countries is rather subtle given the collegial and diplomatic character of the CFM meetings. The OECD Secretariat has no formal sanctions to bring to bear upon countries for following a course of action which is not consistent with its overarching codes of liberalization -- except that of "world opinion." Thus, the only instrument that the OECD can use is moral suasion. However, it has been the OECDs influence on generating acceptance of the ideas surrounding openness and the globalization phenomenon which has been notable. As the globalization net spread, countries which had not followed found themselves and their financial systems in an unsustainable position⁵²-- which required some action on the liberalization front.

In the Canadian situation there were many sources generating ideas about securities industry liberalization: foreign owned firms operating or wishing to operate in Canada; the Quebec government, engaged as it was in "nation-building," the OSC via its

⁵¹ OECD, Activities of the OECD in 1986: Report by the Secretary General. (Paris: OECD Publication Service, 1987), 24

⁵² Paul J. Quirk, "In Defense of the Politics of Ideas," 31; and, OECD, Why Economic Policies Change Course (Paris: OECD Publication Service, 1988).

numerous enquiries, the JSIC which was trying to debunk the importance of globalization and hence the maintenance of a "closed" system in this country, and the users of capital who were forced to absorb the costs of this closed system.

The Dependent and Independent Variables

While the objective of the project is to explain the political and economic dynamic surrounding the liberalization of ownership restrictions in the securities industry in Canada, the explanatory variables will provide a complementary account of deregulation of the financial industry, as policy output, to that which is "traditionally provided" by economics and political science scholars. They will endeavor to show that the key regulator of the investment dealer industry in Canada (the OSC) was initially regulating the industry's restrictive ownership provisions -- effectively inhibiting competition by restraining entry -- in the interests of the industry and its principals and that the OSC subsequently altered the regulatory regime in the face of "political" forces which were more compelling than these interests alone. This was a phenomenon which was already observed in the US and UK. Similarly, the forces which pushed Quebec to liberalize earlier, and in more dramatic fashion than Ontario, reflected not only Quebec's political aspirations arising out of the social upheavals beginning in the early 1960s, but also the desire to sustain a measurable role for Montreal's financial community in North America, especially in the face of the pre-eminent position of Toronto.

This analysis adds political economy or political rationality as an important explanation of the supply of financial regulation to the arguments traditionally used by economists to argue the case for deregulation.⁵³

This analysis will also use the regulatory convergence theory⁵⁴ (i.e., externally rooted pressure) as an explanatory variable driving securities industry liberalization. But the important objective is to show that it was domestic political and economic dynamics,

⁵³Michael Trebilcock, The Political Economy of Economic Adjustment: The Case of Declining Sectors.

against the background of globalization, which were the factors accounting for the timing and particular form of the liberalization process of Canadian securities dealers, the influence of the traditional economic arguments noted earlier has not been profound.

The qualitative analytical model which will be developed can be summarized as follows:

Dependent Variable:

Policy output of the Ontario, Quebec and federal governments associated with the liberalization of the ownership provisions of the investment dealer industry.

Independent Variables:

- (a) the demands of interest groups representing the key private sector actors as they influence the demand side of the policy equation. The demand side will be influenced by the competitive position of the indigenous industry relative to other financial intermediaries both domestically and offshore; the character of financial services demanded by consumers and firms; and, the pace of technological advancement as it affects the overall competitive position of the industry. Thus, it will be shown that the demand for different kinds of policies will depend on the environment which encircled the industry's business.
- (b) the pressures which influence the appointed and elected officials to supply a certain type of liberalization policy. Inasmuch as there was an evolution in the liberalization rhetoric of the key governments as they moved towards a policy

⁵⁴David Vogel, National Styles of Regulation: Environmental Policy in Great Britain and the United States (Ithaca, New York: Cornell University Press, 1986). The phenomenon of regulatory convergence is intended to suggest that there are basic patterns of regulatory behavior within nation-states. Patterns of regulation associated with environmental protection will also be manifest in financial industry regulation. In the US, for example, regulation is generally a competitive litigious affair between business and the state, whatever the substantive policy field. More recently, it has become apparent that countries with historically different regulatory patterns have been supplying comparable regulatory policy under comparable patterns. Financial regulation in the US, UK and Canada is one example. See Michael Moran, "Theories of Regulation and Changes in Regulation: The Case of Financial Markets," Political Studies, 34(1986) for a good discussion of this phenomenon which complements Vogel's work.

equilibrium, it will be shown that the incremental changes to announced (but not implemented) policy intentions could have had potential political repercussions on elected officials and as well affect the life cycle of bureaus in a Downsian sense.⁵⁵ More generally, this variable will be informed by the public choice literature dealing with the behavior of elected officials and appointed bureaucrats.

- (c) inter-provincial competition and federalism in Canada. In this regard, like Cairns⁵⁶ it will be shown that the provinces used the constitution for their own purposes (e.g., growth, power and self-preservation) when considering the liberalization of the securities industry. This phenomenon cuts across activities of both the elected and appointed officials.
- (d) the changes in global regulatory policy and regulatory ideas. The international transmission of ideas -- through international institutions (mainly the OECD)⁵⁷ -- are important in contributing to the liberalization process globally. That is to say, we will see the effects of the rise of fashion⁵⁸ in public policy -- across countries and within countries -- among those who influence or take the decisions in the financial regulation field. The "fashion" we speak about is generically known as "industrial adjustment" or "economic adjustment." Thus deregulation/ reregulation of the investment dealer industry can be seen as part of this broader "adjustment" process.

⁵⁵ See for example Anthony Downs, Inside Bureaucracy and Barry Mitnick, The Political Economy of Regulation.

⁵⁶ Allan C. Cairns, "The Government's and Societies of Canadian Federalism."

See also Albert Breton and Anthony Scott, The Economic Constitution of Federal States (Toronto: University of Toronto Press, 1978).

⁵⁷ Organization for Economic Cooperation and Development, International Trade in Financial Services (Paris: Committee on Financial Markets, September 1986).

⁵⁸ As was noted in the preceding chapter, this observation is attributable to Michael Moran, The Politics of Banking.

The use of the phenomenon of ideas in public policy reflects the work of G. Bruce Doern and Richard W. Phidd, Canadian Public Policy: Ideas, Structure, Process.

The financial policy liberalization and globalization developments outside Canada and competitive pressures among governments within Canada can be considered contextual factors that have influenced regulatory change in Canada. The former can be viewed as exogenous to indigenous Canadian processes in this area while the latter can be seen as exogenous to the individual governments concerned. It is in this area that we can see the state as an independent and autonomous actor (in the neo-institutional analytical framework)⁵⁹ and not as a neutral arbiter in a contest among self-interested groups seeking public policy output. This will be evident particularly in the context of the conjuncture of the final events leading up to the ultimate liberalization decisions at both the federal and provincial (Ontario and Quebec) government levels.

As was demonstrated in Chapter Three, the international transmission of influence on the domestic supply of financial deregulation is seen from the perspective of a recursive model. That is to say, the time dimension of the analysis across countries does not coincide,⁶⁰ but the policy formulation process is interdependent across countries and over time.

Thus, there are discrete lags in the model which can be described in the following stylized fashion: the germ of financial deregulation was planted in the United States where deregulation of broker commissions occurred in the mid-1970s, and important spill-over effects were observed in the United Kingdom and Canada. The "Big Bang" in respect of regulatory reform occurs in the City of London in the mid-1980s. Policy and institutional developments in the US and early deliberations in the UK influenced Canadian authorities'

⁵⁹ Theda Skocpol, "Bringing the State Back In: Strategies of Analysis in Current Research," in Bringing the State Back In, ed. Peter B. Evans, Dietrich Rueschmeyer and Theda Skocpol, (Cambridge: Cambridge University Press, 1985)

James G. March and Johan P. Olsen, "The New Institutionalism: Organizational Factors in Political Life", American Political Science Review, Volume 78, 1984

James G. March and Johan P. Olsen, Rediscovering Institutions: The Organizational Basis of Politics.

⁶⁰ Indeed, the initial acceptance of a more liberalized entry and ownership regime for the investor dealer industry in Canada was expounded in Quebec in the early 1970s while others in the country were debating the merits of foreign ownership generally, and protection of the investment dealer industry in particular.

attitudes towards such structural reform. Indeed, the evolution of financial regulatory reform in Canada overlaps, in time and space, developments abroad. The dynamics of deregulation cause second round effects in the US and the process starts anew.

Generally, then, developments in other countries have formed the backdrop against which the Canadian analysis will be undertaken. It will be shown that the removal of restrictions on competition in the investment dealer business was taken for reasons that are best explained by the explanatory variables embedded in the analytical framework of this dissertation. That is to say, it will be seen that the policy actors in Ontario and Quebec, while responding to the same exogenous stimulus, had to take account of the internal political dynamics when the decisions were taken to alter their respective regulatory regimes.

Operationalizing the Qualitative Analytical Framework

The "empirical" analysis of the second half of this dissertation has two dimensions: (i) an examination of the official government and industry documents dealing with the issue of liberalization in the Canadian securities industry. This literature will map the development of official attitudes towards the entry and ownership issue and the industry's response to it and (ii) unstructured interviews with the key private and public sector participants involved in the decision to alter the operating framework of the industry. These field work conferences involved discussions and interviews with almost two dozen individuals comprising:

- the key actors in the federal, Ontario and Quebec governments;
- principal interest group representatives of both producers and users of financial services;
- a number of industry actors; and other scholars of the financial services industry including the major "think tanks."

These interviews were invaluable to the author in helping to understand the pressures that were exerted upon the regulators and the elected officials by the major

industry groups. Listening to these key policy actors review the relevant events highlighted the power available to the industry vis-a-vis the regulatory bureaucracy as a consequence of the asymmetric distribution of information between the state and the industry constituents. In the absence of this information the subtleties of public policy supply in the financial services industry would not have been nearly as rich as it now is in this study. Furthermore, the ability to reconstruct events surrounding regulatory change in Canada would have been considerably more difficult, if not impossible.

The empirical evidence will be integrated against the background of the three streams of literature in order to provide the explanation of what happened during the period leading up to the liberalization decision, why the liberalization occurred, and the timing of the decision to essentially eliminate entry and ownership restrictions in 1986.

PART TWO

Entry and Ownership in the Investment Dealer Industry:

The Evolution of A Policy

INTRODUCTION TO PART TWO

With Chapter Five begins the journey of operationalizing the analytical framework outlined in the preceding chapter. The objective is to understand the political and economic factors which gave rise to the symbolic and tangible public policy activities of the relevant state and private sector actors in the evolution of the regulation of entry in and ownership of the Canadian investment dealer industry. Realization of this objective requires the identification of the motives of the key policy-related actors at work in the area. It also necessitates the documentation of the forces which lay behind the "partnership" between the securities industry and the state, and the illumination of the inter-provincial and federal-provincial dynamics, including differences among the industry participants themselves in Ontario and Quebec. All of these influences served to constrain the decision-making processes vis-a-vis entry in and ownership of this industry. This analysis will take place against the background of the main bodies of literature reviewed in the first part of the project, namely the political economy of regulation, the theory of interest groups and the public interest, and the comparative studies of the financial services industry.

The evolution of the relevant regulatory policy in the entry and ownership debate in *Ontario* spans some three decades of mostly symbolic pretense designed to entrench the status quo by protecting the industry and its elites from the pressures of a competitive and changing financial market environment. It was only more recently, in the mid- to late 1980s, that the regulators proclaimed new rules which had the effect of transforming the traditional accommodation between the industry and the state and of ultimately altering the ownership structure of the industry. The resulting modernization of the organization of the industry¹ and the refashioning of state-industry relationships occurred amid an

atmosphere of confrontation, bitterness, and even of perceived betrayal of industry elites by those responsible for the regulatory apparatus in the province.

In *Quebec*, on the other hand, the objectives of public policy in the area of entry and ownership in the securities industry had a dual purpose: to protect the indigenous industry, essentially comprising the "smaller" firms in the Canadian investment dealer industry², and to ensure that Quebec, as a state, would have sufficient capital to facilitate its economic development in the future. These objectives were manifest in policy rhetoric that initially gave the appearance of a more liberal attitude, on the part of provincial regulatory authorities, toward competition in and ownership of the securities industry. Nonetheless, this provincial government was also slow to act to achieve its objectives, in part, because of the inability of the federal and provincial policy-makers and the industry to converge on a coherent policy strategy until the mid-1980s.

It is interesting, nonetheless, to contrast the forward looking perspective of the Quebec provincial authorities -- narrow as it was -- with the backward looking perspective of the Ontario authorities. In the past, the Quebec Government's patterns of action were formulated from the interdisciplinary perspective of social scientists with an indisputable vision of the future. The outlook in Ontario, on the other hand, was formulated in a rather sterile fashion by members of both the legal profession and of the securities industry itself.

For much of the initial phase of the policy debate surrounding the entry and ownership issue the federal government was a passive observer, although from time to time it lamented the absence of a consistency in regulatory policy across the country, which would facilitate the "efficient" functioning of the Canadian capital market. It was at least a decade and a half into the policy debate before the federal government took appreciable actions which served to address that objective, although there were studies undertaken of the practicality of a national Canadian Securities Commission modelled after the US Securities and Exchange Commission.³ In any event, the federal

¹ This can be seen as what is known today as industrial adjustment.

² The most important investment dealers, as measured by dollar value of capitalization, had their head offices on Toronto.

government's ultimate actions were indirect, although they served to upset the long standing equilibrium in the actual entry and ownership arrangements in the Canadian securities industry.

The overarching phenomenon driving the policy processes surrounding the regulatory regime for entry and ownership can be conveniently located in the public choice precepts of self-interest seeking behavior. This was initially manifest in Ontario in regulatory capture. The capture phenomenon was itself driven by the information gap within the state's regulatory apparatus -- which created a dependency relationship of the state (the regulators) on the securities industry (the regulated) -- and subsequently by the state's perception that it was required to act in order to ensure the survival of the securities industry. The issue of the survival of the indigenous industry will be seen in the context of both the globalization of capital markets and of the jurisdictional rivalries among Ontario, Quebec and the federal governments and among the regional representatives of the industry.

The second part of this dissertation comprises seven chapters. Chapter Five, which follows immediately, examines the events surrounding the takeover of Royal Securities by Merrill Lynch and its immediate aftermath -- the initiation of a study by the securities industry of certain questions surrounding the capacity of investment dealers to adequately carry out their responsibilities as market intermediaries. This study had the effect of setting out the parameters upon which the public policy debate on entry in and ownership of the member firms comprising the securities industry would take place during the ensuing years. Indeed, this review by the industry is critical to understanding the observed pattern of policy responses among the members of the industry and the public decision-makers. Chapters Six and Seven, encompassing the decade of the 1970s, study the reactions of the key actors in the public policy drama to the industry's study. It will highlight the dynamics of the interaction between the private and public sector players at

³ Canada. Consumer and Corporate Affairs, Proposals for a Securities Market Law for Canada (Ottawa: 1979).

both the federal and provincial government levels. Because of the numerous interests at play during this period, public policy supply came to a virtual standstill across all relevant jurisdictions, despite the numerous iterations through which possible regulatory regimes were propelled. Chapters Eight through Ten consider the events of the late 1970s and early 1980s when the securities industry was compelled to begin a period of rapid structural adjustment as a consequence of overt actions by the state in response not only to the mushrooming globalization of financial markets but also to the market innovations which were straining the capital base and competitive position of the Canadian industry. The ability of the indigenous securities firms to carry on their traditional functions came into question during this period. Chapter Eleven will conclude the dissertation.

CHAPTER FIVE

SETTING THE PARAMETERS FOR THE PUBLIC POLICY DEBATE ON ENTRY AND OWNERSHIP IN THE INVESTMENT DEALER INDUSTRY

Introduction

Chapter Five addresses the first phase of the two decade adventure of policy change surrounding entry and ownership in the investment dealer industry. The parting shot in this first scene was the acquisition, in 1969, by Merrill Lynch Pierce Fenner and Smith, the largest investment dealer in the United States,¹ of Royal Securities Limited, an old and well established Canadian investment dealer. Although foreign ownership of the securities industry was not a public policy issue during the period leading up to the takeover, there were already restrictions in place on the ability of non-residents to own a controlling interest in a Canadian chartered bank. More generally, however, the issue of economic nationalism -- essentially concern about foreign ownership and/or control of the Canadian economy -- was percolating in the background.² In any event, the Ontario based Canadian-owned firms in the industry³ ultimately succeeded in making the Merrill Lynch - Royal Securities transaction a public policy issue in Canada across a broad range of

¹ Trevor Moore, Report of the Committee, 156-157.

² Early in 1970 the federal government established a task force to examine the issue of foreign ownership in Canada and to develop policy proposals in this area for the government to consider. See the Gray Report.

³ There were, at the time, some 15 foreign owned firms operating in Canada. Of this total 11 were members of the IDA, 9 of the TSE, and 12 of the MSEs and 2 of the VSE. Trevor Moore, Report of the Committee, 158.

substantive areas including economic nationalism, prudential supervision, competitive federalism and federal-provincial relations. Moreover, the actions of the domestically owned firms gave rise to a proliferation of government and industry sponsored studies and reports dealing with the ownership and entry issue. Table I below provides a chronology of these examinations

Table 1:

<u>The Unfolding of the Entry and Ownership Debate</u>		
<u>Year</u>	<u>Sponsor</u>	<u>Study Subject</u>
1970	IDA, TSE, MSE and VSE	Sources of Capital in the Cdn. Securities Industry(Moore Committee Report)
1971	IDA, TSE, MSE and VSE	Moore Report and Recommendations for policy development
1971	Quebec Government	Study on Securities industry in Quebec (in response to Moore) -- Interim Report
1972	IDA	Variation on 1971 IDA, TSE, MSE, and VSE recommendations
1972	OSC	Report on the study of the Moore Report
1972	QSC	Study on Securities industry in Quebec (in response to Moore) -- Final Report
1973	IDA, TSE, MSE and VSE	Supplementary Recommendations on 1971-72 considerations

Despite the extensive scrutiny of the issues by the key actors in the policy communities, including representations from users of the financial services industry, the policy response of the Ontario authorities, aside from their initial inclination to provide

policies which served to shield the domestically owned industry, was sluggish at best. The Quebec impulse, on the other hand was long on rhetoric and symbolism but short on concrete action. The federal government was generally inactive during this initial phase of the debate because the regulation of the securities industry was solely within the capacity of the provinces. However, its views, expressed both privately and publicly, were important considerations in the overall evolution of public policy vis-a-vis the financial industry.

I now turn to a detailed examination of the events in this first phase. A thorough analysis of this initial period -- the Merrill Lynch takeover and the industry's response -- is required because the events and rhetoric of this brief period (mid-1969 to mid-1970) forms the backdrop against which all of the other relations and actions in this policy process were staged. The basic response patterns of the industry are validated and this allows the researcher to locate the basic character of the industry's polemics within the self-interest seeking paradigm. The location of this reasoning frequently compels the industry, or its representatives, to bring illogical inference to bear on its position. This has the unfortunate effect of undermining its legitimate stake in the policy process and foreshadows the ultimate restructuring of the Canadian securities industry.

The Merrill Lynch Takeover of Royal Securities

The issue of foreign ownership in the Canadian investment dealer industry had not been a matter of serious concern until the late 1960s, when, as noted in the preceding section, Merrill Lynch, Pierce, Fenner & Smith acquired Royal Securities -- a Canadian owned firm. Indeed, up until 1969, eleven American owned firms had operated in Canada successfully and in a relatively unencumbered way,⁴ although these firms were relatively small in terms of market penetration and were not active as primary underwriters.⁵ As a

⁴ Although there had been some discrimination against non-resident owned firms in respect of membership in banking and underwriting syndicates for corporate securities.

⁵ Ontario Legislative Assembly. Hansard. 11 June 1969, 5857-5585. Various comments by Hon H.L. Rowntree (Minister of Financial and Commercial Affairs) and a number of members of the opposition parties.

consequence, their impact on the competitive position of the indigenous industry was difficult to discern and not much concern was expressed about their presence. However, in the course of a debate on some routine amendments to a bill dealing with the TSE, the Ontario Minister of Financial and Commercial Relations did acknowledge the positive impact of the comparative advantage held by the US owned firms in the area of research.

The question of education research [provided by US firms] is good advice. There can be no question that the American companies...certainly have set a pattern in this country. There is a standard there that might well be emulated by Canadian companies if they want to achieve, maintain and retain a position of dominance in this service industry, which is to supply an orderly market place for the sale or purchase of securities.⁶

Generally, up until the early to mid-1960s the Canadian economy had been very receptive to foreign direct investment.

However, the appropriateness of the Canadian hospitality to foreign investment began to be questioned beginning in the late 1950s with the Royal Commission on Canada's Economic Prospects,⁷ followed subsequently by the Gordon Budget in the early 1960s,⁸ the Watkins Report⁹ in the late 1960s and the Gray Report in the early 1970s. Specifically, the Gray Report, perhaps the most influential document of the period, noted that the desire by Canadians to achieve greater domestic participation in the ownership of the infrastructure of the Canadian economy was not being pursued for itself but for a number of other reasons, among which were:

- the need to foster economic growth,
- the desire to preserve sovereignty and independence,
- to encourage harmonious federal-provincial relations,

⁶ Ontario Legislative Assembly. Hansard. 11 June 1969, 5857.

⁷ Report of the Royal Commission on Canada's Economic Prospects

⁸ Department of Finance, Various Budgets.

⁹ Melville H. Watkins, Foreign Ownership and the Structure of Canadian Industry (Ottawa: Queen's Printer, 1969).

- to facilitate access to the best available technology, and,
- to ensure industrial efficiency.

The generalities of the criticism of foreign ownership, focussed as they were on the lack of benefits accruing to Canada at the enormous cost of lost sovereignty, constituted the background against which the Canadian-owned Ontario based investment dealer community launched an attack on the Merrill Lynch - Royal Securities deal. Indeed, this attack mirrored the general political sentiment that was echoing in the Ontario legislature. Although the Ontario government of the day was generally obscure on its own position vis-a-vis the takeover during much of the first year following the event, the debates in the legislature dealing with matters such as the TSE, Securities Act Amendments, and the estimates of the Ministry of Financial and Commercial Relations -- the Minister responsible for the OSC and issues surrounding the Merrill Lynch - Royal Securities transaction -- had a decidedly nationalistic pitch.¹⁰ In Quebec, on the other hand, the sentiment was for more openness in respect of the participation of non-residents in the securities industry -- although the objectives in that province also reflected a nationalistic refrain inasmuch as the openness was seen as benefiting the economic development of that province.

As events unfolded, the tension between the objectives of the economic nationalists and those who wanted to liberalize the entry and ownership provisions in the securities industry became apparent. Economic nationalists, it seemed, derived utility from the production of financial services in Canadian territory by Canadian brains and were prepared to use whatever government instruments were necessary (subsidies, price controls, regulations etc.) at whatever the social cost to achieve that goal.¹¹ It will become apparent that for the securities industry, the goal of complete Canadian ownership was a mask for its primary purpose -- to insulate the Canadian institutional structure from competitive incursions. Competition from foreign firms would limit or perhaps diminish

¹⁰ Ontario Legislative Assembly. Hansard. 20 May 1969, 4548; 21 May 1969, 4627; 27 May 1969, 4853; 9 June 1969, 5474; 11 June 1969, 5589, 12 June 1969, 5630.

¹¹ Albert Breton, The Economic Theory of Representative Government, 33-35.

the rents associated with the industry's preferred competitive position in the Canadian market.

Thus, the concern about foreign ownership in the Canadian securities industry approached its climax in 1969 when Merrill Lynch acquired 100 percent of the voting shares of Royal Securities Limited. Royal was an "old established" and large nationally based securities dealer, was a member of the major stock exchanges in Canada, had representation in London, England and New York, and as well was a "jobber" designated by the Bank of Canada to borrow from it on a secured basis as a last resort and to trade with it for the purpose of implementing monetary policy. At the time of the acquisition Royal employed almost 250 people.¹²

Merrill Lynch had been operating in Canada since 1925 -- first under the name of E.A. Pierce & Co. in Toronto and subsequently under its own corporate name in Montreal, Vancouver and Calgary. At the time of the takeover Merrill had four offices in Canada, compared to 15 for Royal Securities.¹³ Merrill had joined the Investment Dealers' Association in 1952 and the Toronto, Montreal and Vancouver Exchanges in 1940, 1960 and 1964, respectively.¹⁴

The most disconcerting element in this whole affair, for the Canadian investment dealer industry, was the size of the parent company of Merrill Lynch Canada. Indeed, at the time, Merrill Lynch (New York) was the largest stock broker in the world, with 197 offices in the US and some 30 elsewhere, excluding Canada. The parent company employed some 16,000 people and had a net worth of some US\$271 million. In contrast, the 167 Canadian owned firms had a net worth of CAN\$183 million and employed just over 12,000 people in some 500 offices across the country.¹⁵ Thus the whole of the

¹² Merrill Lynch, Pierce, Fenner & Smith Incorporated and Royal Securities Corporation Limited, Submission by Merrill Lynch, Pierce Fenner & Smith and Royal Securities Corporation Limited to the Ontario Securities Commission Industry Ownership Study (Toronto: September, 1971), 11.

¹³ Merrill Lynch, Submission, 3.

¹⁴ Merrill Lynch, Submission, 3.

¹⁵ David Smith, "Merrill Lynch to acquire Royal," Montreal Gazette, 16 May 1969; Merrill Lynch, Submission, 3; Trevor Moore, Report of the Committee, 15, 153, 156, 157.

Canadian industry was dwarfed by one American firm. The mere thought of the Canadian industry confronting this US giant caused the Canadian industry's elites, senior bureaucrats in Ottawa and in the provincial capitals, senior elected officials across the country and the economic nationalists, to tremble -- in public at least. The fear of course was that this important pillar of the Canadian financial system would soon come under the domination of the American industry. For the most part, however, the immediate policy response -- the patterns of action -- of governmental elites directly involved in this matter did not mirror the public rhetoric that preceded their actions. A sampling of initial responses is illustrated below.

Some St. James Street sources were arguing last night that Royal's status as a [Bank of Canada] money market dealer should be revoked.¹⁶

Finance Minister E.J. Benson is studying the proposed sale of Royal Securities...He told John Diefenbaker in the Commons yesterday that he does not think the transaction will place the outflow of Canadian funds under the domination of the United States. Mr. Diefenbaker had asked if this would be the result.

The Ontario Securities Commission is studying the proposed takeover...Financial and Commercial Affairs Minister Leslie Rowntree said yesterday. [He] told the legislature he met OSC Chairman H.E. Langford on Friday to discuss the pending takeover and its likely effects.

The prime minister expressed his government's 'concern' over 'the seriousness of the situation.'...This is a matter of concern to the government and may lead us to a position where we shall want to state more general policy that will apply to the role of financial institutions in the country...Mr. Trudeau pointed to two possibilities: One is that the federal government might act unilaterally to limit the growth and participation of American brokers in the Canadian investment field. [Second]. 'I envisage that if we cannot act in a strictly federal sense, we might alert the provincial governments to take some joint action in an area as important as this one to the Canadian economy and government.'¹⁷

¹⁶ David Smith, "Merrill Lynch to acquire Royal," Montreal Gazette, 16 May 1969.

¹⁷ Canadian Press, "Sale of Royal being studied by Benson," Globe and Mail, 21 May 1969.

The Toronto Stock Exchange is considering the imposition of a formal limit of 45 percent for future non-resident ownership or control of member firms.¹⁸

Finance Minister Benson said officials from his Department and the Bank of Canada are considering the money market position of Royal Securities Corp. Limited.¹⁹

It is interesting that even against the background of economic nationalism which had dramatically influenced the public policy agenda in Canada for a number of years, the initial response was from a defensive posture. This occurred, in part, because the comfortable position of the industry elites was threatened, while the government's leaders did not fully comprehend how the takeover would alter the status quo environment. For example, almost one week following the Merrill Lynch announcement, the Minister representing the primary regulating province in respect of the securities industry, on the occasion of the first question in the Ontario legislature regarding the relevance of the takeover for the "public interest" stated

Last week, on Friday, I had a discussion with the chairman of the securities commission with respect to this particular transaction and the effect. I will ask him to supply me with certain information which would put me in a position to consider this matter further.

We are also aware that the Economic Council of Canada is conducting a study at the moment with reference to similar matters, particularly as they affect competition and foreign ownership. It is expected that the report from that source might be handed down some time during the month of June.²⁰

Thus, the response was consistent with the "classic" state response in Canada. That is, the state confronted with a policy dilemma for which there is no apparent solution,

¹⁸ Irvin Lutsky, "TSE proposes to limit holdings of board seats by non-residents," Globe and Mail, 23 May, 1969.

¹⁹ Dow Jones Wire Service, "Finance Dept. and Bank of Canada consider money market position of Royal Securities," 27 May 1969.

²⁰ Ontario Legislative Assembly. Hansard. 20 May 1969, 4548.

typically wants to be seen to be doing something -- so an elaborate study apparatus is put in place. The Royal Commission is a fashionable governing instrument in such situations. Although the Royal Commission was not the formal instrument chosen for this situation, the intensity and productiveness of the process that was put in train because of the takeover was certainly equal to such more formal responses. Indeed, the studies referred to above by the government officials would be the pattern of state action for more than a decade. The industry elites, on the other hand, would look for some sort of public retribution, to compensate for the potential threats to the oligopoly.

The initiative for the takeover of Royal Securities by Merrill Lynch came from the partners of the former firm. This "instigation by the vendors"²¹ occurred against the background of the advancing age of the senior partners (in excess of sixty years) and their wish to retire. Furthermore, there was a desire on the part of the senior partners to keep the firm in business, maintain ownership in Canadian hands, and to preserve the many jobs that were at stake.²² However, the firm's high market value was a major obstacle in respect of keeping the firm in Canadian hands because the more junior members of the firm were unable to secure the necessary financing to underwrite such a transaction.

Merrill Lynch's interest in acquiring Royal Securities was

a desire to obtain participation in the Canadian underwriting market. Representatives of Merrill Lynch had in prior years been advised on a number of occasions, informally, that neither Merrill Lynch nor any other American brokerage firm would be invited to participate generally in syndicate or banking groups in Canada. Accordingly, prior to the acquisition of Royal Securities the participation of Merrill Lynch in this aspect of the securities business had been confined principally to underwriting Canadian governmental and municipal securities.²³

Royal Securities' strengths, in the areas of money market operations and underwriting, were an important complement to Merrill's existing operations in Canada²⁴

²¹ Merrill Lynch, Submission, 11.

²² Globe and Mail, 17 May 1969, B1.

²³ Merrill Lynch, Submission, 11.

and would thus serve to help neutralize the discrimination that it had earlier experienced in the Canadian marketplace.

The symbolic tumult in the aftermath of the announcement of the takeover stands in contrast to the record of bilateral discussions which were undertaken by Merrill Lynch (New York) and the key Canadian actors immediately after the Merrill Lynch - Royal Securities deal became public. Merrill Lynch officers met with officials of the key stock exchanges across Canada (Toronto, Montreal and Canadian and Vancouver) in the spring of 1969 at which time the acquisition and business plans of the new entity were outlined. In each case the transaction was approved without qualification.²⁵

Official Responses and the Public Rhetoric

In the case of the Toronto Stock Exchange the meeting over the transaction gave rise to a rethinking by the Exchange of the extent of foreign ownership of member firms that it would permit.

...the Board while not opposed to the investment of capital by non-residents in member firms, would require that at least 55% of the beneficial ownership of each member firm be held by Canadians.

Member houses owned and controlled by non-Canadians have been active members of this Exchange for a number of years. The presence of these member houses in Canada has presented a substantial degree of competition and many Canadian members would readily agree that this form of competition has been advantageous in many respects. The nine American-owned firms of this Exchange have been good corporate citizens of Canada and their seat-holders, all Canadians, have contributed to the Canadian financial community in very substantial ways. *At the same time there has been a strong feeling on the part of many that the number of American members should not increase beyond the present complement.*

²⁴ David Smith, "Merrill Lynch to acquire Royal," *Montreal Gazette*, 16 May 1969.

²⁵ Merrill Lynch officers met with both the TSE officials the Montreal and Canadian Exchange officials on May 16, 1969. See Merrill Lynch, *Submission*, 11-13.

The acquisition of Royal Securities by Merrill Lynch however, has added a new dimension to the problem and is causing very real concern. The concern is based, of course, on the anxiety that there be a continuation of a substantial Canadian element in the Canadian securities community. There has been no suggestion that Merrill Lynch has acted beyond the existing policy limits of the Exchange which would apply equally to any other member of the Exchange.

The investment process is a vital one for the Canadian economy. It should be responsive to purely Canadian objectives and purposes. Its proper functioning is vital to both the public and private sector. In this respect it is akin to other financial institutions such as banks, trust companies and insurance companies. This is why the reaction to the further expansion of non-Canadian member houses by the acquisition of Canadian firms is causing such immediate and widespread public and private concern. The concern is not solely or principally confined to the straight brokerage functions of a member but also extends to the underwriting and distribution of new securities issues and money market and quasi-banking functions.²⁶

The Toronto Stock Exchange is a self-regulatory organization (SRO). This means that the institution's corporate governance resides with the members of the Exchange themselves. Although the Exchange is ultimately supervised by the OSC, the TSEs regulatory provisions are the authority of record unless overturned by the provincial bureaucracy. Thus, for practical purposes the Exchange has the power to set conditions for membership.

This power, which is vested in the Exchange's members, is important in the context of the "Notice to Members" quoted above because it sets the stage for the pattern of actions that will be taken by the indigenous industry to defend its competitive position, through the whole of the coming episode. That is to say, the industry's "strong feeling," as stated in the "Notice," that membership in the TSE of foreign-owned firms should be restricted, apparently in the public interest, masks the real objective of the member-firms. Given the elusiveness of the concept of the public interest, the fact that the securities

²⁶ Toronto Stock Exchange, "Non-Resident Ownership of Member Firms." Notice to Members, No. 599, May 23, 1969.

industry, rooted in markets as it is, is not known to be promoters of the social welfare.²⁷ Profit maximization is what is optimized in this industry. Thus, the real objective of the members, in proposing such a TSE policy, was the self-interest (rent) seeking purpose of limiting competition within the securities industry. Implicitly, the industry was saying in its "Notice" that only a "little" competition from small insignificant "non-resident" firms is acceptable -- but in the face of uncertainty, threatening competition from a comparatively large foreign-owned firm, with ties to a "substantial" parent, is not. It will be recalled that there was a good deal of supporting sentiment among members of the Ontario legislature for the TSEs position. Indeed, a number of opposition members unsuccessfully put forward amendments to a bill dealing with the TSE that would have had the effect of limiting non-resident membership on the exchange.²⁸

This first statement of intent by the industry, is an important point of departure for the strategy to be used by securities firms to defend the then existing industrial organization. The arguments imbedded in this strategy would be used frequently in the future. Even following this statement, and prior to its coming to a vote by the TSE membership, Mr. J.R. Kimber, the President of the TSE (and future chairman of the OSC) in testimony before the Ontario Legislature's Legal Bills Committee, indicated that "We have wondered if there should be a limit on foreign ownership, but we have never been able to resolve how to make it retroactive... We have had an unwritten rule that no more non-resident firms should be made members."²⁹

The meetings between Merrill Lynch represented by Donald T. Regan, President of Merrill Lynch New York and federal authorities, represented by Louis Rasminsky

²⁷ That is not to say that there is no "social policy" component to the work of the Exchange. As is the case for all such institutions, the Exchange does regulate the ethical and financial practices of its members in order that the public can be protected from fraudulent and/or unprofessional activities. If the exchanges repudiated such responsibility, equivalent regulatory activities would undoubtedly be assumed by the state -- an eventuality that the industry would wish to avoid. See William D. Coleman, "Self Regulation in the Canadian Securities Industry: A Case Study of the Investment Dealer Association of Canada."

²⁸ Ontario Legislative Assembly. Hansard. 11 June 1969, 5574-5587.

²⁹ Globe and Mail, 4 June 1969, B2.

Governor of the Bank of Canada, the Minister of Finance, E.J. Benson and R.B. Bryce the Deputy Minister of Finance, reflected a certain ambivalence. Federal authorities were on the one hand concerned about the efficient functioning of financial markets, but on the other would be unhappy if all of the major dealers were owned by non-residents. In that regard federal officials noted that the takeover transaction had created a good deal of political hand-wringing but it was unclear what the fall-out eventually would be.³⁰ The federal representatives also had expressed some interest in the possible extraterritoriality of the US antitrust laws in respect of the use of moral suasion in the implementation of monetary policy. But in the event this turned out to be a "non-issue." There had been some discussion in political circles of expelling Royal Securities from the list of Bank of Canada approved money market dealers, but ultimately not this, nor any other action was taken by the federal authorities in regard to the takeover. Indeed, on July, 2, 1969 Mr. Benson, the Minister of Finance noted in the House of Commons that

The IDA and two of the main stock exchanges announced that they are going to study together the whole subject of foreign ownership and control of member firms and to decide what policies and courses of action they themselves should follow within their institutional jurisdictions. They have also made it clear that pending this study they will defer consideration of new applications for membership from foreign based brokers and investment bankers as well as any new applications for approval of purchase by foreign interests of Canadian investment firms now holding membership in any of these industry organizations. I welcome this initiative. I believe that the subject merits such a study. The Government will follow with great interest its course and outcome.

We will, of course, actively pursue our own review of the situation as it affects the national interest. This review will include a study of limitations which might be placed on the access to foreign-owned firms to the credit facilities available to money market dealers.

I do not believe it would be appropriate nor have we presently the power to stop the sale of Royal Securities Corporation to Merrill Lynch. Nor do I

³⁰ Bank of Canada. "Notes on Discussion with Royal Securities and Merrill Lynch," Tuesday, May 20, 1969."

believe it would be appropriate to request the Bank of Canada to amend at this time their credit arrangement with Royal Securities as a money market dealer.

However, I feel we should be free to bring them and any other firms in a similar position within the ambit of any general limitations which may result from our review.³¹

The above quoted Ministerial "statement was jeered by opposition parties who criticized its failure to come to a firm decision."³² Thus, the federal authorities were thankful that the industry (the stock exchanges and the IDA) had decided to establish a committee and sponsor a study (the Moore Committee) of the capital requirements including the implications of non-resident ownership in the Canadian securities industry. Indeed, any punitive action by the federal authorities on Royal Securities and/or Merrill Lynch would have imposed some social cost because Royal Securities was a major player in the money market and in the distribution of Government of Canada debt. The federal authorities were relieved. The proposed Moore Committee study took the "political heat" off the federal government.

This political pressure came not only from elected officials at the federal level, but also from authorities in Ontario. In fact, during virtually the whole of the first year following the takeover, the Ontario government did not pronounce officially its position on it. The Minister of Financial and Commercial relations persistently deflected questions on the matters to studies that were then being prepared in the Ministry and in the OSC -- but none was ever produced. The provincial government's stance was depicted as follows:

...it is a matter which is being seriously considered by the government itself.

These are not easy matters that can be simplified and settled in a matter of 15 to 20 minutes, or even a week or two weeks. And...there are discussions

³¹ Department of Finance New Release, "Statement by the Honorable E.J. Benson, Minister of Finance in the House of Commons," Ottawa, July 2, 1969.

³² Dow Jones News Service, "Ottawa reserves the right to move on Royal Securities takeover," Montreal Gazette, 3 July 1969.

pending with respect to the federal government. I am hopeful that, between the views of our own securities commission and our own government's views on the matter and those of the federal government, who have declared an interest in securities generally, in their new department, we will be able to meet the situation in a substantial way, in what I would describe as the immediate future...³³

It remains to be seen what the federal government's final view will be about government participation in an American-owned underwriting house with respect to government issues, whether they be provincial or federal. Some of these matters and the answers to them must be answered before a decision is taken.³⁴

Thus, there was a certain degree of paralysis or circularity in the decision processes of the two levels of governments -- neither really willing to take ultimate responsibility for a definitive resolution to a gritty public policy matter. As a consequence the private market forces played out their game plan.

Merrill Lynch's discussions with the other important SROs in Canada, the IDA, the Montreal and Vancouver Stock Exchanges, as well as with the Ontario and Quebec Securities Commissions did not result in any objections to the takeover. Thus, by the end of July 1969 the 100 percent ownership of Royal Securities by Merrill Lynch Canada had been approved by all of the concerned regulatory organizations.

³³ Ontario Legislative Assembly. Hansard. 11 June 1969, 5587.

³⁴ Ontario Legislative Assembly. Hansard. 11 June 1969, 5589.

Appointment of The Moore Committee

Aside from the use of exhortation, the lack of a lucid response to the Merrill Lynch takeover of Royal Securities by the public authorities, at either the provincial or federal levels, the Toronto based component of the industry itself seized upon the opportunity to promote its agenda. The industry appointed a committee to examine the questions which it was reckoned would serve its purpose. Indeed, it is important to stress that the Moore Committee study was not one undertaken at the behest of the OSC, or of any other regulatory agency -- it was proposed by the largest and most powerful constituency of the industry which was based in Toronto. This constituency can be seen as a "pressure group," so that its interests would form the foundation upon which the public policy debate regarding entry and ownership would be hinged. Indeed, as Kingdon suggests, "much of interest group activity in [the agenda setting process] consists not of positive promotion, but rather of negative blocking... [I]nterest groups often seek to preserve prerogatives and benefits they are currently enjoying, blocking initiatives that they believe would reduce those benefits."³⁵ The industry wanted to continue to reap the rents of the past which were associated with industry practices having the effect of limiting competition.

The ability of the industry to set the agenda will be shown to have hinged, to a great extent, on its monopoly of information about to the activities of the industry itself and the likely impact of foreign intrusions. Furthermore, the industry's strategy, the exploitation of the information set surrounding the potential impact of the Merrill Lynch takeover on the indigenous industry, would constrain the fall-back position for the policy-makers to that of the status quo. Indeed, the industry's preferred regulatory regime was something less than the continuation of the existing scheme which would permit similar takeovers in the future. The present rules threatened the expected profits that could be derived by the industry's owners from the protection accorded by a public policy which limited entry in and ownership of the industry. The unearthing of the evolution of the Moore Committee's work will attest to the validity of these observations.

³⁵ John W. Kingdon, *Agendas, Alternatives, and Public Policies* (Boston: Little, Brown and Company, 1984), 52.

The Moore Committee was appointed in July 1969, following an announcement in June that the industry would undertake the study. The Committee was sponsored by the key SROs across the country -- the IDA, the two Montreal and the Toronto and Vancouver Stock Exchanges. It consisted of seven members, six of whom were senior officers of member firms of the sponsoring SROs and the seventh, the Chairman, Mr. Trevor Moore, was the retired senior vice-president of Imperial Oil who also had an extensive career in the securities industry prior to joining Imperial.³⁶ The Secretary to the Committee was an economist at a large investment firm.³⁷ The mandate of the Committee was

to study the requirements and sources of capital and the implications of non-resident capital for the Canadian securities industry [but] its responsibilities were not restricted to the question of non-resident capital. The Committee was [also] asked to examine the adequacy of present 'sources of capital' and to consider the possibility of outside financing for securities firms.³⁸

The sponsoring SROs

also undertook to suspend applications for approval of non-resident capital participation in their member firms or to consult with respect to such applications until the Committee's report was completed and such report subsequently reviewed by the five organizations.³⁹

The Quebec Response to a Joint Industry Study

The initial response to the proposal for a study, which came from the TSE and the Toronto based IDA, was not one of unanimous acceptance. As was noted earlier, the Quebec governmental authorities and the Quebec resident firms recognized that the capital limitations of its provincially based industry would impinge not only on the viability of the indigenous firms, but also on the future economic development of the province and the

³⁶ *Globe and Mail*, 23 June 1969, B1.

³⁷ Trevor Moore, *Report of the Committee*, iii, 1.

³⁸ Trevor Moore, *Report of the Committee*, 1.

³⁹ Trevor Moore, *Report of the Committee*, 1.

ability of Quebecers to play a full role in it. Thus, processes were already in train to liberalize ownership requirements for firms based in that province. Indeed, on June 18, 1969, just one day after the TSE, the IDA and the VSE announced their intention to launch the Moore Committee Study, the "Montreal and Canadian Stock Exchanges...approved in principle a plan to permit member brokerage firms to take outside capital."⁴⁰ The Chairman of the MSE, Peter Turcot, said that "a decision to permit outside capital in the industry would make firms more competitive." He also suggested that a shortage of capital had been plaguing the Canadian securities industry for a long time.⁴¹

Charles Neopole, the President of the MSE at the time the Toronto based industry announced its plans for the study indicated that the Montreal based industry "prefer[ed] to be independent thinkers. If you take part in a study you commit yourself to its findings to some degree. You could write a dissenting report, but if you are in it, you're in it."⁴²

The initial lack of enthusiasm of the Montreal exchanges to participate in the study was attributable to the fact that the TSE had already placed a freeze on its non-resident membership. The MSE considered this discriminatory.⁴³ Subsequently, immediately after the 1969 Annual Meeting of the IDA, where a good deal of pressure had been put on them, the MSE and CSE announced that they had agreed to participate in the Moore Committee study.

The Montreal exchanges switched their positions in part because they presumed that they would have an opportunity to influence its recommendations, but also because they wanted to find out just what the precise thinking was in Toronto. However, the Montreal Exchanges also indicated that although they were joining-in the Moore project without any "strings attached," they were making "no promises to support or be guided by the study group's findings and recommendations."⁴⁴

⁴⁰ Globe and Mail, 19 June 1969, B1.

⁴¹ Globe and Mail, 19 June 1969, B1.

⁴² "Foreign investment houses begin to sense the new mood," Financial Times of Canada, 23 June 1969, 8; Globe and Mail, 23 July 1969.

⁴³ Financial Times of Canada, 16 June 1969, 3.

From the industry's perspective, the participation (i.e., sponsorship) of the Moore Study now included all of the regional exchanges across the country. The national character of the Committee would cloak its recommendations, when put forth, with more legitimacy than if they merely represented the industry located in Toronto.

The industry, through the Committee, could now set out to cover all possible avenues of intrusion by non-industry and non-resident participants in the domestic securities business. The industry could now pursue its primary objective -- to formalize the cartel-like arrangements that had existed informally for so long.

Overview of the Moore Committee Conclusions

The Moore Committee arrived at a number of conclusions which may have been predetermined, but which nonetheless leave the researcher with little scope to arrive at the conclusion that the industry had no other objective but to protect its advantageous position in the Canadian financial marketplace. Perhaps this is not a startling objective, but the apparent transparency of the industry's arguments, particularly when juxtaposed against its use of the precepts of the public interest, called into question the legitimacy of the industry's stake in the transformation of public policy regarding entry and ownership in the securities business.

Indeed, the unwillingness of the Committee to broaden its membership to include both participants from other countries and outside capital became immediately apparent in the structure of its Report. The Committee required an anchor to which it could secure its arguments for excluding the participation of foreign owned firms in the Canadian industry. It found this anchor in the recently modernized rules of the NYSE which permitted its members to raise equity from the public rather than solely from their officers and employees -- as had been the tradition since the inception of the securities industry in the US.

⁴⁴ Financial Times of Canada, "Its not just the Americans, its money," 28, July 1969; Globe and Mail, 24 July 1969.

Thus, at the very outset of its analysis the Committee reviewed and dismissed the relevance of arguments studied by the NYSE regarding access to public equity capital not only for the Canadian Exchanges, but mockingly questioned the NYSEs decision vis-a-vis its own members. Needless to say, the Committee excluded the possibility, for the foreseeable future at least, of the Canadian industry using this vehicle as a method of raising capital. Moreover, US firms who raised capital in a manner which was not permitted by Canadian firms would be prohibited, by the Committee, from participating in the Canadian industry -- either directly or through subsidiaries.

The narrowness of the Committee's vision was hardly credible. It was driven to suggest that over the medium term the Canadian securities industry, because its capital had been adequate in the past, would not require additional sources in the future. There was widespread opinion that could challenge this view. For example

Many observers...say that the industry needs capital and more sources of capital -- soon. They point to increasing demands for such services as highly sophisticated research, particularly from institutional investors. In this, many Canadian houses simply cannot match the efforts of their much larger U.S. competitors.⁴⁵

However, there was one caveat in the Committee's thinking: greater access to supplementary sources of capital could be helpful in resolving the industry elite's "turnover problem." The turnover problem, it will be recalled, was what prompted the partners of Royal Securities to "sell-out" to Merrill Lynch. That is to say, the junior partners were unable to raise the necessary financial capital in the institutional credit markets to facilitate the transfer in ownership. If financing had been available, it would have ensured that the firm would have remained closely held in Canadian hands, and the public policy issue of ownership and entry would not have been put on the agenda. Some have argued that it was the industry itself which was responsible for its current problems.

⁴⁵ Financial Times of Canada, "Its not just the Americans, its Money," 28 July, 1969, 7.

The industry had been too conservative and too clubby⁴⁶ which resulted in an inward-looking attitude in the industry's business practices.

The Moore Committee, representing the securities industry, used arguments related to the public interest as the justification for closely held ownership. Thus, it recommended that no more than 40 percent of a firm's capital be held by outside investors -- but no more than twenty-five percent of the *participating* shares could be held by this class of shareholder. Furthermore, the Committee was of the view that no individual investor should hold more than ten percent of a firm's participating shares.⁴⁷ And only industry investors should be officers of securities firms.

With respect to the overarching question of non-resident capital and/or participation in the industry, the Moore Committee was unequivocal. There was essentially no benefit accruing to Canada or Canadians (individuals or businesses) from the presence of foreign owned firms in the country and therefore it recommended that no further investments by foreign firms in the Canadian securities industry be permitted.

In summary, then, there were three areas of investigation for the Moore Committee: sources of capital for the securities industry, its capital adequacy, and foreign participation in the business. The only factor identified by the Committee, as a rationale for altering the existing ownership restraints, was related to the need for a "bailout opportunity for aging senior partners with substantial equity investments in their firms."⁴⁸

In the end the Committee resolved all of the issues in a manner that would have the effect of preserving the status quo.

⁴⁶ John G. Doherty and John Osler, "When Boardroom Nationalism is Not Enough," Financial Times of Canada, 2 June 1969, 6.

⁴⁷ This is what will later be referred to as the 10/25 rule.

⁴⁸ Joseph Auerbach and Samuel L. Hayes, III, Investment Banking and Diligence: What Price Deregulation (Boston: Harvard Business School Press, 1986), 89-90 Italics added.

A Critical Review of The Moore Committee's Analysis

In early April, 1969 just prior to the Merrill Lynch takeover announcement in early May of the same year and well before the start of the Committee's deliberations, the parent company, Merrill Lynch Inc., of New York announced its intention to make a public offering of its securities over the course of the following two months.⁴⁹ This event was important because it was appropriated by the Committee as a crucial mooring for its case to limit the infusion of outside capital into the Canadian industry. Indeed, this was virtually the first item of business which the Committee dealt with in its Report and it turned the rationale for implementation of public ownership rules on its head in order to beat down the possibility that such a proposal could even be considered for implementation in Canada.

Sources of Capital -- Public Ownership of Securities Firms

In the US, the rationale utilized by the industry for "going public" was the fact that many member firms of the NYSE, during the 1969-70 period, had difficulty coping with the enormous rise in stock trading volumes. The huge volumes virtually strangled the industry's "back office" processes. In response to the need to bolster their administrative operations with technological improvements, many firms "sought to strengthen their competitive positions...by selling their own equity securities to the public...This move to raise public capital was justified by the desire of the firms to lock in funds to service better the growing institutional sector and *to cushion the firms from the consequences of volatile swings in operating results.*"⁵⁰ The amplitude and frequency of the cyclical swings in the financial markets, and thus in the industry's fortunes, regularly threatened its capital base and of course its ability to conduct business. The availability of financial capital from the public would alleviate the requirement that new capital come from the partners of each

⁴⁹ Globe and Mail, "Merrill Lynch proposes 4-million-share public offering," 13 April 1969. This issue of public securities occurred against the background of an amendment to the constitution of the New York Stock one year earlier which permitted member firms to sell shares to the public.

⁵⁰ Joseph Auerbach and Samuel L. Hayes, III, Investment Banking and Diligence: What Price Deregulation, 89. Italics added.

firm and thus partially insulate the capital base from the vagaries of temporary financial market movements.

The agreement of the NYSE to amend its Constitution to permit public ownership had been debated for a decade before being implemented. The exchange's initial opposition to public ownership of securities firms was directly linked to the issue of institutional membership on the exchange (see discussion in chapter 3 dealing with the liberalization of broker commission rates). Institutional members were barred from membership on the NYSE as a consequence of two rules: prohibition of public ownership; and, the requirement that members be brokers and/or dealers as their primary function. The NYSE was reluctant to change the public ownership rule because it feared that the Justice Department, using the provisions of the antitrust laws would "challenge" the primary purpose provision and if successful permit institutions to own seats directly on the NYSE. In the event, one firm challenged the NYSE's rules, threatening to resign from the Exchange if the rules were not amended to permit public ownership. The rules were subsequently changed.⁵¹

The response of the exchange, as an institution, to this threat was certainly predictable in light of its past patterns of response to pressure. It will be recalled from the earlier discussions of the "Big Bang" in the UK and the liberalization of brokerage commissions in the US and Canada, that when the SROs in this industry seemingly run out of ideas to support the status quo on many issues, and they are threatened by unilateral action on the part of a key actor (either a regulator or an industry participant) which could undermine the autonomy of the SRO, the SRO succumbs to the pressure and gives up its position on protecting the existing regime. The length of time required to reach this new equilibrium can vary. It took ten years for the NYSE to succumb to the pressure to liberalize the ownership rules. It would take about fifteen years to equilibrate in Canada.

The upshot of the Moore Committee's discussion of public ownership, however, was an underlying disapproval "in principle" of the decision of the NYSE to permit its member firms to raise equity capital in the market. The negative attitude of the Committee

⁵¹ Joel Seligman, The Transformation of Wall Street, 466-67.

towards public ownership prevailed despite many safeguards put in place by the NYSE to deal with potential problems of conflict of interest, of undesirable elements infiltrating the industry and the like:

- industry participants would be required to own at least 51 percent of the outstanding shares of the firm;
- the broker-dealer function would have to remain the primary business of the firm;
- the key members of the firm (executive officers and directors) would have to be industry participants;
- any individual who owned 5 percent or more of the voting stock of a member firm would have to be an industry participant or an "approved person" by the NYSE;
- any person who failed or ceased to be an "approved person" would be required to convert its voting stock to fixed income security;
- a majority of the board of directors of each firm would have to be made up of industry participants.⁵²

These rules were consistent with the traditional overarching regulatory function for securities dealers: the preservation of honesty and legitimacy (ethics) of the principal participants' financial market activities and to ensure a climate of trust in the objectivity of securities markets. This is "the primary reason for the regulation of the industry."⁵³ In the absence of this trust, securities markets would be unable to function, thus imposing a costly burden on society. This type of "policing" enhances social welfare and is in the public interest.

The NYSE had implemented a decision to liberalize the public ownership restrictions for its member firms for reasons related not only to pressure from the industry itself,⁵⁴ but as well because of structural developments within it which pointed to the necessity for additional permanent capital in the US industry. However, the Moore Committee's attitude toward public ownership was shaped by a minority opinion in the US

⁵² New York Stock Exchange, "Amendments to New York Stock Exchange Constitution and Rules," Membership Bulletin, September 18, 1969, in Trevor Moore, Report of the Committee, 32-33.

⁵³ Simon M. Lorne and Morris Mendelson, "Regulation in a Market Environment," in Structural Deregulation of the Banking and Securities Industries, ed. Lawrence Goldberg and Lawrence White (Lexington, MA: Lexington Books, 1979), 41.

which opposed the concept of public ownership of securities firms. Furthermore, as noted earlier, the Committee seemed to be at odds with the understanding of a number of independent observers as well as with the industry based in Quebec.

This minority opinion in the US was formulated in a law firm (Wilmer, Cutler and Pickering) which subsequently hired Mr. Manuel Cohen, a former Chairman of the SEC.⁵⁵ The SEC, it will be recalled was a staunch supporter of the status quo when it came to issues of structural or organizational change in the securities industry. It was also the case that the SEC resisted change because its own structures were not sufficiently flexible to adequately adjust to a changed environment. Indeed, in the aftermath of the NYSE decision to liberalize ownership arrangements, by permitting public ownership, some observers in the US felt that the SEC was "improperly organized, with the wrong type of personnel, to provide oversight for the real regulatory issues of the next two decades. One of the results of being caught with the wrong structure and personnel is that some believe the SEC has begun to exhibit the most invidious type of regulation-deregulation possible in a free economy."⁵⁶ There was a great deal of inertia within the SEC which explains its reluctance to support or initiate structural change.

In any event, the opinion, expressed by Wilmer et. al., in its brief to the SEC during the deliberations on the question of public ownership, suggested that "there has never to our knowledge been made public the results of any study into the threshold question of the need for public ownership of broker-dealer firms."⁵⁷ Indeed, this is an

⁵⁴ Some of the pressure from the industry to permit the sale of share to the public was related to the "turnover" problem -- although this was not the primary reason for the decision to liberalize the ownership arrangements. See Joseph Auerbach and Samuel L. Hayes, III, Investment Banking and Diligence: What Price Deregulation, 89; and, Michael Keenan, "The Scope of deregulation in the Securities Industry," in Structural Deregulation of the Banking and Securities Industries, ed., Lawrence Goldberg and Lawrence White, 125-129.

⁵⁵ Trevor Moore, Report of the Committee, 36. It is surmised that the public philosophy of Mr. Cohen and his new employer converged and thus given the discussion in the first part of the dissertation, it is not surprising that the Wilmer submission championed the status quo.

⁵⁶ Michael Keenan, "The Scope of deregulation in the Securities Industry," 128.

⁵⁷ Wilmer, Cutler and Pickering, "Brief to the Securities and Exchange Commission," in Trevor Moore, Report of the Committee, 36.

argument to which both the Committee, and the industry more generally, frequently return to support their case against public ownership. The prevailing academic and industry opinion in the US suggested that there was a "reasonable" case for public ownership.⁵⁸

The Wilmer, Cutler and Pickering brief rejected the idea of public ownership for a number of reasons:

- it could result in increased concentration in the industry as the more profitable firms generated the capacity to take over the less profitable ones⁵⁹;
- the SROs and the SEC would have more difficulty policing the management of the public firms, and, moreover, effective policing could be curtailed because the regulators would now have to look out for the interests of the public shareholders;
- the earning record of securities firms is very volatile and thus not a prudent investment for public investors;
- management of publicly owned firms may not have effects which are in the public interest; the 49 per cent limit on outside ownership would not be sufficient to ensure that effective control remained within the circle of industry participants;
- The potential conflicts of interest that could arise would not be satisfactorily resolved by the NYSEs regime.⁶⁰

It is important to note here again, that not only the kernel, but also the essence, of the Moore Committee's arguments against public ownership can be found in the Wilmer et. al., submission. The point which must be stressed here is that the opinion of the Committee, and subsequently that of the industry more generally, had been influenced by arguments that were out of the contextual arrangements of the Canadian securities industry. Therefore, it appears that the Moore Committee had already judged the arguments for public ownership before the case had even been stated in a Canadian context.

⁵⁸ See for example Joel Seligman, The Transformation of Wall Street, 301.

⁵⁹ There were a number of mergers in the US securities industry in the early 1970s, in part because its fortunes had turned negative, and a number of firms had trouble raising finance capital in the market. See Michael Keenan, "The Scope of deregulation in the Securities Industry," 126.

⁶⁰ Wilmer, Cutler and Pickering, "Brief to the Securities and Exchange Commission," in Trevor Moore, Report of the Committee, 37-38.

Moreover, the Committee failed to adequately consider how changes in the "organizational paradigm" of the industry would impact on the ability of the securities industry to adequately carry out its market intermediary function in the long run. As will be seen later, the critical changes with which the industry would struggle would be those which impinged on its capacity to continue its intermediary function.⁶¹ It boiled down to capital adequacy and its sources. Whether public ownership was in the interests of the industry or contrary to them, ownership arrangements became an anchor upon which the Committee (and the indigenous industry) would secure the arguments against foreign participation in the Canadian capital market.

Capital Adequacy of the Securities Industry

The issues of the adequacy of the industry's capital and entry and ownership were related to the controversy surrounding the capacity of the industry to maintain its crucial contribution to the economic development of the country -- facilitating the transfer of capital market claims (instruments) between surplus and deficit spending units in the economy. More specifically, this capacity would include the industry's brokerage activities -- where firms act as agents in the transfer of claims -- and its dealing activities -- which encompasses firms' underwriting, money market and government and corporate bond undertakings. These latter activities entail carrying large inventories of financial claims to meet client demands for financial assets and secondary market trading. Inventory positioning is a costly business; small changes in market conditions can have a significant impact on the value of the inventories held by dealers. Changes in the value of these inventories can have a very profound negative (and of course a positive) impact on the underlying capitalization of the firm.

Generally, the need for capital in respect of these activities, beyond the regulatory requirements, is a function of the volume of transactions conducted by the firm. While capital requirements are imposed by the regulatory authorities -- the IDA and/or the TSE -- they are designed to protect the investor. These requirements have little to do with the scale of business that can be sustained by individual firms, and by the industry in

⁶¹ Michael Keenan, "The Scope of deregulation in the Securities Industry," 126.

aggregate, or with the normative precept of the scale of activity that the industry should be able to facilitate. Thus, the liquidity of the capital market in general was a function of the ability of the market intermediaries to accommodate the growing importance of institutional traders. This capability would be influenced by the capitalization of the firm. The relative liquidity of the market would impinge, more or less, on the costs in and efficiency of the markets and on willingness to transact business in the debt and equity markets. In this respect the SEC observed that

The U.S. markets for equity securities are generally recognized as providing greater liquidity and depth than the markets of any other country. In recent years the growing importance of institutional trading has put added strains on these markets in a number of respects. Of particular relevance...are the increased demands placed on the market-making mechanism by the relatively large transactions preferred by institutional investors.⁶²

Despite mounting evidence to the contrary the Moore Committee concluded that

Although the securities industry generally experienced a substantial rate of growth in the period under review [1958-59 and 1964-69], the question remains whether the industry would have been able to provide a broader service to the economy as a whole if it had been possible for firms to raise capital from other sources. The answer to this question is matter of judgement and a conclusion cannot be reached by statistical analysis. Therefore, the Committee's judgement is based on its understanding of the industry which was further developed in the course of its discussions with other members of the securities industry. The Committee has concluded that there was sufficient capital available throughout this period to allow the industry to expand its services in step with the demands placed upon it by the needs of the economy. However, it is realized that if the volume of business had continued to increase after mid-1969, there would have been no assurance that some firms might not have been limited in the expansion of their activities by capital considerations. It should also be noted that,

⁶² United States Securities and Exchange Commission. Institutional Investor Study Report of the Securities and Exchange Commission (Summary Volume) Washington, DC: US Government Printing Office, 1971, 95.

because of the currently low level of market activity, some firms are experiencing operating losses which could lead to capital problems.⁶³

The Committee seemed to be ignoring the emerging trends in the institutionalization of savings. This phenomenon was an important consideration in the discussions surrounding the liberalization of brokerage commissions -- which was elaborated upon in Chapter Three.

This is also an interesting conclusion because it flies in the face of the logic used by the Committee to debunk the arguments put forward by the US securities industry to support a NYSE rule change which would permit the industry to raise capital from the general public. That is to say, the US industry suggested that there was a need to stabilize sources of capital from the volatility in the industry's earnings, and there was a need to enhance the industry's infrastructure to better enable it to service the needs of the economy.

The Canadian industry had escaped some of the unfortunate infrastructure problems of the US industry in the 1969-70 period. However, by the Committee's own admission, the Canadian industry's capital would not have been adequate to support the continued growth in capital market activity. Using the same judgmental model invoked by the Committee, it could be argued that the Canadian industry's capital was not adequate in the period examined -- particularly if firms wanted to invest in the electronic technology that would ensure that the experiences of the US industry would not be mirrored in Canada in the future. It is important to reiterate the lack of a forward-looking component -- either by design or by chance -- in the Committee's deliberations.

Some 15 years later, the restructuring which the industry was obliged to confront was attributed to its need for a "larger capital base."⁶⁴ The industry, because of its past efforts designed to insulate itself from the effects of the evolving globalization of the

⁶³ Trevor Moore, Report of the Committee, 53.

⁶⁴ Observations by Charles Freedman, "Universal Banking and Integrated Financial Systems: The Canadian View," revised version of notes used for presentation to the Seminar on Financial Sector Liberalization, Cambridge Massachusetts, June 14, 1990, 22.

world's financial markets was inadequately prepared to compete in and support the intermediary function in the Canadian capital market.

Furthermore, in order to preserve competition in the securities industry the Committee wanted to prohibit the development of public trading in the shares of member firms. According to the Committee, not only would public trading in the shares of firms undermine competition in the industry, it could also call into question the good faith relationship between the firms and their clients. With respect to the latter point, firms in the industry, it was argued, would be in a conflict of interest position vis-a-vis their clients if the firm was the distributor of its own shares in the primary market. If a competing firm was instead the primary distributor, the competitive relationship between firms, for reasons of "due diligence"⁶⁵ requirements would be undermined because the primary distributing firm would be privy to what could be considered privileged client-firm information. Thus, from the Committee's perspective there was no conceivable way to distribute the shares of a securities firm without undermining investor confidence in the integrity of the industry.⁶⁶ The NYSE was able to successfully put in place rules to deal with possible latent conflicts.

The Committee did not attempt to examine the securities industry's "predicament" with possible similar situations in other areas of commerce which would be within the purview of a formal regulatory apparatus. For example, the logic of extending the Committee's rationale to the health care industry would lead to the untenable circumstance that physicians could not treat other physicians. Or perhaps physicians would not be able to substitute for other physicians in their absence for fear of undermining patient confidence generally, or for fear of being seen to be second guessing the patient's principal physician, or for fear of patient raiding etc. The Committee's "insight" was misguided as subsequent events in the US so plainly demonstrated.

⁶⁵ The formal process of disclosure undertaken by the issuer's agent to avoid liability for material misstatements or omissions in securities issuing documents. See glossary in Joseph Auerbach and Samuel L. Hayes, III, *Investment Banking and Diligence: What Price Deregulation*.

⁶⁶ Future regulators in the financial services arena were able to devise "Chinese Walls" and other mechanisms that would serve to protect users of financial services from potential conflict of interest risk. It was just not in the interests of the industry to pursue that line of reasoning.

The Committee also registered the idea that if public ownership of securities firms was permitted, the regulators would be unlikely to use the full authority of their legal sanctions against a firm which was found to have violated one or another of its regulations. That was to say, the regulators would be fearful of impinging on the market value of the publicly traded shares of the firm. Actions to sanction a firm, it was argued, would be contrary to the interests of the public shareholders. This is another example of rather curious logic used by the Committee -- a class of reasoning which would not stand up to scrutiny in other areas of commerce. For example, the regulatory mandated recall of automobiles or other manufactured products by the state's health and safety bureaucracy is not unusual.

The relevance of this discussion to the main matters at hand -- the raising of finance capital from the public -- seem rather "far-fetched" to the uninitiated. However, this side-discussion was intended to demonstrate how absurd the industry's position was on this question.

The only area in which the Committee was unequivocal regarding the "adequacy" of capital sources was in the matter of the turn-over problem. So although the Committee was adamant about preserving the status quo in respect of the organization of the industry, it obliquely acquiesced to some relaxation on the restrictions on capital sources.⁶⁷ This would take some of the pressure off of the partners to provide new capital for expansion purposes.

Partnerships in securities firms are a part of the compensation package for industry participants.⁶⁸ If there was a public trading market in the shares of securities firms, the *book value* of firms -- which is the valuation used for transferring shares to juniors (i.e., the "turn-over") -- would be exceeded significantly by the *market value* of the shares (the value of shares traded on a public exchange). This of course would exacerbate the problem

⁶⁷ It is worth noting again that up to this point only those individuals who are directly engaged in the securities firm may be partners or shareholders in the firm. Thus capital was sourced exclusively from current staff-members.

⁶⁸ Industry participants for purposes of this discussion can be defined as officers and employees of a securities firm.

of bringing juniors into the industry -- given the industry's then current practices -- and thus erode the traditional power, wealth and elite status of industry participants in the future.⁶⁹

In order to facilitate some modest liberalization in the sources of capital to accommodate the turn-over problem the Moore Committee made provision for the very limited participation of "outside" investors. This reflected the influence of the Quebec industry, which had already indicated a move in that direction. However, from the perspective of the Moore Committee, industry investors (officers and employees) should predominate and only *individual* outside investors should be permitted. These outside investors should

be restricted to persons of integrity who understand that their investment will not carry any influence over the operations of the securities firm in which the investment is made (other than influence attributable to voting rights at shareholders' meetings or to election or appointment to the board of directors or similar body of the securities firm)."⁷⁰

Of less concern to the Committee was the "equity" in securities firms which was associated with subordinated loans from approved lenders -- mainly chartered banks. This was because the banks were at this time prohibited from participating directly in the affairs of the business with whom they engaged in lending. Moreover, there was a general prohibition of intermingling among the four pillars of the financial system.

The basic restriction insisted upon by the Committee was that industry investors would be required to hold not less than 60 percent of total capital of the firm. This would ensure that no outside influence would be exercised over the firm. Therefore outside/ approved investors would only be able to acquire limited participation securities firms.

Furthermore, the maximum amount of voting shares which could be held by approved investors would be limited to twenty-five percent of the total issued. And, a

⁶⁹ The Committee was opposed to a two price structure for a firm's shares -- one for public trading and one for pricing internal share transfers among partners.

⁷⁰ Trevor Moore, Report of the Committee, 75.

single outside investor would be limited to ten percent of the participating shares.⁷¹ Thus, there could be no influence by outside investors on the firm except through voting rights.

These recommendations, if implemented, would ensure the continued closely held character of industry ownership while at the same time facilitating the turn-over from seniors to juniors. Thus, the cartel-like structure of the industry would persist under the regime proposed by the Moore Committee.

While the status of the industry elites would be preserved under the beliefs of the Moore Committee, the introduction of outside directors (participants) would not validate the tenets of the principal-agent relationship. The "new" owners would be unable to invoke sanctions against the directors who were industry participants -- but they would have to share in the risks.

Before we turn to the final component of the Moore Report, dealing with non-resident ownership, it is interesting to recall the events in the UK, leading up to the "Big Bang." One of the key issues to which the UK's Office of Fair Trading was responding at the time was the restriction (ten percent) on outsider ownership of member firms of the London Stock Exchange. While there were a number of other important issues which, combined with the ownership limitations, formed the base upon which the UK's state authorities attacked the entrenched interests of its securities industry, the industry's case was based on the notion that its restrictive practices were in the public interest. The evolution of the events and the reasoning which lay behind them, first in the US, subsequently in Canada, and much later in the UK, are remarkable in their symmetry.

⁷¹ Moore and Peter Kilborn (a committee member) believed that an investment of up to 10 percent of a Canadian firm made by a privately owned securities firm would not result in an undue influence over the Canadian firm, and would improve the quality and the competitive ability both of that firm and of the Canadian securities industry as a whole. Such a rule would permit a Canadian securities firm to seek additional strength through investment by a foreign firm so that it would be better able to compete with other foreign securities firm that are already operating without restriction in Canada. Trevor Moore, Report of the Committee, 139.

Non-Resident Participation in the Securities Industry

We now turn to the final element in the Moore Report dealing with the participation of non-residents in the Canadian securities industry. The chapter of the Report, dealing with this question was analytically weak -- and was the only part of it not to have the unanimous support of the Committee. The Committee's bottom line was that the 25/10 rule, noted earlier in this chapter, was to apply equally to non-resident *individuals*, but foreign owned *firms* were to be prohibited in any circumstances from investing in Canadian owned securities firms.

The Committee argued its nationalistic case from the perspective of what was characterized as cost-benefit analysis as well as from the key-sector precepts. The cost-benefit analysis was qualitative, which is not a reason alone to be critical of it, but it was also saturated with contradictions. It is interesting as well, that the overarching arguments of the "liberal" marketeers relied on the work of both Watkins, representing the ideas of neo-marxist political economy in Canada, and Safarian, representing the more liberal interpretation of economic events.⁷² Indeed, the Moore Committee claims to have independently arrived at some of the same conclusions as Watkins and Safarian in respect to their applicability to the securities industry.⁷³ It is likely that this contrast in paradigms is rooted in an unconscious misunderstanding of the sources of the ideas of the Canadian political economy school rather than a conscious effort to provide legitimacy to these ideas. More cynically, the argumentation of the Moore Committee can be seen as a confirmation of the shallowness of the processes used by the securities industry to support its interests.

An overarching concern expressed by the Committee was that the presence of non-resident owned firms operating in Canada could precipitate an outflow of Canadian capital to the US, thus diminishing the liquidity of the Canadian equity market and starving

⁷² See The New Canadian Political Economy, ed. Wallace Clement and Glen Williams (Kingston: McGill-Queen's University Press, 1989) and The New Practical Guide to Canadian Political Economy, ed. Daniel Drache and Wallace Clement (Toronto: James Lorimer & Company Publishers, 1985).

⁷³ Trevor Moore, Report of the Committee, 122.

indigenous firms of needed financing for expansion. Moreover, the Committee was concerned that those Canadian investors which would direct funds to offshore markets, through non-resident owned intermediaries, would probably be ignorant of investment opportunities in Canada.⁷⁴ The plausibility of such an assertion is questionable to say the least. The hypothesis is that an investor (individual or institutional) would have the necessary sophistication to assess the foreign exchange risks associated with the offshore purchase of a financial asset, but would not have the capacity to gather the necessary information about Canadian investment opportunities for portfolio diversification which would eliminate the need to take on foreign exchange risks. The Moore Committee's concern here was just too simplistic. The Committee's implicit view was that the presence of non-resident owned firms would somehow inhibit or preclude the industry (both its indigenous and foreign-owned members) from informing independent thinking and "rational" investors about potential profitable opportunities in Canada.

For the Moore Committee, the question on the cost-benefit side was "how to increase the benefits and decrease the costs" of non-resident participation in the Canadian securities industry. The Committee's inquiry identified only one benefit -- the research which would be provided by United States firms.⁷⁵ That was to say, the skills present in and methodologies applied by American firms were known to be superior to those of Canadian firms -- and there already had been positive externalities for Canadian firms in this regard to which the Moore Committee admitted. But there was still more for the Canadian industry to do. "Competition... requires Canadian firms to adopt improvements in research techniques as they are developed even if a foreign firm does not introduce them into Canada. The research techniques used by Canadian firms...are then fully compatible with those of United States firms."⁷⁶ Even if this was the only benefit of foreign participation in the securities industry, it was nonetheless significant with respect to both competition in the industry and efficiency of the Canadian capital market. Market efficiency is critical to ensuring capital formation and economic growth. Information

⁷⁴ Trevor Moore, Report of the Committee, 126.

⁷⁵ Trevor Moore, Report of the Committee, 128.

⁷⁶ Trevor Moore, Report of the Committee, 129.

production by the institutions participating in the markets can reduce uncertainty and the moral hazard of the lack of information and thus increase market efficiency. Competition in the provision of information spills-over into enhanced firm competition generally, and can be seen as a net social benefit for a market-based capitalist economy.⁷⁷

The Committee saw no benefit associated with non-resident firms operating in Canada with respect to enhanced access to the US capital market. This is so because Canadian clients wishing to raise funds in the New York market typically deal with the head office of the firm and not with the local Canadian office. On this point the Committee was correct. However, at the time, it was unclear whether the US regulatory authorities or the securities industry itself would demand reciprocity. Indeed, it was the case that Canadian dealers were welcomed in New York and were the only non-resident firms permitted to become members of the NYSE. But some Montreal and Toronto brokers were worried about a reciprocal blockade of Canadian dealers in the New York market if there was a hostile reaction to the Merrill Lynch deal on the Canadian exchanges.⁷⁸ The Moore Committee, on the other hand, assumed that the US regulatory authorities, and the US industry itself, would be indifferent to the presence of Canadian firms in New York even if US firms were prohibited from accessing the Canadian market directly.

Broader distribution of Canadian financial instruments to US residents as a consequence of the presence of US firms in Canada was identified by the Committee as a potential benefit but was subsequently beaten down like a straw "person." The evaporation of this positive net benefit was due to the presumption that "Knowledgeable investors, who usually include the more substantial investors, in other countries who are interested in Canadian securities will seek out and obtain information concerning such securities regardless of whether the firms with which they usually deal have Canadian offices."⁷⁹ This is a rather provocative assertion because the Committee did not allow this same rationale to hold for the Canadian investors' knowledge of Canadian opportunities when

⁷⁷ James C. Van Horne, Financial Market Rates and Flows (Englewood Cliffs: Prentice Hall, 1990), Chapter One.

⁷⁸ Globe and Mail, 18 June 1969, B1.

⁷⁹ Trevor Moore, Report of the Committee, 130.

they made choices which involved the acquisition of offshore financial assets. Implicitly, the Moore Committee was stating that US investors were more efficient or more rational than their Canadian counterparts. There was not any empirical evidence presented on this point, although the evidence provided on the comparative advantage of the US research could support such an assertion. Apparently the Committee was unaware of this contradiction in its analysis.

More generally, the Committee dismissed any notion that the presence of non-resident owned securities firms could have the effect of enhancing the efficiency of the domestic industry. To support this conclusion the Committee cited a portion of a statement by the Canadian-American Committee on The Performance of Foreign-Owned Firms in Canada which was a lead-in to Safarian's study of the same title:

*...the actual performance of foreign-owned subsidiaries in Canada is seen to be little different from that of comparable Canadian-owned firms...Thus, within the presence of purely business-motivated behavior, the economic performance of firms within Canada is primarily determined, not by nationality of ownership, but by the economic and social environment, and particularly by the Canadian policy environment, within which all firms alike -- however owned -- must operate in Canada. The key to both improved performance of all Canadian firms and fuller economic benefits from foreign investment is to be found in a more appropriate set of Canadian trade and other industrial policies...*⁸⁰

The relevance of this line of argumentation for the Moore Committee's study, inasmuch as it pertains to the manufacturing industry and not the financial services industry, is murky to say the least. But the Safarian study notes clearly that

If the foreign-owned firms in Canada suffer in terms of comparisons with the parent, it is likely that the resident-owned firms competing with them generally appear less impressive in a number of aspects of performance."⁸¹

⁸⁰ A.E. Safarian, Performance of Foreign-Owned Firms in Canada (Washington: Canadian-American Committee, 1969), v. The phrases in italics were not included in original citation by the Moore Committee.

⁸¹ A.E. Safarian, Performance of Foreign-Owned Firms in Canada, 88.

In a later work Safarian notes that improved performance of Canadian owned firms could result from the adjustments these firms make to meet the competition from foreign owned firms.⁸² This point is not unrelated to the impact of US firms' research on the competitive environment and market efficiency noted earlier. The conditional nature of Safarian's observation reflected the absence of data upon which he could rely to test his hypothesis. In any event he noted that

Maximum competition both internally and internationally is necessary to assure that the gains from foreign investment are in fact passed on to the domestic economy...Given her tariff, Canada was better off economically having access to direct investment rather than doing without it.⁸³

The character of public policies which Safarian suggests are required to enhance competition and efficiency of Canadian industry, generally, was a liberalization of international trade barriers. The Moore Committee ignored this element of the national debate on foreign ownership. Indeed, the Committee's argumentation flies in the face of conventional wisdom and was contrary to liberal economic precepts -- where one would expect to locate the source of economic/market ideas which influence the securities industry's policy prescriptions. Competition inevitably results in broader choices for users of the commodities or services in question, the quality of service is enhanced in a competitive environment while prices allocate output more efficiently. Also, a competitive environment results in greater product innovation and responsiveness to changing market demands as well as enhanced efficiency of the firm.

Certainly government policies have a great deal to do with the "environment" in which commerce is conducted, and if government policy is directed towards protecting entrenched interests against the vagaries of the market one is hard pressed to argue that anything but the state's policy output is the determining factor of the level of economic performance. Indeed, this is exactly what Safarian was debating. His industrial policy prescription -- which in retrospect can be seen as very forward looking -- reflected a more

⁸² A.E. Safarian, *Foreign Ownership of Canadian Industry*, 304.

⁸³ A.E. Safarian, *Foreign Ownership of Canadian Industry*, 304-305.

open world trading system which, for Canada would enhance its domestic competitive environment. Thus any way one squares the circle, government policies are an important influence on economic performance. The Moore Committee suggests that this is the end of the story. This is a curious path of argumentation indeed. Bad policies can be corrected in order to alter outcomes -- but this alternative did not enter into the set of solutions considered by the Committee.

Indeed, even the Gray Report, although somewhat later in time, recognized the benefits of foreign direct investment:

The foreign investor...may add significantly to the competitive climate of the industry involved (and perhaps also of supporting industries, as he puts pressure on those suppliers to be more efficient). Indeed, for the direct investment may be the only viable source of new competitive challenge to existing firms...

Foreign direct investment also offers the potential for training local personnel -- both managers and workman -- in new techniques which are more productive. Increased productivity leads to greater real wages and salaries. Furthermore, the skills acquired in working for a foreign controlled firm may later be made available to Canadian controlled enterprise as the persons involved change jobs and move around the country.⁸⁴

However, Gray, a nationalist, was concerned about the presence of foreign owned firms in Canada in respect to the loss of sovereignty by the host.

(T)here is a pressing need for the Canadian government and the Canadian people to take stock of the present situation, particularly in view of rapidly changing circumstances at home and abroad, and to consider measures that will permit Canada to exercise greater control over the domestic environment, to obtain a larger share of the benefits from foreign

⁸⁴ Gray Report, 41. Certainly this report set out a list of many costs that would serve to more than offset whatever benefits would accrue from foreign direct investment. The sole purpose in setting the details of this particular benefit is to demonstrate the one-sidedness of the Moore Committee's "analysis."

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investment, and to achieve greater Canadian participation in the economic life of the nation...⁸⁵

The difference between Gray and Safarian was that the former was concerned about the political repercussions of foreign ownership and advocated autarchy, while Safarian was concerned about state policies which prevented firms -- whether Canadian or foreign owned -- from minimizing production costs and maximizing output. Safarian favored liberalization while Gray favored government intrusiveness to address the perceived problems.

The costs of foreign participation in the Canadian securities industry, which were identified by the Moore Committee, were also borderline with respect to their substance. The Committee was of the view that any relaxation of foreign ownership provisions would result in an overwhelming presence of foreigners in the ownership ranks of the indigenous industry.⁸⁶ Indeed, the Committee surmised that the industry would be under foreign (US) control in short order. The mode of direct investment would be through Merrill Lynch type takeovers. Such an eventuality could serve to undermine economic development in this country because domestic firms would likely be issuing their primary securities in the US capital markets (i.e. in New York) and have to satisfy criteria of that market which could not be as conducive to Canadian borrowers as would the domestic market. According to the Committee, this migration of Canadian borrowers to the US market would also have a detrimental impact on economic and financial policy in Canada and extraterritoriality⁸⁷ could also become a problem.

The resilience of these arguments is suspicious. *First*, it would seem to be a costly exercise indeed, for US securities firms to takeover Canadian firms for the express purpose of capturing additional business to transact in the New York market. There would have been cheaper ways to do that, such as setting up a branch office without the elaborate

⁸⁵ Gray Report, 8.

⁸⁶ Trevor Moore, Report of the Committee, 136.

⁸⁷ This was the issue upon which Safarian expressed most of his concerns in relation to foreign direct investment. Extraterritoriality, however, had no impact on the economic performance of firms.

infrastructure that had been established in the major Canadian dealers -- for which US dealers would have to pay if takeovers were indeed the method used to invest directly in the Canadian industry. *Second*, it is also questionable, because the Merrill Lynch takeover of Royal Securities was based on the potential "synergies" of the two firms in the Canadian capital market. *Third*, there is an assumption that the US capital market would have welcomed offshore corporate borrowers at costs of capital that would have been considerably less than loanable funds could have been obtained in Canada. Inasmuch as there were no capital or currency controls, indigenous firms always had the opportunity to choose in what market they wished to borrow, given the costs they would have to confront -- including the exchange risk. Major Canadian firms, as well as provincial governments frequently borrowed in offshore markets. *Fourth*, the development of the money market in Canada followed a reverse path from that prognosticated by the Moore Committee. Indeed, in the period preceding the establishment of the Bank of Canada, a good deal of the liquidity adjustments of the Canadian chartered banks occurred in the New York money market. The establishment of the Bank, and the beginnings of the money market resulted in the migration of such operations from New York to Montreal and Toronto. The Moore Committee chose to ignore this relevant component of Canadian financial history.⁸⁸

Finally, the Committee, relying on the key industry precepts, recommended that foreign participation in the Canadian Securities industry be limited. The securities industry satisfied the key industry precepts. According to the Gray Report, "Preserving Canadian control of the capital intermediation process appears to have been the main *economic* consideration that has prompted the designation of certain key sectors in the financial field to date...[The] concern appears to have been based on the fear that non-resident controlled intermediaries would be more disposed to siphon an excessive amount of domestic savings out of the country than would Canadians."⁸⁹ Thus, for the Moore Committee, the securities industry was a key sector because:⁹⁰

⁸⁸ Even today, in a world of global markets, trade and issuance of securities by Canadian entities is concentrated in Toronto.

⁸⁹ Canada. *Gray Report*, 497.

- firms in the industry play an important role in the allocation of loanable funds;
- distribution of securities in both the primary and secondary markets relies for its effectiveness on the members of the industry; and
- the Royal Commission on Banking and Finance affirmed that the banking industry is a key sector -- although it refrained from including the securities industry under the umbrella of "banking institutions."⁹¹

As noted earlier, there is little doubt that efficient capital markets are crucial to the economic development of a capitalist nation-state. Efficient markets depend on the existence of an appropriate institutional infrastructure -- including a viable securities industry. However, inasmuch as securities dealers were/are *market* intermediaries rather than *financial* intermediaries -- acting more frequently as agents rather than as principals -- it is not clear that the nationality of ownership of the industry, or a part of it, is critical to its efficacy or to the interests of the nation-state in which the operation takes place.⁹² Of course, systematic short-circuiting of the indigenous market by foreign owned firms would not be in the nation's interest. However, there was sufficient depth and maturity to the Canadian capital market generally, that there would be little incentive for foreign owned firms to migrate Canadian business to New York and thus little risk that it would occur.

The bottom line of the Moore Committee's analysis of this component of the securities industry's capital requirements was to propose restraints on foreign ownership of the firms in the industry which were similar to those for non-industry participants outlined earlier. Thus, restriction on outside ownership of the voting/participating securities issued by a Canadian firm to twenty-five percent would include both Canadian and non-resident ownership so that the maximum outside ownership by non-residents would be twenty-five percent. Foreign securities firms would not be eligible for treatment under these rules.⁹³ Furthermore, over fifty percent of the participating and voting

⁹⁰ Trevor Moore, Report of the Committee, 138.

⁹¹ Canada, Report of the Royal Commission on Banking and Finance, 374.

⁹² The only empirical evidence available on this point relates to the world since the late 1980s. There is no suggestion that nationality of ownership matters to the performance of the industry.

securities of any firm which was a member of any of the SROs sponsoring the Moore Committee's work would at all times have to be owned by industry investors associated with that firm and resident in Canada.⁹⁴ Existing foreign owned firms would be grandfathered but this provision could be revoked if:

- (i) if the parent obtains capital in a manner significantly different from those permissible for Canadian securities firms (e.g., public distribution of its securities). In this case, Merrill Lynch (New York) would be negatively affected.
- (ii) if control of the parent changed, and
- (iii) if the parent merged, amalgamated or experienced another corporate reorganization.

The Committee agreed that the Merrill Lynch - Royal Securities deal should be grandfathered. That was to say the newly formed company would be permitted to operate in Canada, but subject to the rules regarding access to capital that it had recommended.

The Quebec Position Restated

Just prior to the publication of the Committee's Report, the Quebec Minister of Financial Institutions, Companies and Cooperatives, Jerome Choquette, in a speech to members of the Montreal Financial community formally carved out the provincial government's position on the participation of non-residents in the Quebec securities business. The essence of the Quebec stance was that there is a good deal of support for offshore capital and enhanced membership on the Montreal exchanges. Choquette indicated that

The Government wants the Montreal and Canadian exchanges to expand...In 1970 we no longer can maintain tight economic partition between provinces or countries...Economic interdependence is a reality that we must face and live with.⁹⁵

⁹³ Trevor Moore, Report of the Committee, 141.

⁹⁴ Trevor Moore, Report of the Committee, 141.

⁹⁵ Clair Balfour, "Quebec favors end to barriers," Globe and Mail, 30 May 1970, B2.

There was a clear convergence between the views of the Quebec securities industry and Government. The industry's views were stated at the outset of events surrounding Merrill Lynch - Royal Securities and were manifest in an initial reluctance on the part of the Montreal and Canadian exchanges to participate in the Moore Committee's study. In any event, the ultimate decision of the Quebec industry to participate was not unequivocal. It had to confront the pressure from the IDA and the TSE. Consequently, not only the statement by the Quebec Minister, but also its timing, set the stage for the complicated policy debate that was to ensue.

Conclusions

The validity of the arguments used by the Moore Committee to support its objective of insulating the Canadian securities industry from the impulses of the market have been questioned. In addition, the interpretation of some "facts" by the Committee have been distorted. All of this primary "lobbying" activity was carried out in the context of furthering the interests of the Canadian securities industry. Little candor was evident that would suggest the "public interest" was a variable in the equation supporting the industry's rather narrow interests. Indeed, the industry's interests were equated with the public interest, thus validating the pluralists beliefs (Herring and Bentley) that there is no legitimate equivalent of the concept of the public interest. Indeed, the policy process, marked by the Merrill Lynch takeover, and the subsequent industry study, reflect the diagnosis and subsequent prognosis of Domhoff. The line of argumentation used by the industry reflects the forecasts embedded in the theoretical precepts of the Stiglerians and other public choice scholars.

But given the industry's goals for the Moore Committee's work, its efforts were well rewarded. The Committee (really the industry) set the public policy agenda in respect of entry into and ownership of the Canadian securities industry. The industry held the upper hand, and as will be seen, all other actors in the policy drama were compelled to begin representation to the regulatory authorities with the position enunciated by the industry. Moreover, the regulatory authorities and the elected officials would have to rely on the industry itself for information about the policy alternatives that were considered, so

that it is not difficult to anticipate the character of the policy outcome of this phase of the process.

From the social sciences perspective, however, there was a means end-rationality⁹⁶ to the work of the Committee -- although the arguments did not seem to be sufficiently robust to support the objective of the analysis. Indeed, a basic underlying assumption of the Committee was that there would be no change in the character of the industry's work in the future -- a rational, but questionable, assumption which works to preserve the status quo. It will be shown later that this basic hypothesis -- which in the social sciences is characterized as the "naive forecast" -- was severely flawed and later served as an important component which undermined the traditional support which the industry received from the state. Concurrently, there was rationality in the industry's overarching objective of self-interest seeking behavior in demanding the supply of public policy which would optimize its interests.

The means-ends rationality pursued by the Moore Committee set the following objectives of the "ideal-type" regulatory scheme to which the securities industry should properly be subjected in regard to entry and ownership:

- protecting the investor,
- maintaining competition within the industry,
- maintaining a trustworthy relationship between the members of the industry and its clients. It will be recalled that the primary purpose of regulating the securities industry was to preserve the integrity of the industry and the confidence of users of its services, and
- preserving the public interest. However, as noted above, it was not the social welfare function which is being maximized by the securities industry, but just its profits function.

The logic of the objectives set out by the Committee gave rise to the basic criteria required to ensure their realization. These criteria follow very closely the arguments put

⁹⁶ It should be recalled, as noted earlier, that the industry's use of the nationalist arguments was in fact an instrument used to achieve the objective of limiting competition in the securities industry.

forth by the lone dissenter to the NYSE regulatory decision to liberalize ownership in the US industry -- the Wilmer et. al., submission to the SEC. They also ignored the requirements of both the Quebec industry and Quebec as a "nation-state".

The Committee's arguments disregarded the impact of competition within the industry and the ways in which the structure of the securities industry, if it did not change, would impact on other areas of economic activity in Canada. Historically, the industry's primary concern was that of protecting its members. It did this through a price-setting cartel in respect of brokerage commissions and it was now in the process of doing the same by restricting entry into the industry. This inwardness demonstrated by the industry would eventually be the cause of its structural adjustment. Subsequent analysis will show that the structural adjustments forced upon the industry reflected the fact that its "ideal-type" model of regulation surrounding entry and ownership did not achieve its objectives.

CHAPTER SIX

PLODDING TOWARDS A POLICY RESPONSE: THE SEARCH FOR AN EQUILIBRIUM

Introduction

It is the purpose of this chapter to explore the evolution of the entry and ownership policy debate in the aftermath of the Moore Committee findings from the perspectives of the key actors outlined above. It will show that in Quebec, it was the Government which was first off the mark to respond to the Moore Report. Its efforts were partly targeted as an educational exercise to disclose information about the industry, and to determine if the industry as it was then constituted could fulfil the vision foreseen for it by Quebec officials. In Ontario, on the other hand, the regulatory authorities, without any overarching framework for entry and ownership regulation and reliant as they were on the industry itself for information which would contribute to an understanding of its work, continued its dependency role in the immediate aftermath of Moore. In short, the Ontario authorities did not act in the first year after Moore; they awaited a Joint Industry Report. The events of the first part of the decade are mapped out in the accompanying Table 2 below.

Table 2:**Chronology of Events in the Aftermath of the Moore Committee Report**

<u>Date</u>	<u>Event</u>
May 1970	Moore Report Published
June 1970	Quebec commissions a study of the Moore Committee Report (Bouchard Committee)
July 13, 1971	Premier Davis announces OSC Study
July 13, 1971	Premier Davis concurrently announces restrictions on ownership of investment dealers
July 28, 1971	Joint Industry Committee Report
Sept. 8, 1971	Quebec's Bouchard Committee Interim Report released
May 11, 1972	OSC Study Released by Davis in the Legislature
Sept. 24, 1972	Bouchard Committee Final Report (Vol. 1) released
August 29, 1972	Kniewasser announces Quebec Chapter of IDA setting up study committee to review Bouchard Report -- report in one month
November 23, 1973	Joint Industry Report

A Matrix of Tensions: The Prelude to Policy Decision-Making

The publication of the Moore Report in the late Spring of 1970 had the effects on the policy community that the sponsors of the study, the four key SROs in Canada responsible for regulating the securities industry, intended. The industry was first off the mark, in July 1970, with its response to the Merrill Lynch takeover of Royal Securities. From a public policy perspective, the state actors, at both the federal and provincial levels, appeared unable to respond coherently to the intrusion of a major foreign investment dealer into the Canadian securities industry -- despite the policy fashion of the time to restrain, to the extent possible, the participation of foreign-owned entities in key sectors of the Canadian economy.

The industry, moreover, wanted to be in a hegemonic position. This would facilitate the setting of the policy agenda for future consideration by the state and reinforce the industry's already existing monopoly on information about its operations. In this respect the industry was eminently successful. So effective was the industry, that its work sparked major state sponsored and additional industry underwritten studies of the issues surrounding capital adequacy of and foreign participation in the securities industry. Most importantly, however, was the fact that the industry compelled the state to respond -- usually in a fashion that supported the industry.

The aggressiveness of the Ontario based industry, moreover, brought into clear focus the objectives of the Quebec authorities, which were in sharp contrast to the considerably more opaque purposes of the Ontario regulators. The Quebec state policy-makers were initially acting within the overarching framework of the "maitre chez nous" precepts -- and thus their vision was clear if not proscribed by contextual events. Although, earlier studies in Quebec of possible structures of its financial institutions were clearly at odds with mainstream thinking in the rest of Canada. Indeed, the Parizeau Report¹, published in 1969, had already called for a blurring of the four pillar structure and the establishment of a universal bank type of structure.

....inevitably steps must be taken so that legislation covering financial institutions may be brought into line with changes that have taken place in financial markets. Seeking to maintain by law elements of traditional specialization in financial institutions which have abandoned their specialized functions merely amounts...to preserving certain abusive prohibitions or even to setting up pointless restrictions...

...what the Committee's recommendations presume is the emergence of institutions offering the whole range of financial services needed by consumer and saver -- what might be called 'departmental' financial institutions, using the analogy of department stores.²

¹ Report of the Study Committee on Financial Institutions 1969 (Quebec: Government of Quebec, June 1969).

² Report of the Study Committee on Financial Institutions 1969, 213-214.

Furthermore, Quebec's Liberal politicians, early in their electoral mandate, wanted to be seen to be acting in the economic and social interests of Quebecers.³

The Ontario authorities, on the other hand, were operating from the perspective of the domestically-owned industry's interests and against the background of the cross-currents emanating from both the federal government and the Canadian nationalists' camp more generally. The Ontario authorities, dependant as they were on the SROs and the individual firms comprising the industry for information (operating statistics and institutional/organizational knowledge) about the industry, were thus inadequately equipped to independently evaluate the potential "industrial," economic, social and regulatory repercussions of the Merrill Lynch takeover.

An important characteristic of the Ontario Government's response to the events of the early part of this period was its paralysis: Ministers seemed unable to speak knowledgeably about the issues surrounding the takeover. And by default, the elected officials in Ontario permitted the industry's representatives to speak for the Ontario policy position. This contrasts sharply with the more clearly assertive attitudes and actions of elected officials in Quebec. In Ontario, among both industry practitioners and former members of the OSC -- either employees, Commissioners and Chairpersons -- there is universal acknowledgment that neither the primary regulator nor the Ministry responsible for the regulator had the analytical capacity to challenge the industry.⁴ Indeed, the industry elite were seen as legitimate persons, they held a monopoly on the information required by policy-makers to make decisions about regulatory policy supply, and were thus able to strongly influence the state into supporting its demands. Using policy output as the indicator, the industry had truly captured the regulators in this period.

³ Amy Booth, "Bourassa whip starts to crack," *Financial Post*, 6 June 1970, 1. In this regard the earlier noted public comments by Jerome Choquette regarding the structure of the Quebec securities industry should be recalled.

⁴ These views were expressed in confidential interviews and confirmed the earlier assertions, in the first part of the dissertation, that the OSC did not have vision for the future development of the investment dealer industry.

It is important to stress that a central feature of the industry's work was to highlight the differences in the objectives between all of the key actors in the drama. The inconsistency among the objectives of the Quebec and Ontario Governments were sufficiently powerful -- and passionately held -- to delay the realization of an equilibrium in the regulatory environment because there was an apparent desire within the apparatus of the IDA to have a uniform entry and ownership regime across the country.⁵

Quebec wanted to enhance both the position of its industry and the importance of Montreal as a financial center. Ontario did not want to disrupt the post-Merrill Lynch equilibrium foreseen by the Moore Committee. Concern about the capacity of Toronto to continue as the Canadian financial center did not materialize seriously until a decade later -- although the TSE, as an entity, had for a long time seen its organization as the preeminent stock exchange in the country. It saw a very much lesser role for the "regional" exchanges in Quebec and British Columbia.⁶

The tension between the "industry" actors, dominated as they were by the Toronto perspective, and the Quebec authorities was potent because both were of a view that the policies advocated by the other resulted in a win-lose outcome. The public policy dilemma appeared, at the outset at least, to be a zero-sum game. There was also an important element of intrigue within the Quebec component of the industry: the Canadian "continentalists" in Quebec opposed the Quebecois nationalists in the province and supported the Toronto world view of how the securities industry should be structured. There were also strains among the small and large firms in Quebec -- which in part also reflected the Ontario - Quebec cleavage.

This matrix of tensions complicated the achievement of an equilibrium in the policy supply surrounding the entry in and ownership of the securities industry. This fluid situation was manifest in the dynamic iterations between Quebec, the industry, the foreign-owned firms and the Ontario authorities and resulted in protracted negotiations for

⁵ Based on a confidential interview.

⁶ Paul Gibson, "Peace, say Kimber, but who gets control in market feud?" *Financial Post*, 26 September 1970, 1.

virtually all of the decade of the 1970s. Indeed, for the most part, it was the industry's views on entry and ownership which prevailed in all jurisdictions until the mid-1980s.

The Initial Responses to the Moore Recommendations

It was not surprising that the release of the Moore Report's recommendations was a more controversial matter for the industry and state actors in Quebec than it was for their counterparts in Ontario and in the rest of Canada more generally. A number of actions foreshadowed this controversy.

First, the Quebec Minister of Financial Institutions, Jerome Choquette, had already drawn his line in the sand by suggesting, in a speech, just days before the release of the Moore Report, that the Quebec Government supports a diversely based ownership and participation structure in the Quebec securities industry. Thus, the Quebec Government's official starting point for what negotiations would take place surrounding the entry and ownership issue was clear.

It should be noted here, however, that the basis for Choquette's statement, as the new and temporary Minister, was a meeting with Louis Rousseau, President of Molson Rousseau Company -- a prominent Quebec based investment dealer at the time. This meeting occurred some 90 minutes before the speech was delivered by Choquette to the members of the Montreal exchanges. Inasmuch as Choquette was also the Minister of Justice, he had not had time to meet his Deputy Minister of Financial Institutions (Louis-Phillipe Bouchard who was to be the author of the Bouchard Report), and thus the purpose of the Rousseau-Choquette meeting was to provide the Minister with the grist for his speech. (Bouchard apparently joined the meeting late and met his Minister for the first time in Rousseau's office.) The issue which Rousseau chose for the Minister's speech, was one upon which his own private sector-public sector committee looking at the needs of the investment dealer industry had been focussing on for a long time -- the entry and ownership issue.⁷ Thus, as in Ontario, the Quebec based industry set the stage for the debate on the entry- ownership dilemma.

⁷ Based on a confidential interview.

Second, the only French Canadian member of the Moore Committee, Jacques Belanger, was appointed a Vice President of White, Weld Canada, a newly established company in Canada with its head office in New York, and was forced to resign from the Committee.⁸ Belanger was also Chairman of the CSE.

Mr. Belanger said he did not want to resign from the committee after joining White, Weld but felt he had to offer. 'I suggested resigning -- and they accepted...it was a gesture on my part...and I think that they took advantage to say yes, we would like you to resign.'

'If a French Canadian and a representative of an American firm had been there, I think it would have denoted a better feeling when the report came out.'⁹

Third, White, Weld was also elected to membership on the Canadian Stock Exchange, concurrently with Belanger's appointment. In this regard, it will be recalled that the MSE and CSE were reluctant sponsors of the Moore Committee's work and did not unequivocally concur with the other sponsors that consideration of non-resident membership applications to their respective organizations would be suspended until the Committee's deliberations had been completed. Indeed, the MSE had been studying the industry capitalization situation long before the Merrill Lynch takeover¹⁰ and on the day the Moore Study was announced the MSE had approved in principle a plan which would allow outside capital to participate in the Quebec securities industry.¹¹

⁸ The key paragraph in Belanger's letter of resignation to Trevor Moore stated "In view of my change in employment I submit my resignation for the Committee in the belief that there might be a possible conflict of interest between the terms of reference of the Committee and my employers." There was sufficient conditionality in the letter to give the Committee scope to refuse to accept it. Subsequently, in a letter to the IDA, Moore stated that the Committee does not "think that any further announcement is necessary. When the Report is issued, Mr. Belanger's name will not appear." The Committee was glad to rid itself of a renegade.

⁹ Clair Balfour, "Opposition to Moore report mounts; Quebeckers think it backs Toronto's domination of markets," Globe and Mail, 19 June 1970, B 5.

¹⁰ David L. Torrey, Vice President, Pitfield, Mackay & Company, "Capital Provided By 'Outsiders' in I.D.A. Firms," October 14, 1966. Pitfield, a Montreal based investment dealer, was opposed to public distribution of investment dealers' shares.

Fourth, the prevailing attitude in Toronto was that the Canadian capital market had evolved to that city from Montreal, over a long period of time, and it was unthinkable that the now much smaller Montreal community could interfere with or indeed reverse this "natural" evolution. The "nationalistic" concerns were not an issue about which the mainstream of the industry was concerned.¹²

The response in Quebec to the Moore Report was unanimously negative. Jerome Choquette reiterating his earlier comments said that "The Moore Committee represents thinking of the large Canadian Toronto based firms...The question is: Does this correspond to our best interests?"¹³

At the official level, Marcel Lajeunesse, the Chairman of the Quebec Securities Commission (QSC) had views which paralleled those of the Jerome Choquette¹⁴. Lajeunesse's bottom line was that the Report "was not well balanced."¹⁵ He reiterated the view expressed earlier by the MSE and CSE, that the QSC had no objections to the participation of outside capital in the Quebec industry -- even in the form of public ownership.¹⁶ Lajeunesse was also critical of the analytics of the Moore Report -- particularly with respect to the fact that the Committee did not evaluate the benefits which could accrue to the Canadian economy by having large underwriting houses managing the primary distribution of Canadian securities in Canada. The presence of the large American firms on the Canadian capital market would enhance competition in the domestic market.¹⁷ Furthermore, "he noted that the report states that foreign participation in the

¹¹ Clair Balfour, "U.S. firms feel impact of Montreal restrictions," Globe and Mail, 7 August 1970, B1.

¹² Based on confidential interviews.

¹³ Clair Balfour, "Quebec's Financial Institutions Minister differs from Moore, wants foreign cash," Globe and Mail, 26 June 1970, B1.

¹⁴ Mr. Lajeunesse had formerly been a fund raiser for the Union Nationale Party in Quebec and thus did not have any special allegiance to the current Liberal Party regime.

¹⁵ Clair Balfour, "Quebec may oppose Moore group's report on outside capital in securities companies," Globe and Mail, 16 June 1970, B 5.

¹⁶ Clair Balfour, Globe and Mail, 16 June 1970, B 5.

¹⁷ Clair Balfour, Globe and Mail, 16 June 1970, B 5.

Canadian securities industry is at its maximum acceptable level. That might be true. We might say the same thing about Ontario firms in Quebec...Where do you stop this thing?"¹⁸

Lajeunesse's views really set the pattern for : ponses to the Moore Report in Quebec -- substantial opposition. The Report was seen in Quebec as supporting the status quo -- which meant favoring the continued and growing importance of Toronto in the Canadian capital market.

At the industry level, H.W. Andrews, Chairman of the CSE noted that

It's too restrictive...We feel that as a group that we've welcomed non-domestic capital in our industry...It's helped us a lot in our industry...Foreign capital has made our market more competitive...Quebec is different. It's more internationally minded.¹⁹

Louis Rousseau was equally negative is his assessment of the Report.

'The big thing with the Moore Committee is that it is not a real national study...The committee does not represent all types of firms. I'm not sure of anything between pages 2 and 160.' [*The report has 160 pages*]...

Mr. Rousseau recalled that when the committee was established the Montreal exchanges...reserved the right to look at any applications for outside capital investment...the Moore committee statement on the suspension of applications 'is not true.'²⁰

¹⁸ Clair Balfour, Globe and Mail, 16 June 1970, B 5.

¹⁹ Clair Balfour, Globe and Mail, 16 June 1970, B 5.

²⁰ On this point, Charles Neopole president of the CSE and MSE said the understanding is vague having been made by "a group of people sitting around representing the exchanges. Somebody said, well, it would be a good idea if we did noting until the members have a chance to study it. It's not a question of whether we have adopted a different position...or a question of having a kind of formal resolution. However, it could readily be argued that it's a change, but it's awfully difficult to be precise." See Clair Balfour, Globe and Mail, 19 June 1970, B 5.

Mr. Rousseau said the financial industry must be international. 'While not implying we want to be taken over by the U.S..., we want our industry to be real, we want to be international.'

He said Canadian firms like his could participate with big U.S. firms in Canada in placing large issues of securities, those of Hydro-Quebec, for example. Hydro issues often are placed out of the country because they are too big for Canada.

U.S. firms in Canada would add to competition and would encourage bidding for the right to sell large issues...Moreover, Canadian firms like his could work with them for 20 percent of the fee instead of one-half of 1 percent from syndicates dominated by big Toronto investment companies. 'I'm not a bit worried about limited competition.'²¹

The lone dissenting voice from the Quebec based industry participants was that of Fred Whittall, who was also the chairman of the MSE. He was a member of the Moore Committee, and a staunch opponent of opening up the Quebec and/or Canadian securities industry to non-residents.

At the political/academic level, Jacques Parizeau, at the time a professor at Hautes Etudes Commerciales and a defeated candidate for the Parti Quebecois said that adoption of the

Moore recommendations will reinforce the tendency for Toronto based investment houses to get all the business...an underwriting cartel functions in the Canadian capital market, to Quebec's disadvantage. Access to capital markets is a greater problem in Canada than the source of capital. Restricting outside participation in the business of the capital market reduces competition in the market, strengthening the cartel of large dealers.²²

Within a month of the release of the Moore Committee Report, the Quebec Government had appointed a committee, under the chairmanship of Louis-Phillipe

²¹ Clair Balfour, Globe and Mail, 19 June 1970, B 5.

²² Clair Balfour, Globe and Mail, 19 June 1970, B 5.

Bouchard, the Deputy Minister of the Department of Financial Institutions. The mandate of the Committee was "to examine this Report and the recommendations made therein so as to determine what its repercussions might mean for Quebec."²³ Because of the sentiment in Quebec, the flavor of which has already been revealed, the outcome of the study was in some sense predictable. This would be so because the Quebec bureaucrats leading the study would be unlikely to bring forth recommendations which would be contrary to what would be acceptable to their political masters -- whose views had already been put on the public record -- or to the industry itself. As well, not a long time had past since the publication of the study on the structure of the financial services industry under the direction of Jacques Parizeau and it would have appeared odd indeed if another government sponsored study, by the same Ministry, appeared inconsistent with the earlier recommendations.

In addition to the Deputy Minister of Financial Institutions, the Quebec Study Committee comprised four industry participants from Quebec based firms, the Chairman of the QSC, the President of the Caisses de Depot and a senior civil servant from Mr. Bouchard's ministry. Commenting on the composition of the Quebec Committee, one securities industry representative suggested that "It's just as impartial as the Moore Committee."²⁴

It was not unexpected that the reaction to the Moore Report elsewhere in Canada was more muted if not outright supportive. The federal Minister of Finance observed that "the underlying principles of the report concerning foreign ownership in the securities industry are very much in line with government policy concerning other segments of the financial community in Canada."²⁵ With the exception of ill-fated attempts at fashioning a national securities regulator, this would be virtually the last word from the federal

²³ Department of Financial Institutions, Companies and Cooperatives, Study on the Securities Industry in Quebec: Interim Report, August 1971.

²⁴ Clair Balfour, Globe and Mail, "Committee set up in Quebec to Study Moore report effect," 26 June 1970, B 5.

²⁵ Irvin Lutsky, "Brokers critical of some findings, but Benson, Lawrence, OSC approve," Globe and Mail, 19 June 1970, B 5.

government on the issue of entry and ownership in the securities until the mid-1980s when its actions triggered profound structural change in the industry. But in any event, this response by the federal government reflected the relief that was earlier present when the industry, at its own initiative, embarked on its self-examination.

The initial response of the Ontario Minister of Financial and Commercial Affairs -- outside the Legislature -- was that "there is nothing I would react against in what I have seen to date -- I share the overriding concern every Canadian has for control of our monetary institutions."²⁶ This well-worn explanation of and support for the industry's position is not only remarkable for its transparency (if not for its naivete) but also an indication of the ignorance of the government and the primary regulator (the OSC) about the "workings" of the securities industry.²⁷ It would be repeated again in the Legislature. At the officials level, the Chairman of the OSC, Edward Royce, approved of the Study's recommendations. He indicated that they "prevent[s] the takeover of the securities industry by foreign interests and is generally sound, satisfying the requirements of the industry for additional capital without taking control outside the country."²⁸ In a more restricted audience, the 1970 Annual Meeting of the IDA Royce, made the following comments:

I read your report with great interest and had the opportunity of discussing it very briefly with the Minister before I left. I should say that it's considered of very great importance to the Province of Ontario, that the financial community be regarded as vital to Canadian life, and must be protected, in a reasonable way. So far as raising capital you feel may be necessary for the future, *that is one of the great advantages of having a self-regulatory body. We don't have to suggest anything to them, they suggest it themselves. We look forward, with great interest to your solution that you finally arrive at.*²⁹

²⁶ Irvin Lutsky, Globe and Mail, 19 June 1970, B 5.

²⁷ This response by the Minister was recorded in the same week that he tabled legislation to limit foreign control of Ontario chartered trust and mortgage loan companies to a maximum of twenty-five percent with a limit of 10 percent on any single foreign holding. See Irvin Lutsky, Globe and Mail, 19 June 1970, B 5.

²⁸ Irvin Lutsky, Globe and Mail, 19 June 1970, B 5.

The dramatically more muted response of the Ontario Government to the Moore Committee stands in sharp contrast to the active patterns of action in Quebec.

On June 16, 1970 the Ontario Minister of Financial and Consumer Affairs was asked in the legislature to "make a statement to the House as to how he sees the responsibility of the province in controlling the sale of any further part of the securities industry to non-resident ownership."³⁰ The Minister's response was vacuous indeed, especially when seen from the perspective of some twelve months after the announcement of the Merrill Lynch takeover of Royal Securities. The Minister stated, "I think our responsibility is first to study the report and have greater knowledge of its recommendations. Ultimately, of course, I think the province, if it wishes to act through this Legislature, can have complete control over the operation of that particular exchange and its members."³¹ The Ontario government was officially silent on the matter of the entry and ownership issue until the early spring of 1971, when in the Speech from the Throne the government proposed to convene a conference on foreign investment.³² This was almost a year after the Quebec Government had appointed its study group.

According to Premier Davis, this Ontario Conference on Economic and Cultural Nationalism was designed to "air a wide range of viewpoints and to put into perspective the many diverse problems affecting the Canadian identity."³³ While the relevance of this conference to the ownership and entry issue was rather oblique, the convening of the conference underscored the importance of the ideas surrounding national sovereignty as a constraint, at the time, on public policy decision-making in Canada.

The Conference will have placed before it a wide range of viewpoints to help put into perspective the many and diverse opinions being expressed

²⁹ Edward Royce, Comments to the 1970 Annual Meeting of the IDA, in "Transcript of Notes Taken at the Annual Meeting of the Investment Dealer's Association of Canada, Held on June 19, 1970. By Doug Ayers, Official Court Reporter," 52. *Italics added.*

³⁰ Ontario Legislative Assembly. *Hansard*. 16 June 1970, 4000.

³¹ Ontario Legislative Assembly. *Hansard*. 16 June 1970, 4000.

³² Ontario Legislative Assembly. *Hansard*. 3 March 1971, 3.

³³ Ontario Legislative Assembly. *Hansard*. 3 May 1971, 1179.

about economic and cultural nationalism. The agenda is designed to bring forward relevant aspects of the debate, including philosophical, economic, cultural, legal and industrial points of view. From these the public will gain a greater knowledge of these important matters and the government will become acquainted with the informed views of people who have given a good deal of thought to these complex and emotionally charged issues.³⁴

Against the background of this conference on nationalism, as well as both the earlier noted political documents dealing with Canadian ownership, and the securities industry's recommendations regarding entry and ownership contained in the Moore Report, Premier Davis, on 13 July 1971 made the following statement in the Legislature:

The government shares the concern of the federal government about the foreign ownership of essential Canadian financial institutions. The nature and extent of foreign investment in the Canadian investment community and its implications were examined with some care by the industry's own committee headed by Trevor Moore. In parallel areas of concern, in particular loan and trust companies, we enacted legislation restricting foreign ownership.

We believe it to be essential that ownership of investment companies remain substantially Canadian.

Therefore, we are now taking steps through the Ontario Securities Commission to ensure that all new entrants into the Ontario investment community meet these standards, with the capital owned or controlled by non-Canadians not exceeding 25 per cent, and no more than 10 per cent being owned or controlled by a single person or associated group of persons who are non-Canadians. They would also apply where there is a material change in the control of an existing registrant.

The government has requested the Ontario Securities Commission to examine this problem further, concentrating on several matters dealt with in the Moore report, including the question of public participation in investment companies and the continuing status of existing registrants which are foreign controlled.

³⁴ Ontario Legislative Assembly. Hansard, 27 May 1971, 1996.

...this policy of using a 25-10 formula for non-Canadian ownership is consistent with that now in effect in the loan and trust field and which we used in connection with the distributors of paperback books. It is a sound yardstick for use in most areas involving foreign ownership, enabling the encouragement of foreign investment and funds while protecting our own Canadian interests.

...This is the beginning of the policy of this government as it relates to the investment community; it is something the Securities Commission itself obviously will be dealing with, and I would assume the exchange as well.³⁵

Immediately after the Premier's statement, Arthur Wishart, Minister of Financial and Commercial Affairs suggested that securities firms already operating in Ontario, who did not comply with the new restrictions, would be given "a reasonable number of years" to make the adjustment.³⁶ This proposal was remarkably similar the one which would be contained in the Joint Industry Committee Report that would be published later in the month. It is interesting, given the evidence which follows below, that J.R. Kimber, President of the TSE, should claim that "In effect the policy statement by the Government has beaten the industry to the punch on this important topic of Canadian control of the securities industry."³⁷ The industry effectively told the Government what its policy should be.

While it was the case that the Ontario government's initial response to the Moore Committee was consistent with foreign ownership restrictions in other industries, including other components of the financial services industry, it is also the case that the enunciated policy was consistent with the views of the securities industry itself regarding what character of ownership restriction was acceptable to it. Indeed, there was an apparent convergence between the industry, and the state. However, absent from the Premier's statement was consideration of the "monopoly" character of the organization of the industry and the differences and/or similarities among the various industries impinged

³⁵ Ontario Legislative Assembly. Hansard. 13 July 1971, 3868-3869.

³⁶ Vianney Carriere, "Foreign Ownership limit set for investment firms," Globe and Mail. 14 July 1971.

³⁷ Globe and Mail. "TSE president applauds move by Queen's Park," 14 July 1971, B.

upon by this common ownership policy which make it appropriate. More directly, there was an absence of any analytical support for the Government's position and no recognition of the position of the Quebec Government -- which the Ontario officials had a good deal of time to absorb and analyze. The timing of this announcement was driven by the imminent release of a Joint Securities Industry Study of the Moore Committee's recommendations. Indeed, the Premier's statement was probably written in large part by the Joint Industry Committee (JIC) and the IDA.

We...were disturbed to find out that the Joint Industry Committee and members of the Executive of the Investment Dealers Association had talked to various levels of government before the Joint Committee Report was released to members of the industry. We think it most unfortunate that the Province of Ontario took advantage of the work being undertaken by the industry to come up with proposed guidelines prior to an election in the province.³⁸

Indeed, the absence of any real policy action in Ontario during this period was to be the characteristic response of the authorities in the future -- reflecting the fact that they relied almost exclusively on the views of the industry to formulate policies surrounding the industry. Conceptually, the state (the Ontario regulators) was captured by the industry. Moreover, the industry would be given yet another opportunity, via the OSC Study that had been proposed by the Premier, to once again put forth its views on how the industry should be structured. The information set which the OSC would consider would be based solely on the "intelligence" which would be supplied by those who would be most affected by its regulatory pronouncements.

Thus, it is important to acknowledge again that the Ontario government was not well placed to act on the ownership question in any fashion but that which supported the status quo organization of the industry. The Government's statement would serve to both support and reinforce restrictions on foreign participation in the industry. At the same time

³⁸ W.B. Harris, President Harris & Partners Limited, "Submission to the Joint Industry Committee Studying the Moore Report on Foreign Ownership," August 18, 1971.

the Quebec Study Committee was on the verge of publishing its Interim Report. Given these pressures the Ontario government felt compelled to act in the manner that it did.

Some eight weeks after the Ontario Premier's statement, the OSC turned down an application by First Boston Canada -- a subsidiary of First Boston Corporation of New York -- for registration as a securities dealer. The company had requested an exemption from the restrictive rules which had just recently been enunciated by the provincial government. First Boston had first requested registration in May -- before the Premier's announcement -- but was in the process of fulfilling a request for further information when the new restrictions were announced. Although the OSC had the power to grant an exemption from the freeze to those applicants who had begun the process of application, the OSC chose not to exercise this option. The parent company was publicly owned and both the TSE and the IDA opposed the firm's application.³⁹ Counsel for the TSE said admission of First Boston was not in the "public interest"⁴⁰ It is interesting that the OSC *also* concluded that "this application would be prejudicial to the public interest in the context of the Premier's statement..."⁴¹ First Boston was the first casualty of the Moore recommendations and an example of the power of indigenous industry elites over the provincial regulatory authorities.

About one week later, on September 24, 1971, First Boston was granted a restricted registration as a broker in Quebec. The firm was limited to dealing with institutional investors and was the first foreign-owned firm and the first broker whose shares were publicly traded in New York to be granted registration following Moore. First Boston was the lead underwriter for Hydro Quebec⁴² and the Quebec Government's generosity reflected this. This granting of this registration was consistent with the recommendations in the preliminary report of the Bouchard Committee -- to which I now turn briefly.

³⁹ Globe and Mail, "OSC maintains freeze: Big U.S. investment firm barred," 17 September 1971.

⁴⁰ Globe and Mail, "TSE, IDA oppose application of First Boston for registration," 15 September 1971.

⁴¹ Globe and Mail, "OSC maintains freeze: Big U.S. investment firm barred," 17 September 1971.

⁴² Irvin Lutsky, "First Boston accepted as broker in Quebec," Globe and Mail, 25 September 1971.

In the early summer of 1971, around the time that the Ontario provisions outlined above were being conceived, the Quebec government got wind of rumors about the contents of the report being prepared by the industry. The Quebec Government's understanding at the time was that the Joint Industry Report would accept holus bolus the Moore Committee's recommendations. William Tetley, the new Minister of Financial Institutions in Quebec essentially reiterated his predecessor's earlier views:

The Moore proposals would be a disaster for Montreal because we want to create a capital market in Montreal. We want to admit financiers from other countries.

Ontario wants to control everything in its province and this Moore commission favors Ontario. That's why we're against it.⁴³

Thus, on July 6, 1971, Mr. Tetley introduced amendments to the Quebec Securities Act which were designed to reinforce the power of the QSC over the regulatory decisions of the MSE and CSE. Essentially, the QSC was granted power to direct the exchanges to alter any decisions which they have taken.⁴⁴

In pushing through reforms to the province's Securities Act...Tetley made clear that his main objective was to prevent the Montreal and Canadian Stock Exchanges from adopting the protectionist recommendations of the Moore Report...The reforms give the Quebec Securities Commission complete control over the province's stock exchanges.⁴⁵

The complicating factor for Tetley was the fact that there was not unanimity among the investment dealers in Quebec. The "major" francophone firms were not convinced of the provincial government's position that the presence of foreign-owned firms and public ownership would necessarily reduce the province's dependence on Toronto based firms or indeed result in an enhanced flow of foreign capital to the province.

⁴³ Ian Rodger, "Quebec props door open for foreign investment firms," The Financial Post, 17 July 1971.

⁴⁴ Irvin Lutsky, "Securities Industry may change stand on foreign ownership," Globe and Mail, 30 July 1971, B2.

⁴⁵ Ian Rodger, The Financial Post, 17 July 1971.

The smaller firms on the other hand, along with the foreign firms already operating in Quebec, supported the province's position.⁴⁶

It is probably the case that the "major" francophone firms were concerned that their relatively important position within the Quebec capital market would erode in the face of the changes that the Quebec state authorities were advocating.⁴⁷ Thus their stance mirrored that of their counterparts in Toronto.

The Joint Industry Report - An Initial Response to Moore and the Establishment of a Pattern

On July 28, 1970 the sponsors of the Moore Committee, the VSE, the TSE, the MSE/CSE, and the IDA published their review of the main report. As noted earlier, the JIC and the IDA had already met with the Government prior to the Premier's statement on July 13. This review, characterized as the Joint Industry Report⁴⁸ (JIR) by the sponsors themselves, was yet another attempt by the industry to reinforce its influence upon the public policy agenda. The document is interesting from two perspectives: on the one hand it attempts to capture some of the sentiment that had been building against the Moore Report while on the other hand, making it more difficult for those non-resident firms already operating in Canada to continue functioning in the "normal" fashion to which they had been accustomed prior to the Merrill Lynch takeover.

With respect to the first point, the JIC recommended that the prohibition of foreign-owned firms taking an equity position in Canadian firms be loosened. The JIC wanted to permit non-resident owned firms to purchase as much as 25 percent of a Canadian firm, but the maximum an individual foreign firm could own would be 10 percent. If more than one firm had a 10 percent stake in the Canadian firm, the firms would have to be unrelated and have their principle operations in different countries. It will be

⁴⁶ Based on confidential interviews.

⁴⁷ A view which was confirmed in confidential interviews.

⁴⁸ Joint Industry Committee, "Report of the Joint Industry Committee on the Moore Report," 28 July 1971.

recalled, from the preceding chapter, that a minority of members of the Moore Committee favored such a proposal.

They believe[d] that an investment of up to 10 percent of a Canadian firm made by a privately owned foreign securities firm would not result in an undue influence over the Canadian firm, and would improve the quality and the competitive ability both of that firm and of the Canadian securities industry as a whole.⁴⁹

The JIC accepted part of the rationale in the minority reasoning -- the part dealing with undue influence -- but did not address the issue of the competitiveness of the industry because to suggest explicitly that there was such an element in their thinking would undermine the legitimacy of a good deal of the argumentation in the Moore Report. However, the JIC also added a new twist to its explanation for this deviation from the Moore recommendations. It was desirable, they suggested, "that Canadian firms should be permitted to have some contacts in international markets through interlinking ownership arrangements..."⁵⁰ This was probably the first time that the industry recognized the emerging internationalization of capital markets -- the phenomenon that was later to be known as globalization. This was an important admission on the part of the industry, not only because of what was to come with respect to the globalization phenomenon, but also because it reflected the more outward looking attitude on the part of the political and regulatory authorities in Quebec. If the industry was to maintain control of the policy agenda it had to be seen to be bowing in the direction of Quebec's requirements -- otherwise the realization of a uniform entry and ownership policy across the country would be unattainable and the Toronto based industry could find itself caught in the political crossfire between Ontario and Quebec which would likely emerge if the industry as a whole refused to move off of the Moore recommendations.

The offset to this more liberal position on the part of the JIC was the more stringent proposals with respect to the "grandfather" strategy contained in the Moore recommendations. It will be recalled that Moore recommended that "where a foreign firm

⁴⁹ Trevor Moore, Report of the Committee, 139n.

⁵⁰ Joint Industry Committee, "Report," 28 July 1971, 2.

has a Canadian subsidiary which is a member firm [of a sponsoring SRO], the foreign firm should be able to increase its investment in the subsidiary."⁵¹ This "grandfather" clause was designed to protect the property rights of the foreign firm which existed when the Moore Report was published.

The Moore Committee provided this "grandfather" benefit only grudgingly. It denied the right of foreign firms to transfer membership to other SROs (i.e., other stock exchanges) and prohibited the granting of the reciprocity privileges which the various exchanges grant to one another's members. Moreover, membership of foreign firms would be subject to review if

- the parent company obtained capital in a way which was prohibited by the Canadian SROs; and if
- control of the firm changed.⁵²

Since it was already apparent that public ownership of US securities firms was to become a very important source of capital for that industry the Moore Committee implicitly was working to exclude the presence on Canadian soil of US based firms. The Moore Committee argued that these limitations were designed to ensure that the playing field remained level for both the indigenous foreign-owned firms.

The JIC, however, viewed the "grandfather" clause as providing both a benefit to the existing non-resident owned firms which would not be available to future non-resident firms and the capacity to establish international connections which would not be available to Canadian owned firms. For reasons of fairness, the JIC believed that the grandfather clause should not be allowed to stand. Moreover, it undermined the Canadian control requirements and was thus in conflict with the key industry precepts.⁵³ Instead the JIC recommended that

⁵¹ Trevor Moore, Report of the Committee, 142.

⁵² Trevor Moore, Report of the Committee, 142-143.

⁵³ Joint Industry Committee, "Report," 28 July 1971, 4.

the maximum capital that the Canadian company controlled by a non-resident securities firm can employ in its business be that required by the capital formulae of the of the Exchanges and the Investment Dealers Association to maintain business transacted by it during a recent fiscal year ending not later than March 31, 1971 plus 10 percent of its net earnings in each year.

The Joint Committee concluded that without some freeze on capital, the non-resident controlled firm could increase its capital base and ability to expand by ploughing back all its Canadian earnings. They would have the ability to do so since they would have an additional source of earnings outside Canada in the parent company, usually the only shareholder. The same ability would not be available to Canadian firms who must pay out a substantial part of their total earnings to their shareholders in order to give shareholders a reasonable return on capital.⁵⁴

The foreign-owned firms would be able to neutralize to a certain extent this capital freeze by embarking on a "program of Canadianization." The program would permit a foreign-owned firm to increase its capital by retaining in its Canadian securities operations an additional 1.2 percent of earnings for each 1 percent of ownership transferred to Canadians over and above the 10 percent foreign ownership that would be permitted in any event. The schedule envisaged by the JIC would result in 75 percent Canadian ownership by 1986 after which these firms would have an additional 3 years to sell the remaining 15 percent required to comply with the 25-10 rule.⁵⁵

The cavalier character of the JIC recommendations seem remarkable. If one uses the rationale of property rights theorists -- a stylized explanation of the JICs suggestion would be as follows: the externalities associated with the presence of competitive pressures from foreign-owned firms operating in Canada causes the capital value of the Canadian owned companies to diminish. The remedy to deal with this externality is to impose a tax and/or fine on these foreign-owned firms such that the capital value of the Canadian owned firms will be sustained or even enhanced. The costs of this economic

⁵⁴ Joint Industry Committee, "Report," 28 July 1971, 5.

⁵⁵ Joint Industry Committee, "Report," 28 July 1971, 5-6.

nationalism is borne not only by the non-resident owned firms, but also by the citizens of the nation-state as a consequence of the higher costs of transacting for financial services. The costs of such a situation were never really debated openly.

The JIC supported all of the other recommendations of the Moore Committee, although needless to say there were many firms -- both domestic- and foreign-owned -- who did not support the industry's position. Two prominent Canadian owned firms -- Burns Brothers and Denton and McLeod, Young, Weir and Company openly took the JIC to task for supporting the Moore recommendations.⁵⁶ Both firms viewed the restrictions on entry and ownership as too inhibiting and the likely outcome would be that "the Canadian investment industry [would] find itself at a severe competitive disadvantage. Many members of the U.S. investment industry will be able to raise outside capital in much greater volume and significantly cheaper than their Canadian counterparts."⁵⁷ This evolution of events, they claimed, would undermine the competitive capacity of the Canadian investment dealer industry. A number of American owned firms, Bache & Company, Dominick Corporation, Harris & Partners and of course Merrill Lynch, objected strenuously to the proposed JIC rules on the basis of the general flawed analysis of the Moore Committee, the reciprocity granted by the NYSE to Canadian firms, the substantial future capital requirements of firms in the industry, and importantly because the rules would result in retroactive legislation.⁵⁸ None of these objections had any serious impact on the JICs recommendations.

The New York Stock Exchange also reacted adversely to the JIC Report. It focussed its systematic critique of the Report on the growing internationalization of

⁵⁶ Burns Brothers and Denton, "Comments to the Joint Industry Committee Studying the Moore Report," 9 August 1971; G.C. MacDonald, President, McLeod, Young, Weir and Company, Letter to the Joint Industry Committee, 9 August 1971.

⁵⁷ Burns Brothers and Denton, "Comments...", 9 August 1971, 2.

⁵⁸ Stanley F. Klimczak, Executive Vice President, Bache & Co., Letter to the Joint Industry Committee Studying the Moore Committee, 17 August 1971; R.W. Russell, Vice President, Dominick Corporation of Canada, Letter to the Joint Committee Studying the Moore Report, 11 August 1971; W.B. Harris, President, Harris & Partners, "Submission to the Joint Industry Committee Studying the Moore Report on Foreign Ownership," 18, August 1971; Donald I. Webb, Vice President and Director, Letter to the Joint Industry Committee Studying the Moore Report, 10 August 1971.

markets and the requirement of liberal institutional access across borders to ensure capital market efficiency. In an oblique threat, the NYSE reminded the JIC that Canada was the only developed country not subject to the interest equalization tax and of the fact that the NYSE treats Canadian member firms as if they were US citizens, thus exempting them from the 45 percent limitation on foreign participation in member firms. No other country had been given such an exemption. The NYSE also had little sympathy for the reticence regarding public ownership -- especially since the worst fears about it in the US never materialized. Finally, the Exchange also disputed the assertion that US firms were contributing to a capital outflow from Canada.⁵⁹

The JICs response to the NYSE stated that "While your comments are most informative, it seems to us that they have missed the essence of both the Moore Report and the Report of the Joint Industry Committee."⁶⁰ The JIC letter then went on to repeat the already well known arguments.

The reaction of the public policy actors to the JIC modifications of the Moore recommendations was subdued. The Ontario government had already instructed the OSC to study the questions arising out of the Moore Report and thus there was no urgency for the government to act beyond the "non-decision," which in the environment at the time favored the sponsoring SROs and their constituent members. The Quebec Government, on the other hand, had already made its public policy stance very transparent. Moreover, for the Quebec authorities it would be only a short time before the Bouchard Committee would publish its interim report.

Thus, the JICs modification of the Moore recommendations should be seen as yet another offensive by the industry to dominate the future policy agenda and outcome. Its proposed more stringent treatment of non-resident owned firms would have to be debated again among the industry and state actors.

⁵⁹ Robert W. Haack, President, New York Stock Exchange, Letter to the Joint Industry Committee Studying the Moore Report, 9 August 1971.

⁶⁰ Joint Industry Committee Studying the Moore Report, Letter to Robert W. Haack, President of the New York Stock Exchange, 8 September 1971.

The Bouchard Report: Legitimizing the Politics of Foreign and Public Ownership

The "national" securities industry's objective of influencing the policy agenda surrounding the entry and ownership issues was also successful vis-a-vis the Quebec authorities. On this occasion, however, the industry actors were unable to "control" the debate in Quebec once the dialogue got started.

As noted earlier, the Quebec Minister of Financial Institutions created the Bouchard Committee, to study the Moore Report, almost immediately after it had been published. The Bouchard Committee had not completed all of its deliberations when the JIC Report was released. Nonetheless, on August 24, less than a month after the JIC recommended a further tightening of the entry and ownership restrictions, the Bouchard Committee found it necessary to issue an Interim Report because it thought it would be

useful to know right now the conclusions we have already reached, as well as the recommendations whose application may be considered now.⁶¹

Inasmuch as the Bouchard Committee was going to publish a stinging criticism of the Moore Report and its recommendations, this appeared to be a propitious time to neutralize both the Moore and the JIC recommendations and perhaps influence the deliberations of the Ontario Study Committee being conducted under the auspices of the OSC. At the time, the final report of the Committee was expected to be available at the end of 1971.

It is not necessary to go through all the details of the Bouchard Committee's critique of Moore because the analytic weaknesses with it have already been identified. Bouchard, however, adds a number of new twists which reflect the contextual situation and ideological perspectives which were then prevalent in Quebec -- the "maitre chez nous" precepts.

⁶¹ Study on the Securities Industry in Quebec: Interim Report, Letter of Transmittal from the Committee to the Minister.

Bouchard's key criticisms of the Moore Committee's counsel were as follows:⁶²

- (i) The recommendations would result in the continued domination of the Quebec securities industry by the Toronto "world view." This would result in the continued shortage of development capital to finance Quebec's economic future.
- (ii) The difficulties which could arise from permitting securities firms to raise capital from the general public had been exaggerated, especially in light of the fact that the SEC in the US had considered both the "pros and cons" of the same arguments that had been enunciated by Moore. Essentially, Bouchard accused Moore of lacking any imagination in its attempts to deal with issues of conflicts and protection of the "public interest." Moreover, Moore had minimized the potential benefits that could arise from liberalized ownership provisions for the industry.
- (iii) The capital requirements to service the large institutional investors had been underestimated. This was truly a perceptive observation from the Bouchard Committee, because even more than two decades later there are occasions when the liquidity of the Canadian capital market is inadequate to deal with the large block trading requirements of institutional market participants. Furthermore, Bouchard concurred with the observations made in the US, when the SEC was examining the issue of the public sale of shares of securities firms, that undistributed profits were an unreliable source of "permanent" capital.
- (iv) The capital requirements to rebuild the industry's infrastructure were underestimated. Thus, if the securities industry did not invest in state of the art computer and communications technology and enhance its research capacity, it would be unable to service the borrowing requirements of Canadian industry, and moreover, Quebec industry and its economy would suffer. The smaller dealers in Quebec, according to Bouchard, could not adequately deal with the competitive forces confronting them because of the absence of adequate capitalization.

More generally, the Interim Report was critical of the Moore Committee because it did not examine the regional dimensions of the capital requirements -- particularly what

⁶² Study on the Securities Industry in Quebec: Interim Report, 55-88.

were seen as the unique requirements of Quebec. In this regard, the objective of the Quebec securities industry was to ensure the availability of adequate development capital for the province and not solely, as suggested by the Moore Committee, the preservation of a "viable and healthy" securities industry.

- (v) The Bouchard Committee was also critical of the fact that the Moore group did not release the data, obtained from a survey of the industry, to substantiate the legitimacy of its conclusions on capital adequacy.
- (vi) The Bouchard Committee was particularly critical of the individual members of the Toronto securities industry establishment on the matter of capital adequacy. The Committee suggested that the Toronto firms' opinions on this matter were not justifiable because it seemed "that the firms themselves resist growth because their owners want to retain control."⁶³ Indeed, the small and medium sized firms operating in Quebec were "anxious to receive capital from outside..."⁶⁴
- (vii) With respect to foreign participation in the Quebec securities industry the Bouchard Committee likened the relationship between the Montreal and Toronto based firms (one of dominance of the latter over the former) as compared to what the Moore Committee was reacting to -- the potential of the Toronto firms being dominated by foreign-owned entities. However, for Bouchard, the neutralization of the Toronto influence on Quebec firms could be achieved by more liberal entry requirements for foreign-owned firms. Bouchard was not concerned that foreign firms would come to dominate the Quebec financial market. Indeed, Bouchard saw the evolving internationalization of markets -- to which Moore "turned a blind eye" -- and the presence of off-shore firms as enhancing the international character of the Quebec capital market which in turn would facilitate the raising of foreign savings for investment in the Quebec economy.
- (viii) Bouchard debunked the cost - benefit analysis undertaken in the Moore Report. It was seen as totally erroneous.

⁶³ Study on the Securities Industry in Quebec: Interim Report, 61.

⁶⁴ Study on the Securities Industry in Quebec: Interim Report, 62.

Bouchard's bottom line on the Moore Report was a failing grade. On almost every substantive point, Bouchard took the opposite view: the industry's capital is inadequate, the industry is not sufficiently competitive, its efficiency could be enhanced and access to foreign savings could be facilitated by the presence of foreign-owned firms in both Quebec and the rest of Canada. Finally, the Bouchard Committee questions whether the securities industry is indeed a key sector. It concludes that because the firms comprising the industry are not financial intermediaries but are agents in financial transactions, there is less of a need for them to be controlled exclusively by domestic interests. Thus, the degree of foreign presence which the Bouchard Committee would find acceptable in the securities industry could very well be unacceptable in the case of banks and trust companies, for example.

Given these criticisms, it is not a difficult matter to surmise the character of the recommendations contained in Bouchard's Interim Report. The Committee's primary purpose was to ensure that its recommendations would result in the development of a strong Quebec securities industry primarily to look after that province's interests.

The ways in which this could be achieved were at complete odds with the Moore Committee's view. But the Bouchard Committee did not think that the "world would come to an end" if Quebec journeyed in a direction the authorities in other jurisdictions did not condone. If the market was a reflection of freedom, then individual firms could decide in which jurisdiction they wished to carry on their business and they would organize their affairs in a manner that satisfied the regulators and SROs in those jurisdictions. Thus, the Bouchard Committee dismissed the notion prevailing in Toronto that there was a set of one-dimensional requirements upon which all regulatory authorities and all SROs had to agree.

These overarching observations from Bouchard's Interim Report gave rise to a number of substantive, and from a national perspective, controversial recommendations.⁶⁵

⁶⁵ Study on the Securities Industry in Quebec: Interim Report, 11-12.

- (i) It was necessary for Quebec to develop a strong securities industry which would have a dominant position in the Quebec capital market.
- (ii) In order to facilitate rapid growth, the firms in the industry should have easy access to capital.
- (iii) The QSC should adopt measures which would facilitate a strong international dimension to the operations of Quebec securities firms.
- (iv) In order to dilute the Toronto influence on both Quebec markets and institutions the Committee recommended that foreign firms be given access to the province -- within acceptable limits.
- (v) Public ownership of securities firms should be permitted.
- (vi) Measures to enhance competition in the Quebec securities industry should be introduced.
- (vii) Measures should be invoked that ensures that Quebec firms control the stock exchanges in the province.

Thus, the Bouchard Committee envisioned an activist role for the state to ensure that the securities industry evolved in a manner that served the interests of Quebec. This proposed pattern of action was opposite to what had so far transpired in Ontario.

The conduct and organization of the Bouchard Committee reflected Bouchard himself -- and as well the marching orders received from the Minister of Financial Institutions. The Committee was supported by a small group of civil servants from the Ministry. The background work, prepared in the Ministry of Financial Institution's bureaucracy, also reflected the political will of the Quebec Government, although the work of the Committee was never discussed extensively at the Executive Counsel because the policy objectives were clear and unassailable from the nationalists' perspective. There were no serious debates within the Committee because of the convergence of views between the industry and state and because of the composition of the Committee.⁶⁶

Conclusion

The contrast between industry-state relations in Quebec and Ontario is quite stark. The Ontario authorities were captured from the outset of the entry-ownership episode, while the Quebec authorities relied to a great extent on the cooperation of the industry in the development of the policy surrounding these issues. The Quebec authorities had a vision for the province as well as one for the contribution which the securities industry could make to achieving the state's objective. The reverse was the case in Ontario. There was no real policy framework there to help formulate entry and ownership rules, except the political expediency of the moment. As a consequence, the state was persistently operating in a reactive, but as well in a politically efficient and/or rational (utilitarian) mode.

Because of these differences Quebec was able to respond quickly to the activities of the industry while Ontario, tied as it was to the views of the industry elites, was not able to respond in any fashion but that which was supportive of their position. The migration of the 25/10 foreign ownership rule from other areas of commerce in the province partly reflected the Ontario Government's satisfaction with the status quo as well as the policy fashion rooted in Canadian nationalism.

The Interim Bouchard Report was just the beginning of a long journey for both the Quebec authorities and the Quebec based industry. These actors would also have to address the concerns of the securities industry in the rest of Canada. And because the objectives and power of the industry based in Toronto was so overwhelming, the realization of the Quebec objectives would take a long time. In the mean time, the Ontario Securities Commission was readying itself for its inquiry into the questions surrounding public ownership and foreign entry into the Canadian securities industry.

⁶⁶ Based on confidential interviews.

CHAPTER SEVEN

A POLICY VACUUM IN ONTARIO AND “NATION-BUILDING” IN QUEBEC

Introduction

It is the purpose of this chapter to show how the process of decision-making, in respect of entry and ownership in the Canadian securities industry was complicated by the competing interests of the key provinces, Ontario and Quebec, the interests of the large national firms based in Ontario vis-a-vis the smaller regional firms in Quebec, and the more comprehensive view of the Quebec regulators compared to the more narrow and industry-based view of the Ontario regulators.

This chapter also highlights the proposition that the OSC, because it had for so long not concerned itself with the broad issues surrounding the entry and ownership debate, was not prepared to provide credible leadership in resolving the entry-ownership puzzle. This compares to the QSC, which approached the regulatory issues from the broader perspective of nation-building. Its deliberations were thus more focussed, with a particular objective in mind. This position was more defensible than that of the OSC who relied upon the industry for qualitative information in forming its conclusions, and thus confused the private interests of the industry with that of the public interest.

Developing an Ontario View

It will be recalled that the Premier of Ontario, William Davis, called on the OSC in the Summer of 1971, to examine the very issues that had arisen in the Moore Report. The OSC was

requested to study and to make recommendations on specific aspects of two broad issues. The first of these was whether Ontario registrants should be permitted to raise additional capital from the public. The second question was what additional restrictions, if any, should be placed on non-Canadian resident ownership and capital of Ontario securities firms.¹

The OSC would be carrying out this investigation against the background of both the restrictions on foreign entry and ownership which had already been announced by the Premier on July 13, 1971 and the Bouchard Committee's recommendations regarding liberalized entry and ownership rules for the Quebec based industry.

Premier Davis' July 1971 announcement was not based on any analytical arguments and in retrospect can be seen as nothing more than a politically efficient decision: "why start a fight with the securities industry leaders which support your government."² This apparent capture of the government by the industry was further supported by both the evolution of events and observations of the key public and private sector actors during this period. More to the point, there was no one, and no capacity in either the OSC or the Ministry of Consumer and Commercial Relations to counter the arguments of the industry elites who were well respected in the wider Toronto community. As well their legitimacy as experts, in an area that was seen as a very technical one, was unquestioned.³ Despite the general indictment of the OSC's capability, at least one member of the Commission did recognize that the quality of the Moore Study was dubious and the legitimacy of its recommendations suspicious.⁴ On the other hand, it will be recalled that the Chairman of the Commission was satisfied to let the industry work at solving its problems, which implicitly suggested acceptance of the Moore Committee positions.

¹ Ontario Securities Commission, Report of the Securities Industry Ownership Committee of the Ontario Securities Commission (Toronto: Ministry of Consumer and Commercial Relations, April 1972), 2-3.

² Quotation based on a confidential interview with an advisor to the Ontario government during this period.

³ Based on interviews with former and current industry and public officials.

⁴ H.S. Bray, Study Director, "Memorandum Re: Industry Ownership Study," September 17, 1971. Archives of Ontario, RG 70 Series 17, Boxes 1 and 2.

The Vulnerability of the Ontario Securities Commission

The official records of the period indicate clearly that the OSC was ill-prepared to carry out a wide ranging investigation of the securities industry. For example, the OSC had not compiled a comprehensive data base upon which it could have built its own body of knowledge about the industry. It had to rely, initially at least, on the responses to questionnaires used by the Moore Committee in its study⁵ to inform itself about the character of the industry and the issues it was going to review. That is to say, the OSC gleaned its initial insights into the securities industry's ownership and capitalization situation from the data supplied by the members of the industry to their own study committee, which, it is generally acknowledged, supported conclusions which were in the interests of the industry's members themselves. The regulators had no other source to which they could turn for macro-descriptive data about the industry -- save a survey that had been undertaken for the Porter Commission almost a decade earlier⁶ but which had little relevance to the issues which were then current. There was some recognition by the OSC Study Group and its small complement of support staff that the Moore Committee data had shortcomings -- but in the short-run⁷ that was all the OSC could rely upon. However, the Moore data did provide some guidance to the OSC about the character of the data it would have to collect in order to support its analysis of entry and ownership in the Ontario securities industry.⁸

It should be underscored that the lack of knowledge by the commissioners of the OSC, about the issues at hand, is not to suggest that there was anything purposeful or cunning associated with this gap in their understanding. However, one can surmise that the

⁵ D.L. Johnston, Counsel to the OSC Study, "Memorandum to File Re: Meeting with Mr. Roy Reid Re Methods and Literature considered by the Moore Committee," September 7, 1971. Archives of Ontario, RG 70 Series 17, Boxes 1 and 2.

⁶ D.L. Johnston, "Memorandum to File..." September 7, 1971.

⁷ D.L. Johnston, Counsel to the OSC Study, "Memorandum to H.S. Bray Re: OSC Ownership Study -- Topic the Questionnaire," September 17, 1971. Archives of Ontario, RG 70 Series 17, Boxes 1 and 2.

⁸ D.L. Johnston, "Memorandum of Meeting -- OSC Industry Ownership Study," September 7, 1971. Archives of Ontario, RG 70 Series 17, Boxes 1 and 2.

OSC could be accused of shirking. In the past, these were structural matters that were resolved by the key SROs, and the OSC did not have to concern itself directly with quantitative information about the industry nor with these overarching decisions that would have to be taken. Indeed, it will be recalled that this point was stated by OSC Chairman Royce just after the Moore Report was published. Furthermore, the OSC did not involve itself in sensitive political issues up to that point. The main focus of its work was on ensuring compliance by the constituents of the investment dealer industry with the Ontario Securities Act -- which boiled down to ensuring that the investor was protected. Thus the OSC was embarking on a new endeavor for which it was not well prepared.

The Submissions to the Ontario Securities Commission Study Committee

The formal submissions by the securities industry to the OSC Study Committee can be divided into two distinct camps -- reflecting the main protagonists in the conflict surrounding entry and ownership policy: the IDA and the TSE which represented the domestically based securities industry located in Toronto; and, Merrill Lynch Canada who was supported in its argumentation by a handful of other non-resident owned firms who objected to the key precepts of the Moore and JIC Reports.

The IDA and TSE Submissions: A Restatement of the Case

The submissions of both the IDA⁹ and the TSE¹⁰ were clearly cut from the same cloth as the Moore recommendations. While there are some minor variations in the argumentation contained in the submissions, the conclusions of these two SROs was virtually the same as that contained in the Moore Report and the subsequent JIC Report on Moore. The argumentation by the IDA and TSE revolved around the construct of an "ideal type model"¹¹ of entry and ownership, against which validity and/or legitimacy of all

⁹ Investment Dealers Association of Canada, "Submission of the Ontario District of the Investment Dealers Association of Canada to the Industry Ownership Study of the Ontario Securities Commission," October 1971.

¹⁰ Toronto Stock Exchange, "Submission by the Toronto Stock Exchange to the Industry Ownership Study Committee of the Ontario Securities Commission," October 1971.

other alternatives were gauged. It was assumed that this "ideal type model" of entry and ownership would ensure that:

- (i) Arrangements for entry and ownership were not inconsistent with the industry's professional standards. Indeed, from the industry's perspective, professionalism¹² transcended capital "as a prerequisite for the effective performance of securities firms."¹³
- (ii) The firms would be able to satisfy the requirements of Canadian borrowers by having access to sufficient sources of capital. For the industry as a whole, according to the IDA and TSE, there was "no aspect of industry activities where a major need for capital now exists or can reasonably be expected to arise."¹⁴
- (iii) There was sufficient competition in the industry. This was assured, according to the TSE, because of the ease of entry into the industry which was facilitated by the ability of new industry participants to buy shares in firms at a "cheap" price which was equivalent to book value¹⁵; and
- (iv) The entry and ownership provisions were in the "public interest." The industry's SROs never precisely came to grips with what they meant by the public interest. However, from all of the industry's pronouncements it seems clear that the private interests of the *industry* were equated with the public interest. The President of the TSE, in his introductory remarks to his testimony before the OSC Study Group went so far as to say that

¹¹ The IDA "Submission" to the OSC Study speaks of "an ideal regulatory pattern." Investment Dealers Association of Canada, "Submission," October 1971, 6.

¹² Professionalism for the IDA and TSE comprises competence, training, experience, integrity, absence of conflicts of interest and a general high level of service. Investment Dealers Association of Canada, "Submission," October 1971, 8.

¹³ Investment Dealers Association of Canada, "Submission," October 1971, ii.

¹⁴ Investment Dealers Association of Canada, "Submission," October 1971, ii.

¹⁵ J.R. Kimber, President of the Toronto Stock Exchange, "Opening Remarks to the Industry Ownership Study Committee of the Ontario Securities Commission," October 27, 1971, 5

Even where firms state that they wish more capital, it may not be in the public interest for them to obtain capital by resorting to public funds or, indeed, to have any further capital at all.¹⁶

Both of the submissions were critical of the main recommendations of the Bouchard Report, in part because the implicit model mirrored the precepts of the one surrounding the Merrill Lynch takeover. It did not pass the requirements of the "ideal" model, fundamentally because a very liberal entry and ownership regime in Quebec could threaten the viability of Toronto as a financial center to the benefit of Montreal and thus threaten the economic position and power of the Toronto based industry elites.

The IDA and TSE wanted to minimize the probability that certain members of the industry would vote with their feet and move to Montreal, the jurisdiction that seemingly offered a preferred bundle of policies.¹⁷ Moreover, the IDA, under the new leadership of Andrew Kniewasser, with a background as a former Senior Assistant Deputy Minister in the Ministry of Trade and Industry in the federal government, had the vision of a uniform pattern of rules among the provinces with respect to ownership and entry.¹⁸ This factor became more important as the decade of the 1970s progressed and a regulatory equilibrium was difficult to achieve. But nonetheless, even at this early stage the desire for uniformity was a latent factor which influenced the character of the recommendations and responses of the IDA to the entry and ownership issue.

The arguments used by the IDA and TSE to support the "ideal type model" are familiar, but nonetheless require repeating here. For the investment dealers of this period the only way in which professionalism could be preserved was to exclude from the ownership ranks of the firms comprising the industry and their decision-making bodies all those individuals who were not "industry participants." Except for the minority shareholdings that were permitted under the 25-10 rule enunciated by the Moore Committee and amended by the JIC in July 1971 (to include institutions in the ratios),

¹⁶ J.R. Kimber, "Opening Remarks..." October 27 1971, 1

¹⁷ This terminology is borrowed from Albert Breton, The Economic Theory of Representative Government.

¹⁸ Based on a confidential interview.

professionalism in the industry could only be preserved by limiting outside influence. This far-reaching construct was the foundation upon which the TSE and IDA built their arguments to limit public and/or outside ownership in the industry. This precept was linked directly to the capital adequacy question -- for if a firm did not have adequate capital it could not meet the prerequisites of industry professionalism. The IDA brief concluded that

it is clear that there are significant capital needs in many aspects of the operation of securities firms. It is equally clear that from the standpoint of the industry and of the public, the capital needs should not be allowed to predominate over adherence to professional standards of competence and integrity. Capital needs are satisfied at present from available sources of capital and analysis of industry activities does not indicate that extraordinary demands will arise in the future.¹⁹

This is an *extraordinary* conclusion arrived at in the same *extraordinary* manner as the Moore Committee. The IDA and the TSE presented no empirical data to support their position, despite the overwhelming evidence to the contrary. For example, a speech by Douglas Peters, then the Chief Economist of the Toronto Dominion Bank, dealing with challenges to Canadian capital markets in the 1970s, was tabled with the OSC Study Committee. The speech while not remarkable for its time, did highlight the kinds of issues which the securities industry had found expedient to ignore.

Despite the balanced current account, and the implied adequacy of Canadian savings, many Canadian provinces, some large municipalities and a few corporations still find it necessary to borrow abroad because of a lack of depth, or size of the Canadian capital market. The challenge to the Canadian capital market is to develop its facilities so that such new issues in the New York and other markets will be unnecessary and so that Canadian borrowers will be able to satisfy their needs for capital at home.

The challenge to Canadian capital markets in the 1970s will be to improvise the institutions, intermediation and underwriting to ensure that

¹⁹ Investment Dealers Association of Canada, "Submission," October 1971, 24.

Canadian provinces, municipalities and corporate borrowers need rely on foreign sources to only a minimal extent.

...the challenge posed by the sheer volume of security issues that could be associated with the investment boom of the mid-1970s.

...the challenge of foreign competition...the efficiency, and the quality of the services provided by Canadian capital markets will be of utmost importance in the coming years...If Canadian capital markets are loathe to require adequate information and if Canadian analysts are weak in their analysis of Canadian securities, then Canadian institutional and individual investors will turn elsewhere for adequate information and analysis prior to investing.²⁰

Merrill Lynch undertook a comparable study to that of Peters' and arrived at essentially the same conclusions but added the caveat that US sources of funds would probably become less accessible during the 1970s.²¹

It is our submission that such analysis [both the IDAs and TSEs] is inconsistent with the available evidence that heavy demands will be placed upon Canadian brokerage houses and investment dealers in the 1970s to raise needed capital for government and industry. In our opinion it would therefore be dangerous and inconsistent with the public interest for the securities industry to impose upon itself or recommend government restrictions to the effect that additional capital for securities firms must be limited to specific sources and to maximum levels...Imposing artificial constraints on needed capital growth cannot be in the interest of the investing public or of the economy as a whole.²²

²⁰ Douglas G. Peters, "Challenges to Canadian Capital Markets in the 1970s," An address prepared for the Toronto Society of Financial Analysis, March 9, 1971, 3-10. It will be recalled that the Moore Committee recognized that the major weakness of the Canadian investment dealers was on the research and analysis side of their business and it was here that foreign entrants would make their greatest contribution to the Canadian industry.

²¹ Merrill Lynch, Pierce Fenner & Smith Inc., Merrill Lynch, Royal Securities, "Ontario's Securities Industry: Prospects and Problems -- Basic Economic Considerations for the 1970s," 1971, 23.

Even the Chairman of the OSC, Edward Royce, was incredulous of the proposals from the IDA and TSE to limit the growth of foreign-owned firms by requiring them to repatriate 90 percent of their retained earnings each year. Royce suggested at the hearings "that the idea of companies being encouraged to invest in Canada and then being told they could not expand their operations with the profit earned in Canada seemed unfair."²³ Royce went on

I must say that in a country which is a net importer of capital, it grieves me to think of anybody being forced to export their profits...²⁴

This irritation of the regulators, who were typically on the side of the industry, caused the TSEs President Kimber to clarify the institutions' proposal by indicating that the TSE would support a rule which would permit the US owned firms to retain and invest their earnings from brokerage operations in Canada -- but not in the brokerage business itself. This modest adjustment in the TSEs (and the industry's) proposals with respect to the retained earnings of foreign subsidiaries operating in Canada was required, in order for the SROs to maintain their actual and potential influence over the regulator on the more overarching issues. Nevertheless, the transparent self-interest seeking behavior on the part of the industry -- on the capital adequacy issue -- would come back to haunt it later on.

This neglect of such fundamental issues had the effect of undermining the legitimacy of the industry's views about the adequacy of its capitalization. This attitude should also be seen against the industry's call on "those who are proponents of a more permissive regulatory pattern to prove clearly that a pressing need for capital exists."²⁵ It also highlighted the reasonableness of the overarching positions enunciated by the

²² Merrill Lynch, Pierce Fenner & Smith Inc., Merrill Lynch, Royal Securities, "Ontario's Securities Industry: Prospects and Problems -- Basic Economic Considerations for the 1970s," 1971, 23-24.

²³ Irvin Lutsky, "OSCs hearing on foreign ownership could produce major confrontation," Globe and Mail, 27, September 1971, B 16.

²⁴ Ontario. Ontario Securities Commission, "Industry Ownership Study Committee," Public hearings held at the Securities Commission, 555 Young St., Toronto Ontario, 26 October 1971, Volume I, 108.

²⁵ Investment Dealers Association of Canada, "Submission," October 1971, iv.

Bouchard Report in Quebec. Implicitly, the individuals representing the industry were concerned that they would lose control of their firms. These same concerns had been expressed in the Moore Report and were repeated for the OSC.

Most of the firms in the industry have a system by which ownership is transferred from persons retiring from the business to younger persons active in the business at a price representing book value or some figure approaching book value. This has meant that the persons actively engaged in the business have been able to maintain a substantial equity interest in it. If firms issue shares to the public on a "times earnings" basis at a substantial mark-up over book value, it will become much more difficult for the younger persons actively engaged in the business to maintain control over the business.²⁶

In a similar vein, Alfred T. Bunting, the President of a Toronto firm of the same name noted his opposition to public share distribution by suggesting at the OSC hearings that

if some large firms were allowed to go public and had their stock selling on a price/earnings ratio basis, the temptation would be to offer to acquire firms such as his with the much more highly priced stock they could offer...This could eliminate the specialized firm over a period of time.²⁷

One prominent Toronto based firm -- McLeod, Young, Weir and Company -- was supportive of the idea of public distribution of shares of securities firms. These views had been presented to the JIC -- but were not acknowledged in its Report -- and were reiterated in its submission to the OSC's Ownership Study Committee. While broadly favoring public ownership, the McLeod submission included a number of restrictions:

- the maximum percentage of shares which could be voted by one or related shareholder would be 10 percent;

²⁶ Toronto Stock Exchange, "Submission," October 1971, 9.

²⁷ Robert Jamieson, "Investment men show deep worry about securities industry's future," Financial Post, September 1971.

- at least 30 percent of the voting shares should at all times be held by officers or employees of the firm;²⁸ and
- in the case of non-resident ownership, it was the firm's view that the interests of the industry would be well served as long as the majority ownership of investment dealer firms remained in Canadian hands. Furthermore, McLeod proposed that each member firm in the industry should be permitted to work out interlinking ownership arrangements with foreign-owned firms (looking ahead to the future globalization of financial services) without artificially imposed limitations other than that majority control remain in Canadian hands. As well, McLeod favored an unrestrained grandfather clause for those foreign-owned firms operating in Canada prior to the July 13, 1971 pronouncement by the Premier, at the behest of the industry. "...no case has been made that they have acted contrary to Canadian interests or that they have in any way been poor Canadian corporate citizens."²⁹

This proposal by McLeod was a move away from the "ideal model" proposed by the industry at large, and highlighted the existence of an ownership continuum ranging from the restrictive approaches of the TSE/IDA/Moore proposals to the liberal regime of the NYSE.

The rationale used by McLeod to argue for public ownership while not novel was instructive and reinforced the views of both Merrill Lynch - Royal Securities and Douglas Peters:

- overhead operating costs in the industry had been rising in recent years;
- capital required to support brokerage and dealer activities had been rising;
- public ownership would result in more responsible management of securities firms;

²⁸ G.C. MacDonald, President of McLeod, Young Weir and Company, in Letter to the OSC Industry Ownership Study, September 13, 1971.

²⁹ G.C. MacDonald, President of McLeod, Young Weir and Company, in Letter to the Joint Industry Committee Studying the Moore Report, August 9, 1971. See also Ontario Securities Commission, "Industry Ownership Study Committee," Public hearings held at the Securities Commission, Volume II, 305.

- public ownership would strengthen the capital structures of individual firms.

In the matter of the public interest, the submissions of both the IDA and the TSE were as transparent as the Moore Committee Report. This served to undermine any reasonable notion that their recommendations properly reflected the public interest. More specifically, the industry was seeking policies from the state which would concentrate the benefits on the industry, a small group, and disperse the costs across the Canadian economy at large. The industry was trading off political efficiency against economic welfare -- and that is why it had been successful in getting the Ontario government to make its initial move to supply protectionist policies for the industry just before calling for the OSC Study. This political game had little to do with the public interest but more to do with the private interests of the industry and state actors involved.³⁰

On the question of competition in the securities industry, the IDA and TSE once again made an assertion of the existence of a competitive environment in the industry, but provided no substantiating evidence to support such a declaration. The industry suggests

that the presence of 97 Canadian firms on the Toronto Stock Exchange indicates that the level of concentration in this industry is already very low. The rapid changes in the membership of the Toronto Stock Exchange reflecting the emergence and disappearance of participants on a fairly regular basis evidences the competitive nature of the industry. It is also submitted that this number of participants in the Canadian industry should ensure that the public interest in competition can be preserved.³¹

An Academic Critique of the Industry View

At the technical/economic level of analysis, the introduction of legal barriers to entry into the securities industry -- which could otherwise be characterized as one of monopolistic competition or differentiated oligopoly, but not necessarily a perfectly

³⁰ M.J. Trebilcock, D.G. Hartle, R.S. Prichard, and D.N. Dewees, The Choice of Governing Instrument: A Study Prepared for the Economic Council of Canada (Ottawa: Minister of Supply and Services, 1982), Chapter 3.

³¹ Toronto Stock Exchange, "Submission," October 1971, 20.

contestable market -- ultimately boiled down to a discussion of the distributional effects of the resulting market structure. These effects would undoubtedly impose a social cost on the economy. Feltham and Rauenbusch latched on to this idea in a scathing critique of the Moore Committee recommendations.³² They suggested that

A limited foreign presence in the industry is desirable to ensure that the self-regulating securities industry maintain efficient operations by world standards. Moreover, outright limitation of foreign direct participation in the securities industry has serious regional economic implications...there might be a vital role for non-resident direct investment in developing the securities industry in that province [Quebec] and elsewhere..., if Canadian firms, largely centered in Toronto, are not prepared to do so.³³

Feltham and Rauenbusch went on to say that

If foreign firms are prohibited, there may not be any pressure on Canadian firms to improve their efforts or indeed, to maintain efficiency. The [Moore] Committee suggests that Canadian investors would go to US firms if Canadian firms did not maintain comparable service. Is that in fact true? Are Canadian clients in fact mobile to such an extent? Should they be? Even if all this is true, an element of competition by foreign-owned firms on the domestic market would ensure that those questions need never be put to the test.³⁴

The submissions of the IDA and the TSE clearly fail to acknowledge that much of the industry's activity was concentrated in only a few firms representing an important percentage of the industry. Furthermore, it has already been documented that some small domestic firms and as well as non-resident owned firms were unable to break into the government and corporate syndicates which were dominated by the large dealers -- and thus the possibility of these firms leading a domestic syndicate was certainly out of the

³² Ivan R. Feltham and William T. Rauenbusch, "Multinational Enterprises In Canada, Foreign-Owned Enterprises in Canada," A paper prepared for the International Conference on Nationalism and the Multinational Enterprise: Legal, Economic and Managerial Aspects, McGill University, August 23-25, 1971, 48-58.

³³ Ivan R. Feltham and William T. Rauenbusch, "Multinational Enterprises...", August 1971, 52.

³⁴ Ivan R. Feltham and William T. Rauenbusch, "Multinational Enterprises...", August 1971, 50.

question. In any event, it was well understood that this element of the industry's business was conducted in an oligopolistic fashion. For the industry there was virtually no room for a trade-off between its "ideal model" rooted in the Moore and JIC Reports and a more liberal entry and ownership regime which would be required to accommodate future Merrill Lynch - Royal Securities type transactions or the entry of foreign-owned registrants into the Ontario and/or Canadian markets as subsidiaries of offshore firms.

***The Merrill Lynch - Royal Securities and Related
Submissions: Is Anybody Listening?***

The Merrill Lynch - Royal Securities firm was joined in its opposition to the recommendations in the Moore and JIC Reports, at the OSC hearings, by the other major US owned firms operating in Canada at the time. Their attack was multi-pronged: they criticized the self-serving dimension³⁵ of the industry's position as well as the potential long-run harm that could accrue to both the Canadian securities industry and the economy in the absence of public distribution of industry shares and of foreign competition in the domestic market. They were also critical of the retroactive nature of the measures which had been proposed in the JIC Report -- compared to the more liberal grandfather clause in the Moore Report and of the proposed prohibitions on public ownership. At the OSC hearing Merrill Lynch officials stated

there is no legislative precedent that we have found in Canada to support the astonishing suggestion of the Joint Industry Committee that each individual foreign controlled firm should, with no evidence of foreign domination of the industry, be required to divest itself of foreign ownership content down to 10% by 1989. Neither the Federal nor inter-provincial government, to our knowledge, has ever enunciated such a policy. From both an economic and fair play standpoint, the only policies likely to emerge, in our opinion, will embody the principle of 'keep Canadian what is Canadian today.' Any policy which attempts to turn back the clock will, in our opinion, be found to be financially unfeasible or so offensive to international rules of fair play as to offend the world community.³⁶

³⁵ See for example Bruce A. Gordon, Vice President and Director, Letter to H.S. Bray, Study Director, Ontario Securities Commission, Industry Ownership Study, 10 November 1971.

These submissions drew extensively on the experience of the US industry in addressing the issue of capital adequacy which had demonstrated clearly that the historical minimal capital requirements mandated by the NYSE were totally inadequate to the circumstances which were being faced by the industry. The factors which were alluded to in this regard were the need to enhance the technological infrastructure of the industry, the pressure the industry had been under to liberalize the commission rate structure on equity trading, the smaller than desired size of "block" trades which the industry was able to transact for the large institutional investors, and the apparent demand for public capital by many Canadian firms.³⁷ The firms also presented a favorable interpretation of the outcome of the public share issuance exercise. The worst fears of the Canadian industry, as expressed in the Moore Report, had never materialized. Moreover, the turnover problem that the industry had been experiencing would be ameliorated by the issuance of shares to the public.

Contrary to the highly questionable interpretation of the amount of trading commissions earned by the US firms which had been provided by the Moore and JIC Reports, the American owned firms provided a more realistic assessment of the situation. In a special analysis, Merrill Lynch - Royal Securities systematically dismantled the tenuous analysis of Moore and the JIC. They made the following points:

- (i) Canada's securities transactions with the US, on the basis of official statistics, indicate that Canada was a net beneficiary on the flow of funds;
- (ii) Canada had persistently been issuing US Dollar pay bonds in excess of US\$1 billion per annum in recent years; and

³⁶ Ontario Securities Commission, "Industry Ownership Study Committee," Public hearings held at the Securities Commission, Volume III, 354.

³⁷ See Merrill Lynch, Pierce, Fenner & Smith Incorporated and Royal Securities Corporation Limited, "Submission to the Ontario Securities Commission Industry Ownership Study Committee," September 1971, 20-24.

- (iii) Canadians trading in the US secondary market (i.e., the market in outstanding securities) had also resulted in an inflow of funds to Canada. That is, Canadians were net sellers of US securities in the two years preceding the OSC hearings.³⁸

Bache and Company further reinforced the evidence of Merrill Lynch by pointing out to the OSC that the US owned firms operating in Canada at the time provided a "valuable and essential" service because they could mobilize US loanable funds when or if Canadian savings were inadequate.³⁹

The bottom line of the US dealers' positions expressed at the OSC hearings, was that the recommendations of the Moore and JIC Reports had as their objective a Canadianized securities industry such that the domestically owned firms would not have to confront the competitive pressures of the large, well capitalized, US dealer community. Indeed, Donald I. Webb, Chairman of Merrill Lynch Canada suggested that "the Committees [Moore and JIC] are using the opportunity to reduce our effectiveness to the benefit of their own firms."⁴⁰ He was surprised that the Canadian dealer community "including national firms with international operations and connections should sit down together and produce recommendations which would have the clear, and we suggest intended, effect of putting Merrill Lynch, Royal Securities out of business."⁴¹ This was a curious state of affairs, because many US owned firms, based in New York, were transacting a considerable volume of business over telephone lines and were not registered dealers in Ontario. Despite the fact that these dealers were not regulated by the Ontario authorities, there were no prohibitions against such business.⁴²

³⁸ Merrill Lynch, Pierce Fenner & Smith Inc., Merrill Lynch, Royal Securities, "Ontario's Securities Industry..." August 1971, 15-16.

³⁹ Stanley F. Klimczak, Executive Vice President, Bache & Co., Letter to H.S. Bray, Study Director, O.S.C. Industry Ownership Study, 30 September 1971, 3.

⁴⁰ Irvin Lutsky, "Merrill Lynch Decries efforts to curb foreign interest," Globe and Mail 27 October 1971.

⁴¹ Ontario. Ontario Securities Commission, "Industry Ownership Study Committee," Public hearings held at the Securities Commission, Volume III, 357.

⁴² This was further evidence of the OSC ignorance of the affairs of the securities industry in Ontario.

Given Merrill's concern about being shut out of the Canadian securities market entirely, Mr. N.B. Ball, the President of Merrill Lynch New York, at an appearance before the OSC on November 16, 1971 proposed the following compromise on the restrictive scenario that had been put forth by the JIC in the summer:

- (i) Merrill Lynch and other foreign-owned firms would freeze their capital at current levels so that the Canadian firms will be assured that no amounts of capital will become available from the proceeds of foreign securities issues or any other foreign source. (Merrill had proposed to the IDA and the TSE, on the occasion of the public issue in the US that the Canadian subsidiary would undertake a voluntary capital freeze so that no proceeds of the public issue would benefit Merrill Lynch Canada.)
- (ii) If Canadian firms are permitted to accept limited outside financing from approved investors, Merrill and the other foreign-owned firms would be permitted to increase their capital proportionately.
- (iii) Foreign controlled firms would be permitted a dividend payout in the same proportion of profit as the average of Canadian owned firms.

This compromise proposal by Merrill Lynch fell in between the recommendations of Moore and the JIC and would have the effect of allowing Merrill and the other foreign-owned firms to operate in a relatively unencumbered manner and to grow at about the same rate as the indigenously owned industry. The proposal would preclude the dominance of the Canadian industry by foreign-owned firms.⁴³

The industry's response to this proposal was, in part, driven by the OSC. In a letter to W.P. Wilder, President of Wood Gundy [and Chairman of the JIC], J.B. Cronyn, Chairman of the Ontario District of the IDA, wrote

You might be interested to know that the Ontario Securities Commission have indicated to Mr. Kimber that on Tuesday, November 23rd, they are

⁴³ Ontario. Ontario Securities Commission, "Industry Ownership Study Committee," Public hearings held at the Securities Commission, Volume III, 357.

expecting some constructive remarks pertaining to the Merrill Lynch proposal and some form of freer thinking than the Joint Industry Study and the Moore Committee proposals arrived at.

...Jim Baillie and I, along with my Committee have spent some time discussing these matters with the TSE and have modified their stand...to the point where they would take the view that the Industry proposals still stood but if the Securities Commission wished us to reconsider our position we might be thinking along the lines enclosed.

...the view...is that the IDA should say that these proposals are a departure from the Moore Committee and the Joint Industry Committee's proposals and that we would have to have time to call a meeting of the National Executive and gather together the members of the Joint Industry Committee to discuss these matters...⁴⁴

The TSE proposal accepted the Merrill Lynch compromise as reasonable, and added a further liberal element to it by suggesting that foreign owned firms be permitted to further expand their capital by issuing shares to Canadians up to the allowable limit proposed by the Moore and JICs.⁴⁵ This more conciliatory attitude on the part of the TSE reflected the repugnance with which the OSC Chairman Royce viewed the retroactive character of the industry's proposal. The industry, on this issue, seemed to have lost its legitimacy, and in order to preserve its continued influence on both the regulator and the policy outcome, some compromise was necessary. The IDA on the other hand remained as belligerent as ever in its summary remarks to the hearings. It repeated the tired old story from Moore and the JIC -- but conceded that the TSE proposal would be considered by its national executive before the end of the year (1971).⁴⁶ The IDA subsequently joined the TSE in supporting the essence of the compromise put forward by Merrill Lynch. It is not

⁴⁴J.B. Cronyn, Chairman of The Ontario District of the IDA, Letter to W.P. Wilder, President of Wood Gundy Limited, 19 November 1971.

⁴⁵ Financial Times of Canada, "TSE, Merrill give ground," 19 November 1971; Ralph Blackmore, "Canadian Securities Industry Compromising," Investment Dealers' Digest, 14 December 1971, 36; Ottawa Journal, "TSE eases control plan for securities firms," 24 November 1971.

⁴⁶ J.B. Cronyn, "Investment Dealers' Association," Draft remarks to the OSC Study Committee on Foreign Ownership, 16 November 1971.

necessary to provide the details of the IDAs modifications to the Merrill Lynch compromise proposal here. Suffice it to say that the IDA only grudgingly accepted the compromise arrangement and not until it had itself made it somewhat more stringent.⁴⁷

The Ontario Securities Commission's Report: An Attempt at Balancing the Forces While Supporting the Domestic Securities Industry

Some Background Considerations

The OSC, in its deliberations on the ownership and capital adequacy questions had to consider a number of cross-currents in arriving at its set of recommendations to address the issues: the divergent demands of the domestic and foreign owned firms and the regulatory framework that had been proposed in the preliminary report of the Bouchard Committee in Quebec. This matrix of pressures was further complicated by the fact that the OSC did not have an overarching view about what would be the appropriate structure of the industry -- primarily because it did not know enough about the present industry structure or indeed what was required of the industry to meet the needs of the Ontario and Canadian economies. This was further complicated by the OSC's growing skepticism about the legitimacy of the Moore and JIC Reports themselves. Indeed, prior to the formal hearings, the Study Director, H.S. Bray, recorded the following comments for his colleagues on the Study Committee.

The Moore Report, and it seems to me the Joint Industry Study, commences with what we may conclude at the end of our study to be an invalid premise. This premise, as I conceive it, is that the Canadian investment community is adequately serving the capital needs of Canada's industry. This patently is not so, since there are many issuers, Governments at all levels for instance, who must go to U.S. underwriters and latterly European underwriters for financing.

Secondly, it appears to assume (this kind of financing to one side) that it is providing adequately for the capital needs of new industry and industrial expansion. Clearly this is not so...

⁴⁷ Investment Dealers Association of Canada, "Submission to Ontario Securities Commission Industry Ownership Study Committee," 5 January 1972.

The Bouchard Report lays emphasis on the need of Quebec for capital. In our deliberations I would think we ought to be concerned about the need of Ontario for capital.

The disturbing spectre raised through Moore and the Joint Industry Reports is the question of whether the findings of those studies were in reality protectionist rather than taking an objective view of the needs of the Canadian capital market. There is some ground for believing this to be so in that the Reports seem to say:

- (1) The Canadian investment community is doing a good job for Canada;
- (2) We are able to generate all the capital requirements needed within Canada; and
- (3) If you let any of these giants in you will destroy the existing community.

Again I emphasize what I conceive to be the importance of attempting some valid assessment as to the needs of the capital market in Ontario against which we may consider the ability of the existing investment community to service those needs and the possible results of permitting the registration of non-resident underwriters to compete on a side by side basis with existing underwriters to provide those capital requirements.⁴⁸

This is a remarkable statement by the Study Director inasmuch as its orientation is from the negative perspective of what was wrong with then current organizational structure of the securities industry while providing no direction for the Committee's thinking on an "ideal type" of structure against which its recommendations could be judged. The analytical model of the OSC appears to be that of the legal profession.⁴⁹ It involves listening to the arguments of the protagonists in the dispute; determining who is "telling the truth;" and, then rendering a judgement. This model of decision-making provides no vision of what the industry should be doing -- and in this particular context is

⁴⁸H.S. Bray, Vice-Chairman of the OSC and Study Director, "Note to File Re Industry Ownership Study," 17 September 1971. Archives of Ontario, RG 70 Series 17, Boxes 1 and 2.

⁴⁹ The OSC is dominated by members of the legal professions -- which has been one of the criticisms of it. All of the senior players on the Study Committee were lawyers.

very suspect because no "expert" independent witnesses were called by the OSC to render an opinion on the issues at hand. The main witnesses would be those industry participants whose objectiveness or otherwise would have to be determined.

What is also remarkable about this commentary by Bray is that it reflects, in an oblique way, a similar criticism of the "national" securities industry that was embedded in Bouchard's preliminary Report. Indeed, the premise of this important document mirrors that of the Bouchard Report despite the Study Committee's view that

It was agreed that we could not be influenced in our conclusions by their effect on, or different approaches taken, by other provinces and the Federal Government. It is appropriate to look at what happens in other provinces and discuss those developments, but not to be influenced by them.⁵⁰

This is also a remarkable statement because all of the principal actors in this drama commented specifically on the contents of the Bouchard Committee Report. Indeed, the justification for some of the positions brought to the OSC hearings were rationalized by the positions adopted vis-a-vis the Bouchard recommendations. It is argued that the OSC Study Committee could not have reasonably dismissed the developments (in legal terms to admit the evidence but not consider it in deliberations) in other provinces when it came to supply its own recommendations. Indeed, it will be argued that the OSC balanced all of the cross-currents in its recommendations. The Study Report itself recognized that

Any provincial policy must be influenced by Federal economic planning whether imposed through monetary and fiscal guidelines, an economic tribunal or some other form of constraint or persuasion.⁵¹

More precisely, the influence of Canadian competitive federalism was quite clear when the Study Committee acknowledged that

⁵⁰ D.L. Johnston, OSC Study Committee Counsel, "Memorandum to H.S. Bray, Study Director, Re Industry Ownership Study -- Draft Report," Minutes of a Meeting between E.A. Royce, H.S. Bray, J.G.K. Strathy and D.L. Johnston, 23 November 1971. Archives of Ontario, RG 70 Series 17, Boxes 1 and 2.

⁵¹ Ontario Securities Commission, Report of the Securities Industry Ownership Committee, 68.

While our terms of reference do not specifically request that we review the basic policy already established through the interim Ontario regulation, in light of the conclusions of the Bouchard Interim Report rejecting the principle accepted here...we felt it is important to reconsider the control technique previously adopted in Ontario.⁵²

Issues in the OSC Report

The "tone" of the OSC Report, which was released in May 1972, clearly reflected the struggle with which the Committee was confronted. It reviewed the positions of each of the key industry actors and the position of the Quebec Government as reflected in the Bouchard Committee Report. Only as a consequence of studying the various submissions and testimony of all of these actors was the Committee placed in a position to set out objectives for its work. Thus once again it was the industry which set the agenda for the regulator. The "ex post" underlying objectives of the study as outlined in the Report were to ensure that:

- the Ontario based securities industry would be responsive to Canadian needs;
- ownership of it remained substantially Canadian; and
- the industry remain competitive and efficient.⁵³

These objectives would be realized, according to the Committee by dealing with the main policy considerations raised by the industry:

- what to do about the proposal to "rollback" non-resident ownership which was put forward by the JIC in the summer of 1971;
- what to do about those non-resident owned firms whose US parents raised capital in a manner which was not permitted in Ontario; and

⁵² Ontario Securities Commission, Report of the Securities Industry Ownership Committee, 101.

⁵³ Ontario Securities Commission Report of the Securities Industry Ownership Committee, 10.

- what ought the permissible sources of capital be if additional capital is required.

The list of micro-objectives⁵⁴ developed by the Committee is even more revealing of both the influence of the industry and the paucity of information located in the OSC:

- reconcile the turnover problem;
- improve the use of computer technology to enhance the industry's efficiency;
- enhance the research facilities of the domestically owned firms;
- provide a structural environment to enhance the liquidity of the capital market to meet the needs of institutional investors;
- ensure that the industry aggressively seeks out new underwritings and is prepared to take on additional risk; and
- ensure that the jobber subset of the investment dealers continue to be sensitive to the "suasion" of the central bank.

All of these issues had been raised in one form or another by the Moore Committee and the JIC or by the key foreign-owned dealers -- and they were the focus of the Study Committee. Unfortunately, the Committee, given the limited nature of its information sources did not uncover any new facts which could or would influence its decisions. Thus, the Committee was compelled to make subjective judgements, not only given its value set, but also the fact that the Commission had never before been called upon to provide overarching or framework types of rulings. Having said all that, the Committee's early observation was that the realization of the list of micro-objectives "will require substantial infusions of capital during the next few years."⁵⁵

The backdrop to the Committee's recommendations was the skepticism which the Study Group Director (H.S. Bray) had of the earlier Moore and JIC Reports. It was

⁵⁴ Ontario Securities Commission Report of the Securities Industry Ownership Committee, 68-74.

⁵⁵ Ontario Securities Commission, Report of the Securities Industry Ownership Committee, 75.

apparent that this skepticism was not based on any specific knowledge of the industry as such, but more on a sense of fairness and justice in light of the transparency of the self-serving arguments of the industry. For example, as the OSC hearings proceeded, the Chairman, Mr. Royce remarked

I think that anyone who feels they require outside capital should, within certain rules laid down, be able to make their own decision as to whether they can use outside capital profitably. I don't think they should have to justify this to the rest of the industry. It doesn't seem to me to be a proper way to do things.

Within certain terms, which we hope we will arrive at, if anyone wishes to raise outside capital, then surely that is the prerogative of the company itself. We must, of course, determine what these terms should be...and in some cases outside capital is desirable...⁵⁶

As the study proceeded a number of factors served to undermine the legitimacy of the positions of the domestically owned industry in respect of public access to capital:

- one major Canadian and two foreign owned firms argued for public ownership (McLeod,⁵⁷ Merrill and Bache);
- almost half of the firms surveyed by the Committee were in favor of public ownership -- a remarkable result given the direction in which the industry elites had been steering the debate;
- as pointed out in Peters' and Merrill's papers, the Canadian economy would have a medium term need for investment capital which translated into a more strongly capitalized securities industry;

⁵⁶ Ontario Securities Commission, "Industry Ownership Study Committee," Public hearings held at the Securities Commission, Volume II, 196.

⁵⁷ A secret ballot within the McLeod firm suggested that 80 percent of its partners favored "going public." See Ontario Securities Commission, "Industry Ownership Study Committee." Public hearings held at the Securities Commission, Volume II, 292.

- if the capitalization of the Ontario industry was not enhanced it would be at a competitive disadvantage relative to both New York and Quebec⁵⁸ based firms;
- the objectives of competition and efficiency in the industry clearly pointed to a need for sources of capital beyond those that were typically available to the industry; and
- full public ownership would solve the turnover problem.⁵⁹

The Study Committee accepted the point made in the Moore and JIC Reports that professionalism in the industry was important. However, the Commission was of the view that additional safeguards could be put into place to address the concerns of the industry which they put forward when they opposed public ownership. Indeed, the Commission was persuaded by the work of the NYSE in setting limits to outside participation and establishing an apparatus to screen and approve outside ownership to ensure that "undesirable" elements do not gain entry into the industry. The Committee concluded that

there are numbers of significant benefits from additional capital. The access to public capital and permanent sources of capital will reduce the pressures from the turnover problem. An influx of funds will provide a base for an increase in the size of securities firms. Greater sophistication in methods, equipment and management can be anticipated. Capital strength, size, efficiency will give rise to increased competition. The industry will be presented with opportunities for innovation, imagination and diversification.⁶⁰

The Committee was influenced on the issue of professionalism in the securities industry if public ownership was permitted by the comments of Stanley Klinczak, Executive Vice-President of Bache & Company of New York, at the formal Commission Hearings.

⁵⁸ It will be recalled that earlier the Study Committee suggested that there was no need to take account of developments in other jurisdictions in coming to its own conclusions.

⁵⁹ Ontario Securities Commission, Report of the Securities Industry Ownership Committee, 79-94.

⁶⁰ Ontario Securities Commission, Report of the Securities Industry Ownership Committee, 94.

I feel that having a small number of shareholders tends to foster favoritism or blocks, if you will. I believe in any financial organization that is responsible to outsiders, or the public, there is a constant pressure to provide the best service, the highest standards coupled with the responsibility, the long term as well as the short term responsibility.

To me it would appear more likely that somebody could take advantage over a short period of time with a small group than when there is a large number of people to answer to.⁶¹

The contradictions in the Study Group's analysis and the reversal of its earlier position to ignore regulatory developments elsewhere with respect to foreign-ownership and entry is captured in the following statement.

We cannot be insensitive to the possibility that our suggested solutions might have the effect of leaving the securities industry in Ontario in splendid isolation and free of non-resident domination. While Ontario is presently an important financial center, both in Canada and internationally, our recommendations must aim at supporting and not detracting from this fact. The position of Quebec was declared in the Interim Report of the Bouchard Committee and implemented in part by its subsequent action.⁶²

As a consequence of the developments in other jurisdictions the Study Committee was convinced that it was necessary to reconsider the foreign ownership policy that had been enunciated by Premier Davis in 1971. The Committee considered all of the options that had been previously presented by the various actors -- and not surprisingly opted for that compromise which had been put forward by Merrill Lynch and subsequently agreed to by the two major SROs in Ontario -- the TSE and the IDA. It will be recalled that the SROs had shifted their positions modestly on this issue because the costs were not large from the perspective of giving up an important share of the market (if any) and the domestic industry would still maintain its influence over the OSC and thus over the industry's "fortunes" more generally. At the same time the industry's insulation from

⁶¹ Ontario Securities Commission, "Industry Ownership Study Committee," Public hearings held at the Securities Commission, Volume III, 421.

⁶² Ontario Securities Commission, Report of the Securities Industry Ownership Committee, 99.

foreign competition would be protected because the powers of foreign-owned firms would be more limited in the post-OSC Study regime than they were in the pre-Merrill Lynch - Royal Securities era.

The OSCs Recommendations

The OSC recommendation had a number of elements:

- all non-resident firms would be covered by the proposed rules;
- the 25-10 rule would apply to all categories of capital -- voting and non-voting shares and debt securities;
- if the non-resident was a securities firm registered in another jurisdiction and would facilitate "reciprocal trading and research arrangements" the OSC could approve up to 25 percent ownership for such a single non-resident. (This was the essence of the minority recommendation of the Moore Committee.)
- all outside investors must be approved by the OSC if their holdings reach 5 per cent;
- firms presently registered in Ontario and who do not comply with the proposed regulations (i.e., Merrill Lynch etc.) would be able to increase their capitalization by the same percentage rate of growth as the group of dealers (thirteen of the largest investment houses at the time) who were designated as Bank of Canada jobbers. Additional capital could be added if additional voting and fully participating shares were sold to Canadians. Furthermore, the non-resident owned firm would be required to pay a dividend to its parent at the same rate as that paid by the parent to its shareholders.

With respect to the issue of public ownership, the Committee essentially avoided the concerns surrounding professionalism that had been raised by the Moore Committee and the JIC, and opted to implement a variation of the successfully executed NYSE regulations to protect the industry from undesirable participants. The key rules recommended by the OSC Study Committee for the public distribution of shares were:

- the firm would have been actively engaged in the securities business for a least five years prior to the offering;
- a majority of the board of directors would have been actively engaged in the securities business before the filing of the prospectus;
- the value of the public offering could not exceed two times capital;
- a majority of the firm's board of directors must be its officers;
- those directors of the firm who were not employed by it must be "approved persons" by the OSC;
- the firm and its directors were prohibited from owning the securities of other firms;
- an owner of 5 percent of any class of securities, who was not an officer or director must be an "approved person" by the OSC;
- the securities of the firm may be sold to the public by the firm itself or through a selling group, of which the issuer may be a member; and,
- after the offering of securities to the public has been completed, the firm is not permitted to transact in the security for a client or make any recommendation with respect to its securities.⁶³

Analysis and Commentary on the OSC Study Group Report

At a "high" level, the OSCs Study Group appears to have made concessions to the minority of interests in the Canadian owned investment dealer industry as well as to the US owned contingent of the industry operating in Canada. Indeed, the Commission seems to have adopted positions which, on the surface, appear to be at odds with the conclusions of both the Moore Committee and JIC Reports.

⁶³ Ontario Securities Commission, Report of the Securities Industry Ownership Committee, 183-187.

First, the OSC Committee concluded that the capital requirements of the Canadian economy -- to ensure its sustained growth -- would be substantial in the future. This necessity, coupled with the growing institutionalization of savings, pointed toward the requirement of a strong investment dealer industry. To ensure such an outcome, the Committee was of the view that the industry required access to additional sources of permanent capital -- which boiled down to access to public capital. In this case the OSC was acting in the long-term interests of both the industry and the Canadian economy.

Second, in the case of foreign entrants, the Commission adopted the proposals put forth by Merrill Lynch and agreed to by both the IDA and the TSE. The foreign firms currently operating in Canada would be permitted to increase their capitalization at the same pace as their Canadian counterparts -- from a base level of capital on March 31, 1971. From the Committee's perspective, natural justice required a more liberal attitude toward those foreign owned firms operating in Canada prior to both the Moore and JIC Reports.

Third, new foreign entrants would be subjected to the version of the 25-10 rule that was advocated by a minority of members on the Moore Committee. That is, foreign securities firms would be able to hold as much as 25 per cent of a Canadian firm rather than the 10 per cent limit which had been advocated by a majority of both the Moore Committee and the JIC.

Neither of these apparent "concessions" would have the effect of compromising the continued dominant position of the indigenous owned industry. The foreign-owned firms presently operating in Canada could only have the same relative position in the Canadian market as they had prior to the Moore and JIC Reports. The only opportunity that the firms would have to accelerate their growth rates would be to sell shares to the Canadian public. Had the US firms wanted to follow that route they would have opted for a variation of the JIC's recommendation. In any event, this compromise is about as restrictive as the original recommendation contained in the Moore Report which called for an unfettered grandfather clause -- unless the parent of the foreign-owned firm obtained capital in a manner not permitted in Ontario. Inasmuch as public capital would be permitted under the OSC regime, the two proposals are almost identical in practical effect.

The industry's arguments with respect to public distribution of shares were clearly rejected by the Commission. The real effects of this are difficult to evaluate when juxtaposed against the position enunciated by the industry in the Moore and the JIC Reports. The original stance of the industry was never very clear because the legitimacy of its arguments could be challenged at every turn. Simply put, the elites rallied to oppose public ownership because their own positions of dominance in the industry would be threatened. In the end, this representation by the industry was just too transparent to be accepted by the regulators. It will be recalled that in an internal memorandum the OSC Study Director, H.S. Bray, himself questioned the motives of the domestically owned industry.⁶⁴

The rejection of some of the industry's arguments, however, does not translate into the idea that the OSC was not acting in the interests of the domestically owned industry. The industry would still be insulated to a certain degree from unfettered competition from the foreign-owned firms, while at the same time the domestic industry would be strengthened by the more liberal provision of access to more permanent forms of capital. Ultimately, from a financial perspective, the industry elites would also be winners.

Escalating the War: The IDA Response to the OSC Report

The industry was, of course, unhappy with the conclusions of the OSC Study Committee and signalled its position directly to the Premier, William Davis, on November 14, 1972.⁶⁵ The IDA systematically picked apart each of the major recommendations in the Committee's Report.

On the question of public ownership, the IDA suggested that it was "neither necessary nor desirable at this time," despite the fact that there were numerous firms who suggested more permanent forms of capital were required. According to the IDA, the recommendations of the Moore and JIC were still valid. The IDA also suggested that

⁶⁴ H.S. Bray, Vice-Chairman of the OSC and Study Director, "Note to File Re Industry Ownership Study," 17 September 1971. Archives of Ontario, RG 70 Series 17. Boxes 1 and 2.

⁶⁵ Andrew Kniewasser, President of the Investment Dealers Association of Canada, Letter to The Honorable William Davis, Premier of Ontario, 14 November 1972.

"capital advanced by shareholders of a securities firm in the form of subordinated debt is no less permanent than other forms of capital."⁶⁶ It was suggested that the Study Committee was unduly influenced by the events in the US where subordinated debt had led to serious financial problems for the US industry. More generally, the IDA expressed the view that the existing sources of capital available to the industry were adequate -- as suggested in the Moore and JIC Reports.

With respect to the turnover problem, the IDA suggested that issuance of shares to the public would exacerbate the problems of juniors buying into the industry because the resulting higher book value of the shares would make them too expensive to acquire. Moreover, the IDA claimed, public ownership would hamper the ability of the industry to recruit people.

On the question of foreign ownership, the IDA indicated that the OSCs recommendations which gave foreign-owned firms the ability to own as much as 25 percent of a "Canadian" firm would effectively result in control of the Canadian entity residing in foreign hands. Moreover, it was thought that as soon as one firm entered into such an arrangement competitive pressures would force the largest Canadian firms in the industry to follow suit which would place the whole industry in foreign-owned hands.

The IDA concluded with the following:

We do not believe that the Report has demonstrated an existing need for Canadian securities firms to obtain capital from the public. In this connection we are of the opinion that the Committee did not give sufficient weight to the fact that the conditions which brought about public ownership in the United States securities industry do not exist in the Canadian securities industry.

We are also concerned with the combined effect of the Committee's recommendation that a non-resident securities firm should be permitted, subject to approval by the Ontario Securities Commission, to own 25% of the voting shares of a Canadian securities firm. It is our considered view

⁶⁶ Andrew Kniewasser, 14 November 1972, 5.

that the combined effect of implementing these two recommendations must ultimately result in effective non-resident control of the most important segment of the Canadian securities industry...

We trust the areas of our concern will be borne in mind at the time such decisions are made.⁶⁷

There is little one can add, analytically, to what the industry was claiming. More interesting, in any event, was the tactic used by the IDA to attempt to short circuit the recommendations by the OSC by appealing to the Premier. In this situation, again, the industry was trying to recapture the agenda by using the precepts of the public choice paradigm. The choices for the Premier were rooted in the support that the elites in the investment industry provided to the Conservative government. Indeed, the pressures on the industry with respect to the capitalization issue were not acute, while the presence of foreign firms in Ontario, at this time at least, did not in itself generate votes, so the urgency for a decision on the issues by the Premier could wait. Moreover, the detailed recommendations of the Bouchard Committee were still to come.

Bouchard Again: The Detailed Proposal for Entry to and Ownership in the Quebec Securities Industry

The character of the Final Report⁶⁸ of the Bouchard Committee was different than the first, but its substance was the same. However, the Final Report stirred a good deal more emotion in both the Quebec and Ontario based industries than did the Interim Report.

It will be recalled that the objective of the recommendations in the Interim Report could be seen from the macro-economic-political perspective. The Quebec Government wanted to encourage the development of an important securities industry in Quebec which could help both Montreal regain some of its lost glory as a financial center and the

⁶⁷ Andrew Kniewasser, 14 November 1972, 14-15.

⁶⁸ Quebec. Department of Financial Institutions, Companies and Cooperatives, Study On The Securities Industry in Quebec: Final Report, Volume 1, June 1972

province to develop its economic potential. The Final Report sets out to justify those objectives and then comes forth with specific recommendations.

In comparison to the OSC Study Committee's Report, the Bouchard work is profoundly more important and scholarly because of the extensive data collection work which was undertaken. The profile and analysis of the Quebec industry which could be gleaned from this work far surpasses the analytical output of the OSC Report. The discussion in the Bouchard Committee's Final Report is backed up by empirical evidence while in the case of the Ontario Report it is backed up by conjecture and where based on data it is by inference rather by observation.

The justification of the objectives, and subsequently the recommendations in Bouchard, are based on an analysis of the Quebec based securities industry -- along with some observations about the national securities industry. A key feature of the industry -- and one generally accepted by observers of its evolution -- is the instability of trading and new issue activity. This operational instability is manifest in exaggerated fluctuations in income and profits and to the extent that securities dealers depend on retained earnings to augment their capital, the ability of the firms to expand over the long run can be jeopardized.⁶⁹

Furthermore, contrary to the views of the Toronto based industry, the Bouchard Committee discovered that the Canadian securities industry was highly concentrated, which raised the probability of the existence of restrictive trade practices and of efforts by major firms to control the market.⁷⁰ One example of restrictive trade practices which had been widely acknowledged in the industry was the tight control of underwritings by the large firms. This control was based on the traditional or long standing relationships between the specific members of the industry and the particular private corporations which they serve.⁷¹ Thus the smaller firms were at the mercy of the larger ones regarding appointments as members of borrowing syndicates -- an area of activity from which they

⁶⁹ Study On The Securities Industry in Quebec: Final Report, 73-75.

⁷⁰ Study On The Securities Industry in Quebec: Final Report, 75-83.

⁷¹ Study On The Securities Industry in Quebec: Final Report, 83.

derived a large part of their incomes. Thus, an important part of the smaller firms' incomes was dependent on the larger firms. Moreover, the larger firms overwhelmingly had their head offices in Toronto. Given these cross currents the Bouchard Committee indicated that

we cannot state, as the Toronto Stock Exchange does that 'The rapid changes in membership of the Toronto Stock Exchange reflecting the emergence and disappearance of participants on a fairly regular basis evidences the competitive nature of the industry.'⁷²

The particular arrangements in the Quebec securities business worked to the disadvantage of the Quebec based firms. Furthermore, most Quebec firms dealt with individuals in the marketplace rather than with the large institutional traders. Typically smaller entities are at a competitive disadvantage with respect to the production of research. Inasmuch as the institutional accounts make extensive use of the dealers' research reports, and allocate their business on the basis of the quantity and quality of this research, the competitive position of the Quebec based firms was further constrained.

This small versus large comparison also brought into focus the fact that the larger Toronto based firms dominated the securities business in Quebec. Indeed, there was limited participation of Quebec based firms in the stock and bond issues of Quebec based companies because they did not have the financial power and technical knowledge to advise on and lead the arrangements for such issues. Bouchard was of the view that the existence of this situation was a drag on the development of Quebec's industrial base. Indeed, just as Moore and the JIC argued, Bouchard argued that the Toronto based firms were not as likely to conduct their affairs in the best interests of Quebec as were Quebec based firms.⁷³

Thus, in respect of the issue of size, in addition to a recommendation that would require a minimum level of capital in a securities firm, the Bouchard Committee hoped that

⁷² Study On The Securities Industry in Quebec: Final Report, 83.

⁷³ Study On The Securities Industry in Quebec: Final Report, 83-86.

the Quebec firms, and especially the small ones, will consider regrouping or merging with larger firms in order to increase the average size of the Quebec-based securities firms. This does not necessarily imply that all small firms should vanish. In this industry, as elsewhere, there exist small specialized firms which can better answer particular needs than the larger firms ever could. However, financially stronger firms would permit all firms doing a general type of business to compete more effectively, at least in the Quebec market, with other groups of firms. Further, it would be easier for them to expand their activities outside Quebec. More important[,]⁷⁴ Quebec firms would only benefit Quebec's economic expansion.

The conclusion for the Bouchard Committee was that the Quebec securities industry was quite weak and its recommendations had to address the ways in which it could be strengthened. Key factors which would play a role in this strengthening of the Quebec based industry would be access to broader sources of capital and the admission of offshore firms to the Quebec market to make it more competitive. The latter position had been argued strenuously in the Interim Report.

Finally, the Bouchard Committee wanted to strengthen the influence of the QSC as the regulator of the securities industry in Quebec. It could do this only by ensuring that the industry's national SRO -- the IDA -- and the exchanges in Quebec were subjected to its regulatory authority. For Bouchard

the securities industry is the only field of activity of such importance where, as much in Quebec as in the other Canadian provinces, private interests grant themselves such broad powers without specific legislative guidelines in which to operate. It is highly irregular that such an association take sole charge of protecting the interests of the investing public because of the ever present risk that this protection will only extend as far as the interest of its members dictate. This situation must be remedied...⁷⁵

⁷⁴ Study On The Securities Industry in Quebec: Final Report, 114.

⁷⁵ Study On The Securities Industry in Quebec: Final Report, 127.

The Bouchard Committee's Recommendations

The key recommendations in the report which address the Committee's objectives are enumerated below.⁷⁶

- (i) The Quebec Securities Commission should set a minimum level of capitalization for any registrant of \$250,000.
- (ii) Membership in an exchange or of a dealers' association recognized by the QSC would be required for registration.
- (iii) Purchases and sales of securities in Quebec would be required to take place through a dealer registered in Quebec.
- (iv) The issuance of public securities would be permitted up to 49 percent of outstanding capital as long as officers and employees held a minimum of 51 percent.
- (v) A minimum of 25 percent of the voting capital of all firms operating in Quebec be held by officers and employees resident in Quebec.
- (vi) The granting and/or renewal of a registration by the QSC should be based on the following factors:
 - capacity of the firm to distribute securities in more than one market;
 - the capacity of the firm to increase the volume of transactions on the Quebec market;
 - the firm's potential contribution in terms of know-how;
 - apparatus in place to avoid undue outside influence on the firm; and
 - ability to foster competition in the industry.

⁷⁶ Study On The Securities Industry in Quebec: Final Report, 145-48.

Reaction to Bouchard

The Bouchard recommendations exploded like a bombshell⁷⁷ on the Toronto and Montreal based industries. The most contentious components of the Report were those related to the entry of foreign capital into the Quebec industry and outside capital in the form of share issues to the public.

Not surprisingly, the Toronto based industry seemed to be more disturbed about these recommendations than was the Quebec component. Indeed, J.R. Kimber, the President of the TSE indicated that "certain suggestions are extremely disturbing."⁷⁸ What was most disturbing was the minimum 25 percent ownership rule for Quebec residents of Quebec based firms. This was especially the case because as noted on numerous occasions earlier the Toronto based firms dominate the business across the country "and do not react kindly towards any suggestion that would upset their existing patterns of business."⁷⁹ According to Kimber, if the Report was to be implemented "the Quebec Government would create inter-provincial barriers leading to the fragmentation of the Canadian capital market to the detriment of each part of Canada...we would have capital markets separated by provincial boundaries."⁸⁰ On the issue of foreign ownership Kimber stated

One cannot but be shocked by the acceptance in the report of the concept that Canadians who are not Quebecers are foreigners in Canada and not interested in Quebec. If the desire of the Committee is to strengthen the capital market in Quebec, then the recommendations will not accomplish this...A theme in the report is to reduce the importance of Canadian non-Quebeckers by substituting therefor the influence of non-Canadians.⁸¹

The Bouchard Committee's recommendations on public ownership went somewhat further than did the OSC Study although they were similar. Kimber's reaction

⁷⁷ John Kalbfleisch, "Bouchard call for minimum of 25%," Montreal Gazette, 24 August 1972.

⁷⁸ Irvin Lutsky, "Securities Proposals from Quebec called prelude to isolation," Globe and Mail, 25 August 1972.

⁷⁹ R.G. Gibbons, Financial Editor, Montreal Daily Star, 29 August 1972.

⁸⁰ Irvin Lutsky, Globe and Mail, 25 August 1972.

⁸¹ Irvin Lutsky, Globe and Mail, 25 August 1972.

on this issue was that "the divergent views make it imperative that discussions take place to resolve the differences and to draw the capital market in Canada together."⁸² On the other hand, Edward Royce, Chairman of the OSC indicated that he was pleased by the recommendations on public ownership and indicated that the OSC "recognizes the right of any province to take the actions that it considers appropriate in the circumstances."⁸³

Observations on the OSC and Bouchard Reports

The Bouchard Report and the reaction to it point to a number of interesting observations. *First*, we have observed the proposed activist role of the Quebec state in promoting a vision of both a strong investment dealer industry and a strong economy -- the two are closely intertwined. This contrasts markedly with the work of the OSC Study Committee. The latter did not have a vision; it relied on the industry itself (both foreign and domestically owned components) for arguments on the issues and then arbitrated the arguments. In Quebec, we were presented with a "true study" with conclusions based on empiricism and recommendations following from judgements about how to ameliorate the situation presented by the "facts."

Second, we have seen the development of two significant cleavages in this area of entry and ownership: one at the industry level and one at the regulatory level -- both focussed on inter-provincial differences. At the industry level, the small firms in Quebec were desperately seeking ways to strengthen not only their own firms, but the industry generally. The Bouchard recommendations, which satisfied the small firms (along with the state's encouragement regarding mergers) is at odds with the interests of the large Toronto based firms in the sense they coerce those firms to dilute their ownership structure, because of the Quebecer participation requirement, in a way that probably would not have been chosen voluntarily.

Third, with respect to the regulatory cleavage, on important issues the Quebec and Ontario regulators were on diverging paths. For example, the foreign ownership proposal

⁸² Irvin Lutsky, Globe and Mail, 25 August 1972.

⁸³ Irvin Lutsky, Globe and Mail, 25 August 1972.

of the Bouchard Committee is, in qualitative terms, the reciprocal of that of the OSC Study Group. With respect to indigenous provincial ownership, the proposals are not comparable and the Quebec blueprint, if implemented, would ultimately destroy any chance of achieving transparency in the securities regulatory arena. In a world of globalized markets this would not auger well for "Canadian" capital markets because firms operating at the international level must be able to cross national borders without confronting a checkerboard regulatory apparatus. Indeed, the requirement for trading by Quebecers to take place only through Quebec registrants would introduce inefficiencies in the capital market and hinder traders from obtaining the best prices in cross-listed and internationally traded securities.

So the issue of ownership and entry was still not resolved some three and a half years after the Merrill Lynch takeover of Royal Securities -- and the situation did not seem close to a resolution. The Ontario industry's rules (as declared by Premier Davis in the summer of 1971 were still in place in that province) while Quebec was admitting foreign-owned firms to its market -- so long as they trade solely with institutional accounts.

About one year later, in the summer of 1973, the Bouchard Report had still not been implemented in Quebec, and in Ontario there was no action on the OSC Study Committee recommendations. At the Annual Meeting of the IDA, on 12 June 1973 at Quebec City, Latham Burns, the President of the Association indicated that a compromise was near on the issue of foreign ownership. That was to say, the stock exchanges, the investment dealers and the provinces had agreed on a uniform position -- essentially the 25-10 rule along with limitations on both the growth of capital of such firms and on the character of activities that could be undertaken.

The QSC was on the verge (June 28) of issuing a new set of rules to accommodate the participation of foreign owned firms in that province and to implement other recommendations in the Bouchard Report to strengthen the securities industry. As noted earlier, the Bouchard Committee Report had never been discussed in full in the cabinet of the liberal government -- in part because the issues raised were too technical and in part because there was a certain amount of disinterest in the esoterica of regulatory reform.⁸⁴

The seven point program which was enunciated by the QSC mirrored very closely the recommendations in the Bouchard Report.

A non-resident owned firm would be required to supply the following to the QSC in order to obtain registration to operate in the province:

- a statement about the character of the business the firm plans to undertake;
- the potential of the firm to sell Quebec securities in various capital markets;
- expected contribution of the firm in terms of know-how and specialization;
- an assurance that the firm will have in place the mechanisms to ensure that it would not be subjected to undue outside influence;
- the ability of a Canadian firm to obtain an operating license in the home country of the non-resident applicant (reciprocity); and,
- the capacity of the firm to maintain a competitive environment in the industry.⁸⁵

The QSC invited comments from interested actors involved in and with the industry. It is clear that these proposals were the exact opposite of what the OSC Study had recommended.

In addition, the QSC proposed that those firms wishing to trade with the public shall allow their officers and employees resident in Quebec to acquire an equity interest in the firm. It will be recalled that the Bouchard Committee had recommended that 25 percent of the voting stock of all firms operating in Quebec had to be owned by officers and employees resident in Quebec.⁸⁶

⁸⁴ Based on confidential interviews.

⁸⁵ Le Devoir, "Les firmes étrangères seront invitées si elles remplissent les sept conditions," 30 June 1973.

⁸⁶ Denis Giroux, "QSC lists seven conditions for foreign-owned brokerage," Montreal Gazette, 29 June 1973.

Another Joint Industry Report

In November 1973, under the influence of Andrew Kniewasser, the President of the IDA,⁸⁷ a second Joint Industry Report (JIC2) was prepared under the auspices of the IDA, the TSE, the two Montreal Exchanges and the VSE. The main thrust of this work was to reiterate what had transpired earlier with some minor modification. The overarching objective of JIC2 was to ensure that

the Canadian securities industry must be substantially Canadian so that there will be in Canada a strong securities community which is responsive to the needs of each part of Canada and to the special aspirations of governments in Canada, both provincial and federal.⁸⁸

Within this overarching objective the Committee was searching for a uniform set of rules under which securities firms (both domestic and foreign-owned) operating in Canada would become registrants. Given the evolution of the debate almost over half a decade, the surprising thought was expressed in the *JIC2 Report* that the non-resident firms, not operating in Canada but wishing to do so, needed some certainty about the Canadian requirements for registration. The JIC2 put forward a recommendation for three categories of securities firms operating in Canada

- (i) those recognized by Moore and JIC as being Canadian controlled -- i.e., those in which non-residents do not have more than a 25 percent ownership interest in the firm and that no one non-resident has more than a 10 percent interest in the firm.
- (ii) those non-resident controlled firms which were registered in Canada to carry out business in Canada at the time of the *JIC Report* in July 1971 and which were granted the benefit of grandfather status in that *Report*.⁸⁹

⁸⁷ It will be recalled that Kniewasser's vision of the securities industry in Canada was one of uniform rules governing entry and ownership in the industry across the country.

⁸⁸ Joint Industry Committee, "Participation of Non-resident Controlled Securities Firms in the Canadian Securities Industry," 15 November 1973, 2.

⁸⁹ Joint Industry Committee, "Participation of Non-resident Controlled Securities Firms," 15 November 1973, 4.

From the perspective of the JIC2, these two categories of firms would be able to carry on a full range of securities activities in Canada -- as long as they were within the scope of the regulations of the various provinces.

- (iii) A third category of firm would be a wholly owned foreign entity which would be given permission to underwrite or act as agents in the distribution of Canadian issues, both government and corporate, for sale outside Canada. In addition, such firms could sell and trade with institutional accounts.

This was an interesting proposal because it will be recalled that in September 1971 the QSC granted First Boston of New York a similarly restricted registration. That decision by the QSC, at the time, was consistent with the general provisions of the Interim Report of the Bouchard Committee.

While these proposals did move the long drawn out negotiations toward convergence, William Tetley, the Quebec Minister of Financial Institutions, on January 29, 1974, indicated strongly that "the joint committee's statement last November seems to liberalize previous policies regarding foreign-controlled firms, but I find these recommendations constitute an even more restrictive approach."⁹⁰ So the stalemate persisted.

The Ontario Securities Commission's Proposal: More of the Same

Subsequently, in February 1974, the OSC published new rules surrounding foreign owned dealers -- which were more restrictive than the OSC Study Committee had recommended but in line with the wishes of the domestically owned firms. The 25-10 rule in its original form -- rooted in Moore -- persisted for new entrants while the permitted growth in capital for those non-resident owned firms already operating in Ontario, at the time of the original takeover, was essentially the compromise put forward by Merrill Lynch at the OSC Study Committee's hearings. That is, capital as at March 31, 1971 would be permitted to grow only as quickly as that of the domestically owned industry.⁹¹

⁹⁰ Globe and Mail, "Securities Rules," 29 January 1974; Amy Booth, "Tetley attacks report on securities firms," Financial Post, 2 February 1974.

The domestic industry in Ontario had carried the regulators in that jurisdiction toward its point of view. Indeed, it was apparent to the OSC, as late as November 1979, when it again reconsidered this whole series of issues, at the request of the Minister of Consumer and Commercial Relations, that "the existing written and unwritten rules, unsatisfactory as they may be, have resulted in a delicate balance which, while fully acceptable neither to the resident nor the non-resident firms, have proven workable for each."⁹² However, after a brief study, during which the "standard" issues were again reviewed, the OSCs

recommendation for the near term largely correspond with those of the Canadian industry. Non-resident firms, apart from "grandfathered" firms, should be limited in their activities to transactions in foreign securities with Ontario residents and to activities incidental to the sale outside Canada of securities issued by Ontario organizations.⁹³

The OSC came forth with such a recommendation despite the admission in this latest report that

The most important of the...factors which merit consideration in assessing the scope of protections required by the Canadian industry are that Canada is a participant in the international financial markets and that access to the expertise of securities firms in other countries is clearly beneficial to Canadians who are carrying on international transactions. A tension exists between the need for Canadian control and the need for international participation...regulatory shelter from the forces of international competition might, if too rigorously enforced, blunt the competitive edge of firms within Canada.⁹⁴

⁹¹ Peter Dey, "Foreign-owned brokers hit harder," *Financial Post*, 15 June 1974.

⁹² Ontario Securities Commission, "Report to the Minister of Consumer and Commercial Relations on the Application of Ontario Securities Legislation to Non-Resident Securities Firms Not Currently Registered in Ontario," 29 November 1979, 3.

⁹³ Ontario Securities Commission, "Report to the Minister of Consumer and Commercial Relations...", 29 November 1979, 16.

⁹⁴ Ontario Securities Commission, "Report to the Minister of Consumer and Commercial Relations...", 29 November 1979, 8.

It is interesting that there were important precepts of the Bouchard "world view" infiltrating the thinking of the OSC, but the influence of the domestic industry in Toronto was just too overwhelming for the Commission to act autonomously. Indeed, it was very difficult, if not impossible for the Commission to enact regulations that were contrary to the wishes of the industry⁹⁵ because the regulators had no objective information upon which to base a refutation of the claims of the industry elites. Indeed, the Commissioners, in their November 1979 "Report to the Minister" bemoan the fact that

The concern with the lack of relevant data affected all stages of our work. In an industry that rivals baseball for its obsession with statistics, there has been remarkably little effort at the compilation of data as to the extent of non-resident participation...Collection of further data would be of great value in casting light on the issues in this study.⁹⁶

It was clearly this lack of data which prevented the OSC from moving away from the position of the indigenous industry to a more liberal entry position for the non-resident firms.⁹⁷

The OSCs background paper,⁹⁸ which was the focus of discussion for the industry and the subsequent

"Report to the Minister" expounded a very much more liberal view of a deregulatory process for entry and ownership but "the joint submission made by The Toronto Stock Exchange and the Investment Dealers Association of Canada clearly indicates that the role of the non-resident firms that do not qualify for the "grandfather" provision should be limited..."⁹⁹

⁹⁵ Based on confidential interviews.

⁹⁶ Ontario Securities Commission, "Report to the Minister of Consumer and Commercial Relations...", 29 November 1979, 15.

⁹⁷ Ontario Securities Commission, "Report to the Minister of Consumer and Commercial Relations...", 29 November 1979, 15.

⁹⁸ Ontario. Ontario Securities Commission, "Discussion Paper on the Application of Ontario Securities Legislation to Non-Resident Securities Legislation to Non-Resident Securities Firms Not Currently Registered in Ontario," 28 July 1978.

In the event, the Report of the Commission was not published, on the order of the Minister, in a letter to the Chairman of the OSC, James Baillie.¹⁰⁰ However, the letter was drafted by Mr. Baillie 'umself to himself,¹⁰¹ wherein among other things it is suggested that a more liberal entry and ownership regime could interfere with the federal government's decennial amendments to the Bank Act -- which would affect the role of foreign-owned banks in the securities business -- and the Ontario government did not want to fuel a confrontation with the federal government over the issue at this stage. The letter also suggested that the OSC "initiate the data collection process...in order to make a more informed assessment of the need for new regulations. In the meantime, you should continue to administer the regulations currently in place, and to police them rigorously."¹⁰²

Conclusion

This has been a long chapter -- but the journey has also been long. The message is clear. Little progress was made over more than a decade of dealing with the efforts to liberalize entry and ownership in the industry. However, the precepts of the political economy paradigm is helpful in advancing our understanding of why the process we have just documented followed the circuitous route it did.

Enhanced competition, as a consequence of liberalizing the entry and ownership rules would have augmented the social welfare. The lack of "progress" in resolving the entry and ownership dilemma easily falls into the Stiglerian origins of the theory of capture augmented by the specific explanatory variable of "information dependency" enunciated by Mitnick and addressed in the first part of the dissertation.

⁹⁹ Ontario Securities Commission, "Discussion Paper...", 28 July 1978. 5.

¹⁰⁰ Frank Drea, Minister of Consumer and Commercial Relations, Letter to James Baillie, Chairman of the Ontario Securities Commission, "Re: Report on the Application of Ontario Securities Legislation to Non-Resident Securities Firms not Currently Registered in Ontario," 29 February 1980.

¹⁰¹ This was confirmed in a note by A.G. Kniewasser, President of the Investment Dealers Association of Canada, "Foreign Ownership," 22 April 1980.

¹⁰² Frank Drea, Minister of Consumer and Commercial Relations, Letter to James Baillie, 29 February 1980, 2.

Simply put, it was the industry which held all the cards with respect to the institutional and operational arrangements in the securities business. As a consequence of this information monopoly, the securities industry not only set the agenda, it ultimately set the policy. To be sure, the tensions between the regulatory authorities in Quebec and Ontario and between the fragments of the industry in those same jurisdictions, prolonged the deliberation process and ultimately gave rise to a segmented set of rules for entry and ownership -- which up to the point in history we have examined was not of very much consequence.

What is important in this chapter, however, is the demonstration of the power of the elites in the Ontario securities industry to thwart better public policy -- defined as welfare improving policies. These were the prescriptions of social scientists in both Ontario and Quebec, the "reasonable" people in the OSC who were initially driven by a sense of justice but subsequently by a sense of loyalty to the industry being regulated and to its elites. Indeed, frequently the Commissioners of the OSC, in their hearings, alluded to the industry participants as their friends. The politicians in Ontario practised broker politics, or in the terminology of the public choice theorists -- acquiesced to the rent-seeking behavior of the industry by supporting impediments to market entry. The costs of these impediments were borne broadly by the economic system while the benefits were concentrated among both the industry elites and the government in power. The social costs that were imposed on society were difficult to discern, thus there was no clear incentive for the users of financial services and the citizenry at large to protest the protection that was being accorded the Ontario securities industry by the state. Furthermore, the globalization phenomena had not as yet threatened the viability of the industry, nor had the large volume of offshore borrowings that were already taking place created sufficient unease among politicians and regulators to alter their basic position to afford the industry the protection that it had desired.

The capture of the regulators by the industry is clear -- not only from the case study presented, but also from the admission of industry observers and former chairmen of the Ontario Securities Commission. The situation in Quebec was somewhat different. The Quebec state had a vision for itself and for the role that the securities industry should play in that vision. The industry set the stage for the development of that vision, and that state

acted as its advocate. The Quebec policy development process can also be seen from the perspective of the political economy model because the state was supplying policies to ensure that its macro/micro-economic policy objectives would be achieved.

The positions taken by the Quebec government, however, threatened the dominant position of the Ontario based industry. The regulators and politicians in Ontario always took that threat more seriously¹⁰³ than did members of the industry.¹⁰⁴ At the same time, however, the politicians in Ontario also seemed to be concerned with the need to be seen to be converging with the federal government's foreign investment policies. So it was also distracted by the industry's position on foreign investment which played off the federal restrictions. On balance, what we witnessed over this period could not be characterized as cooperative federalism -- but within each of the provinces we have witnessed the evolution of an elite accommodation. Attempts to eliminate competition among the provinces -- particularly by the national securities association located in Toronto -- was a complete failure.

But the story is not over. The threat to the Ontario industry became more pronounced beginning in the early 1980s. The globalization phenomena had taken root and there was a clear requirement for the state to act; and, the capture paradigm then began to erode. It is to that final episode to which we now turn.

¹⁰³ This was acknowledged in the Ontario Securities Commission Report of the Securities Industry Ownership Committee and confirmed in interviews with former officials.

¹⁰⁴ Based on interviews with industry participants and former public officials.

CHAPTER EIGHT

THE PRELUDE TO THE DECISIONS ON THE LIBERALIZATION OF ENTRY AND OWNERSHIP IN THE INVESTMENT DEALER INDUSTRY

Introduction

By the turn of the decade little in the way of progress had been achieved in resolving the entry and ownership issues that had occupied the policy community since 1969. We have seen that the securities dealers had for the most part controlled the policy agenda as a consequence of their monopoly of the information about the industry itself. Moreover, it was widely accepted among government officials, and influential advisors to the Ontario provincial government, that neither the regulators nor the responsible ministry had the capacity to understand the capital requirements of the industry or the immediate and future effects of the state's protectionist measures which had served to insulate the industry from the competitive forces of the marketplace. This ignorance had contributed to the capture of the OSC. The policy rhetoric in Quebec, on the other hand, had been largely driven by the nationalists' sentiments that were predominant during this period, although the political will to act, in what was considered a rather obscure area of public policy, did not mirror the political discourse. For the most part, the Toronto based industry, its SROs and regulator, dominated the national scene.

The source of the indigenous industry's strength was partly related to the fact that it was monolithic -- it spoke with one voice. There was general solidarity within the industry with respect to the self-serving advice which it provided to the state and the public policies which were supplied as a result. Thus, in addition to capture, we have also witnessed classic pressure group politics.

The implications of this situation was to increase the cost of raising capital to the Canadian economy -- a loss of economic efficiency. However, this cost was offset by a gain in political efficiency for the elected officials in Ontario -- because as noted in the preceding chapter the elites in the securities industry were important supporters of the provincial Conservative Party which had been in power for a very long time. Moreover, the industry while not thriving during this period, was for the most part able to provide the financial services required by governments and businesses. Nonetheless, the policies supplied by the state at the behest of the industry served to slow its progress and hindered innovation and risk taking in the Canadian capital market.

As the 1980s began, it became increasingly apparent in Canada that financial markets had already changed dramatically in the United States, liberalization of financial institutions and markets were being considered in many of the European countries of the OECD area.¹ Indeed, it was during the decade of the 1980s, when the phenomena of economic and political efficiency collided, and the loosening of the ties among industry members which had earlier given rise to common interests, all converged to turn attitudes toward the entry and ownership policy on its head.

The first crack in the domestic industry's solidarity occurred in 1980 when two Canadian firms, Midland Doherty Limited and Walwyn, Stodgell, Cochran, Murray Limited expressed a desire to issue shares to the public.² This request set the stage for yet another series of industry and government studies of the entry and ownership questions. These studies will be seen as the manifestation of the industry's efforts to maximize the rents associated with its protected position. During this period, however, interests other than just those of the industry itself were beginning to express their views about the special "competitive" preserve of the Canadian securities industry.

¹ Organization for Economic Cooperation and Development, Committee on Financial Markets, Tour D'Horizon Part II, "Listing of subjects dealt with under Tour D'Horizon Part II since the beginning of the Committee's Activities (1970-78)," Paris, January 25, 1979 CMF(79)5.

² Wayne Lilley, "Bay Street's reluctant virgins," Canadian Business, November 1981, 81. Canadian Securities Law Reports, "Notice: Request For Comments - Public Ownership Restrictions," 58,465.

It is the purpose of this chapter explain the beginning of the evolution of the key decisions to liberalize entry and ownership in the securities industry against the background of a number of cross-currents: the many studies that took place in the first half of the 1980s; the interactions between the state and the industry; the interactions between the industry and other interests in the financial services sector; and, interactions between the provinces and the federal government. This process can also be seen as one of policy learning as a subtle shift began to take place in the belief systems of those responsible for regulating entry and ownership in the securities business.³

As this and the subsequent two chapters will show, the issues examined were complicated because they cut across the four pillars of the Canadian financial system and thus across the jurisdictions of the federal and provincial governments. From an important perspective, what was at stake during this critical period was the character of the Canadian financial system. Would Canada persist with a functional four pillar system or would the financial structure evolve towards the integrated system which characterized many western European countries? Each of these cross-currents had its influence on the ultimate resolution of the entry and ownership controversy.

Public Ownership of Securities Firms: The Industry Consensus Begins To Unravel

In the Fall of 1980, two well known Canadian securities firms, Midland Doherty Limited and Walwyn Stodgell Cochran Murray Limited, both located in Toronto, announced plans to sell shares to non-industry participants (i.e., "go public").⁴ It is interesting that the rationale used by both firms was the same as that observed almost a decade earlier by foreign owned firms, (whose powers were in the process of being restrained by the OSC), by economists, by practitioners and regulators in the US. and by other observers.

³ See Paul A. Sabatier and Hank C. Jenkins-Smith, *Policy Learning and Change* (Boulder: Westview Press, 1993), Chapters 1 and 2.

⁴ Dennis Slocum, "Midland Doherty proposes a plan to go public," *Globe and Mail*, 4 November 1980, B8; "Walwyn Stodgell plans to go public," *Globe and Mail*, 4 December 1980, B1.

The main argument that had been conveniently ignored during this earlier period was that the future investment requirements of the Canadian economy would be sufficiently large as to require a significantly better capitalized and more competitive securities industry than was the case in the late sixties and early 1970s. In this regard, D.B. Weldon, Chairman of Midland in commenting on his firm's decision to go public said

the move was prompted by the need for larger investment dealers to raise the massive amounts of capital required for major projects and to compete effectively with large, foreign owned investment dealers operating in Canada.⁵

Michael Curry, Deputy Chairman of Walwyn, explaining his firm's decision to broaden its shareholder base indicated that "Our projections looking out five to 10 years indicate an increasing need for capital."⁶ Earlier in the same year, at the IDAs Annual Meeting, Andrew Kniewasser, its President, noted that

Longer-term, the industry is faced with the problem of raising unprecedented levels of new financing. The annual demands for the 1980s are estimated at \$100 billion a year of new capital formation, or twice the levels of the 1970s..⁷

It will be recalled that the Canadian securities industry, beginning with the original Moore Report, dismissed such arguments when considering the evidence to liberalize entry into and ownership of the industry. The fallout of that persistently narrow view was now becoming apparent to many of the current participants in the securities industry. The problem at this juncture, as explained by Pierce Bunting President of the TSE, was that the rules of the SROs "as they are currently constituted do not allow going public. However,

⁵ Dennis Slocum, "Midland Doherty proposes a plan to go public," Globe and Mail, 4 November 1980, B8.

⁶ Dennis Slocum, "Walwyn Stodgell plans to go public," Globe and Mail, 4 December 1980, B1.

⁷ Allan Robinson, "Investment industry's forecast is expansionary," Financial Post, 28 June 1980, 21.

we really have not had a case to discuss on the subject. This provides one.'⁸ The industry's response was to appoint another Joint Committee -- this one on Public Ownership.

The Joint Industry Study on Public Ownership: The Beginning of Change

The Report of the Joint Industry Study on Public Ownership⁹ was published in the late winter of 1981. This Report was important because it was the start, by the industry, to reverse a number of its earlier propositions, which had the effect of insulating it from competition.

The JICs rationale for yet another industry study was threefold:

- *first*, it had been almost a decade since the US industry had begun issuing shares to non-industry participants and thus the Canadian industry could use the US experience to make judgments about what should be done in the case of the Canadian industry. The US industry's experiment with "going public" had been a success, and the measures to protect "professionalism" in the industry were in the process of being further liberalized;
- *second*, numerous studies of the Canadian securities industry had been undertaken since the original Moore Report, including the OSCs 1972 Study Committee Report which the JIC said "contains many constructive comments and recommendations,"¹⁰ and it was time to consolidate all of this information. This was a significant turn-around by the industry. It will be recalled that the industry (represented by the IDA) wrote directly to Premier Davis to voice its displeasure with the recommendations in the OSCs 1972 Study Committee Report; and

⁸ Eric Evans, "It isn't easy for broker to go public," *Financial Post*, 15 November 1980, 35.

⁹ Joint Industry Committee, "Report of the Joint Industry Committee on Public Ownership in the Canadian Securities Industry," March 2, 1981.

¹⁰ "Report of the Joint Industry Committee on Public Ownership in the Canadian Securities Industry," 1. It will be recalled the industry was opposed to the essence of the 1972 OSC Report.

- *finally*, two Canadian firms had announced their desire to issue shares to non-industry participants and consequently it was necessary for the members of the industry and the SROs to arrive at some recommendations in this regard.¹¹

The JIC was confronted with two questions regarding the ownership of firms in the securities industry:

...what, if any restrictions or guidelines should be placed on such ownership.

What, if any, changes should be made with regard to existing ownership restrictions.¹²

The JIC began to answer these questions with words that rang familiar: "the securities industry as a whole is not currently subject to a serious shortage of capital."¹³ Nonetheless, the JIC was of the view that firms in the industry should not be unduly restricted in sourcing capital, because the financing requirements of the Canadian economy would likely strain the capital bases of Canadian securities firms.¹⁴ Furthermore the "turnover" problem was of continuing concern to the industry.¹⁵ Thus, the JIC concluded that there was no justification for limiting the capacity of any Canadian firm to "go public." Its recommendation went considerably further than the 1972 OSC Report which proposed a limitation on the capacity of firms going public which was based on the size of the firm. Thus, at this stage in the cycle of deliberations, the JIC saw no reason to discriminate among categories of firms that should be permitted to go public.¹⁶

¹¹ "Report of the Joint Industry Committee on Public Ownership in the Canadian Securities Industry," 1.

¹² "Report of the Joint Industry Committee on Public Ownership in the Canadian Securities Industry," 2.

¹³ "Report of the Joint Industry Committee on Public Ownership in the Canadian Securities Industry," 4.

¹⁴ "Report of the Joint Industry Committee on Public Ownership in the Canadian Securities Industry," 4.

¹⁵ "Report of the Joint Industry Committee on Public Ownership in the Canadian Securities Industry," 11.

It will be recalled that the original Moore Committee Report raised numerous objections to the idea of issuing shares in securities firms to non-industry participants. Briefly, the following were among the more important objections raised by Moore:

- if a firm distributed its own shares it would be in a conflict of interest position vis-a-vis its clients;
- if another firm managed the primary distribution of shares this would compromise competition within the industry;
- too much emphasis could be placed on the need to maximize earnings;
- the regulatory authorities might be reluctant to sanction a firm whose shares were trading publicly because of a fear of unduly impinging on their market value;
- the turnover problem could be exacerbated by the public distribution of shares because price-earnings multiples established in market trading might be too high for juniors to afford. Thus, there was a risk that a two price system could develop where book values would be used for exchange among industry participants and market prices for exchange among non-participants.

Despite these earlier objections and concerns the JIC stated that

In light of the experience over the past decade in Canada and the United States, we have concluded that a number of points raised [by the Moore Committee] involve legitimate concerns that should be addressed in the regulatory structure, but that none of them is now so fundamental or so serious as to dictate that firms be precluded from "going public."

Experience in the United States indicates that primary distributions can be effected, and secondary markets operated successfully, if all concerned are aware of the potential conflicts of interest and deal with them by disclosure and other techniques. If going public adversely affects the motivation of management -- which we doubt -- the negative impact might be off-set by the greater range of choice open to customers when they can select among

¹⁶ "Report of the Joint Industry Committee on Public Ownership in the Canadian Securities Industry," 5.

firms managed by professional managers in addition to those managed by owners. The application of disclosure requirements has not caused significant difficulties for other types of financial institutions in protecting the confidentiality of their customers' affairs, nor are we aware of instances where regulators have been diffident about enforcing sanctions because a public trading market existed.¹⁷

The JIC's main concerns with outside participation in the industry was the one which had been lingering since the publication of the original Moore Committee Report -- that of preserving the professionalism and independence of the industry.

These issues of professionalism and independence were addressed through restrictions on the extent of share ownership by a single investor. That is,

The substantive rule that we recommend is that no outside or public investor should own more than 10% of the voting or participating securities of a firm... The 10% limit should be applied to the aggregate holdings of any outside or public investor and his associates and affiliates. Further, where investors are acting in concert their investments should be aggregated even if they are not associated or affiliated... Provisions should be made for the effective enforcement of these rules. Two things are needed: policing arrangements to detect contraventions of the rules, and remedial procedures to rectify the situation when a contravention is detected.¹⁸

This limitation was less restrictive than the 5 percent ceiling on ownership by one individual investor which had been recommended by the 1972 OSC Study Committee. One member of the current JIC supported the same 5 percent rule because of a view that a 10 percent ownership share would enable any shareholder to exert "substantial influence" on the firm.¹⁹

However, the JIC refrained from putting a limit on the overall degree of outside participation in the ownership of a securities firm. This would leave the management of

¹⁷ "Report of the Joint Industry Committee on Public Ownership in the Canadian Securities Industry," 12.

¹⁸ "Report of the Joint Industry Committee on Public Ownership in the Canadian Securities Industry," 6-7.

securities firms exposed to the discipline of proxy fights which could result in their being ousted from their positions. The only constraint that the JIC imposed was that their replacements "be qualified members of the industry."²⁰ Furthermore, at least 60 percent of the members of the board of directors of the firm should be full time employees of the firm.²¹ It was the view of the JIC that these restrictions served to ensure the independence and professionalism of each member firm in the industry.²² That is

As a professional service industry, it is essential that the management decisions of a securities firm be made by persons who are fully acquainted with the standards of the industry and have themselves met those standards.²³

The JIC specifically noted that no special prohibitions should be proscribed with respect to other financial institutions' investment in securities firms -- except that officers of these other financial institutions would not be permitted to be directors of a securities firm. That is, the ten percent limitation on ownership, noted earlier, would apply to a financial institution's participation in the ownership of a securities firm. This provision in the JIC Report can be seen as the beginning of the acceptance of the idea, by the industry, of the blurring of the four pillars of the financial system.

¹⁹ These views were expressed by J.R. LeMesurier, Vice Chairman of Wood Gundy in "Report of the Joint Industry Committee on Public Ownership in the Canadian Securities Industry," 21. In the US, when public ownership was first introduced, NYSE approval was required for every non-industry participant holding more than a five percent interest in the firm. This threshold had been increased to 25 percent.

²⁰ "Report of the Joint Industry Committee on Public Ownership in the Canadian Securities Industry," 17.

²¹ "Report of the Joint Industry Committee on Public Ownership in the Canadian Securities Industry," 10.

²² There were a number of other recommendations in the JSIC Report that touched on the independence/professionalism questions -- such as the ways in which securities should be distributed, the prohibition on firms from recommending their own securities in the secondary market etc. However, the measures discussed in the text were the key one with respect to non-industry participation in the ownership of securities firms.

²³ Toronto Stock Exchange, "Submission to the Ontario Securities Commission Concerning Public Ownership in the Canadian Securities Industry," 22 July 1981.

The JIC also recommended that the use of holding companies be permitted when a securities firms goes public. However, on this issue the JIC was quite unclear about its motives. On the one hand, a holding company structure provides a mechanism for a firm to diversify its business without impairing the capital of its constituent parts. But, the JIC prohibited the holding company or the securities firm itself from becoming active participants in the banking, trust and loan, or insurance businesses. Thus, securities firms, as financial institutions, were prevented from exploiting the synergies that could arise from this more transparent blurring of the pillars. This recommendation neutralized, to a large extent, the rationale for other financial institutions to own the shares of an investment dealer. Indeed, the question of diversification would be the next topic of a joint industry committee.

The bottom line of this JICs Report was summarized by its Chairman, David Moore (a vice-president of McLeod Young Weir Limited), when he stated that

If adopted, the recommendations will lead to a much stronger capital base for members to meet increasing capital needs in the decades ahead and, also, to meet competition from other financial institutions.²⁴

The Provincial Regulators Consider the JIC Report On Public Ownership

On 3 July 1981 the OSC served notice that it would be holding hearings to consider the Report of the JIC on Public Ownership in the Canadian Securities Industry. The Notice indicated the securities commissions from British Columbia, Manitoba, Alberta and Quebec had been invited to have their representatives present at the hearings.²⁵ This OSC hearing highlighted the continuing philosophical differences between the Ontario and Quebec regulators. The OSC was prepared to go along with the JIC recommendations, but the QSC representatives preferred a regime that would not have

²⁴ Dennis Slocum, "Security industry report supports public ownership," Globe and Mail, 3 March 1981, B1.

²⁵ Ontario Securities Commission, "Notice: Hearing 27 July 1981, Public Ownership in the Canadian Securities Industry," 3 July 1981.

any ownership restrictions, but owners of a large block of shares of a firm -- say 20 percent -- would have to be approved by the provincial regulator. The view in Quebec was that if a securities firm wanted to go public it should only have to follow the same rules as any other Canadian corporation. The QSC would also have preferred no restrictions on the composition of boards of directors of securities firms.²⁶

The decision of the provincial regulators, including the OSC, while a consensus, was clearly a political compromise. The regulators decided that:

- non-industry participants could own more than 10 percent of a securities firm providing approval is obtained from each of the SROs with whom the firm is affiliated. The JIC had recommended a maximum of 10 percent outside ownership.
- a minimum of 40 percent of the members of the board of directors of a firm must be industry participants. The JIC had recommended a minimum of 60 percent. All non-industry board members would have to be approved by the SROs and the regulatory commissions.
- any diversification of a firm beyond the securities business would require approval of the appropriate SRO -- but approval could only be given if it could be shown to be in the "public interest."
- the QSC decided that foreign ownership would be limited to the same restrictions as for any other outside investor -- the 10 percent rule and not the maximum of 25 percent that had been in place in Ontario since 1971.

The OSC indicated the above changes would be subject to a five year sunset provision and thus would become ineffective unless extended. The QSC suggested that it would again review its rules for public ownership of securities firms by 1 September 1984.²⁷

²⁶ Eric Evans, "As dealers go public rules may vary on ownership, directors," *Financial Post*, 1 August 1981, 3.

²⁷ Quebec Securities Commission, "Translation: QSC Decision of August 13, 1981 On Public Ownership of Investment Dealers;" Ontario Securities Commission, "News Release," 14 August 1981.

There was general relief within the securities industry that an overarching policy framework with respect to outside ownership had been accepted by all of the provincial regulators. "...we got uniformity and that's important... it's a workable solution," said Pierre Lortie, the President of the MSE.²⁸ Originally, there had been a fear that the QSC would "opt for no controls at all."²⁹ The QSC, in forcing a compromise from the JIC position, said

it was concerned because the mixed committee representing the exchange houses and the Investment Dealers Association of Canada, held all its discussions in private and had no outside input.

The agency wanted to be sure the MSEs proposed rules were really in the interests of both the public and all potential investors and not just to the advantage of existing owners.³⁰

Paul Guy, the Chairman of the QSC indicated that

We had some tough discussions with Ontario over public ownership. Quebec wanted as few restrictions as possible on who will be able to own a brokerage firm and how. The eventual compromise means that any holding over 10 per cent has to be approved by the relevant stock exchange, subject to review by the provincial regulatory body. So does any diversification into other financial fields. In addition, 40 per cent of the firm's board has to come from the industry. We wanted 20 per cent, and we didn't want any restrictions on the makeup of the board.

On diversification, we accept that brokerage firms should be separate from banks and the Bank Act already ensures that. But we're not sure if insurance or the trust business should be prohibited.³¹

²⁸ Wendie Kerr, "Brokerage firm rules approved," Globe and Mail, 15 August 1981, B18.

²⁹ Wendie Kerr, "Brokerage firm rules approved," Globe and Mail, 15 August 1981, B18.

³⁰ Wendie Kerr, "Brokerage firm rules approved," Globe and Mail, 15 August 1981, B18.

³¹ Wendie Kerr, "Quebec taking new approach to securities law," Globe and Mail, 25 August 1981, B9.

Henry Knowles, the Chairman of the OSC admitted that the changes to the JIC recommendations which were adopted by the provincial regulators "helped placate the Quebec Commission which favored no restrictions at all. But we also thought it was more in keeping with the free market system."³² This is a curious comment, indeed, given that the OSC was initially prepared to adopt the JICs recommendations. It further reinforces the evidence of a lack of both analytical and overall "macro" policy-making capacity at the Commission.

So once again we find that competition among provincial governments to supply public policy to the securities industry has resulted in the regulators in both Quebec and Ontario acting in their own self-interest. The Quebec bureaucrats attempted to remove as many obstacles as possible to entry and ownership to its Montreal based industry, while their Ontario counterparts were initially inclined to adopt the industry's stance portrayed in the JIC Report but subsequently were forced to give up some ground so as not to risk that a number of firms in the industry would vote with their feet and migrate to Montreal.

The Influence of the Ontario Industry on the OSC

But that of course was not the end of the story. On 30 October 1981, A.G. Kniewasser, President of the IDA wrote to the chief executive officers of its member firms to inform them that the Association's delegates to the JIC were of the opinion

that the Securities Commission's amendments...are not in conformity with the industry's wishes as expressed in the Joint Industry Report of March 1981. The Association's delegates would have recommended against Public Ownership under the Ontario Securities Commission's terms.³³

The IDA objected to the following OSC proposals:

- allowing an outside investor to own more than a 10 percent share of a securities dealer -- even with SRO approval. It will be recalled that the JIC was of the view that the 10

³² Wayne Lilley, "Bay Street's reluctant virgins," *Canadian Business*, November 1981, 81.

³³ A.G. Kniewasser, President of the Investment Dealers Association of Canada, "Letter addressed personally to all CEOs of IDA Member firms," 30 October 1981, 3

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percent threshold level was required to ensure that there would not be undue influence on the firm by "unqualified" persons;

- reducing to 40 percent, from the 60 percent recommended in the JIC Report, the number of directors of a firm which must be industry participants;
- regulating on the question of the diversification of securities firms into non-securities related business -- even with SRO approval -- because the industry had just appointed another Joint Industry Committee to look into this issue; and, finally,
- invoking a sunset provision which removes all restrictions on ownership if the rules are not renewed in five years.³⁴

Accompanying Mr. Kniewasser's explanatory letter was a ballot which asked IDA members to vote on two questions:

- (A) Are you in favour of By-laws with the option of Public Ownership in the Canadian securities industry under conditions invoked by the Ontario Securities Commission?
- (B) If your answer to the above is NO, would you agree that the IDA Board of Directors review the subject and then reopen it with the Stock Exchanges and/or Securities Administrators, as considered appropriate in the circumstances?

Of the 57 votes received from a membership of 76, 12 voted YES to question (A), 45 voted NO to question (A) and of these 45, 42 voted YES to question (B).

The Executive Committee at its meeting held on November 25, 1981 reviewed the results of the voting and, in accordance with these results, unanimously agreed that the question of Public Ownership should be re-opened with the Stock Exchanges and the Securities Administrators.³⁵

³⁴ A.G. Kniewasser, President of the Investment Dealers Association of Canada, "Letter addressed personally to all CEOs of IDA Member firms," 30 October 1981, 3-4.

³⁵ E.M. Andrews, Secretary of the Investment Dealers Association of Canada, "Bulletin to all CEOs of Member firms," 26 November 1981.

On 18 December 1981 the OSC issued its Policy 3-62 dealing with public ownership of dealers and conditions of registration, diversification and institutional ownership. Essentially the OSC caved in to the pressure from the IDA. The OSC stated that it

is concerned that the combined effect of permitting unrestricted diversification into areas unrelated to trading in securities and the raising of capital or permitting unrestricted ownership of securities dealers by financial institutions might erode the professionalism of the securities industry, reduce its concern for services to the individual and other so-called "retail" investors, thereby affecting composition of the exchange markets and of capital raising mechanisms of the existing market structures.³⁶

As a consequence of this opinion the OSC announced that it would not give its consent to ownership of more than 10 percent of securities firm, nor would it permit dealers to engage in the business of banks, trust and mortgage loan companies, and insurance companies. At the same time, the OSC announced its intention to hold hearings into institutional ownership and diversification. Looking forward to these proposed hearings, the OSC withdrew the earlier announced sunset provisions that had been agreed upon with the other provincial regulators.

Once again the power of the Toronto based industry vis-a-vis the regulator is apparent. The regulator had no other arguments to offer which would justify its latest actions, except those enunciated by the senior SRO. The OSC was not adequately equipped within its own organization to produce the necessary supporting analysis which would have permitted it to make an independent judgement about the validity of the IDAs opposition to the consensus ruling of the Securities Administrators across the Canada. This is further evidence of the regulator's capture by the industry.

The IDA was pleased with its efforts. W. Gordon Jones, Chairman of the IDA, in writing to the CEOs of the IDAs member firms concluded

³⁶ Ontario Securities Commission. "OSC Policy 3-62: Public Ownership of Dealers. Conditions of Registration Diversification and Institutional Ownership," 18 December 1981.

that the effort we have put into focusing attention on the conditions and consequences of public ownership in the Canadian investment industry have had a very constructive effect.³⁷

The irony of this episode of the ongoing debate became apparent when, in early March of 1982, both Midland and Walwyn announced that they had "shelved" their earlier plans to "go public" because financial markets had deteriorated, the economy was less certain, and, the regulatory framework was rather opaque!³⁸

The Joint Industry Committee on Diversification

The essence of this saga continued, when in May 1982, the Report of the Joint Industry Committee on Diversification of Securities Firms and Their Holding Companies³⁹ was released. This Report was prepared at the invitation of the OSC in anticipation of its convening hearings on the issue. The JIC was given the task of determining whether there should be rules regarding the diversification of securities firms and if so what should the character of those rules be, and what specific restrictions should be recommended.

The JICs "modus operandi" was to ask the member firms of the SROs represented on the JIC how they would respond to those issues. The individual firms generally endorsed the idea of diversification, and if specific rules were necessary they would prohibit securities firms from engaging in the business of banking and otherwise restrict activities which could impinge on the integrity of the firms' capital. The individual firms knew that if a blurring of functions between the banking system and the securities industry were to be permitted, it was clear who would win the power struggle. The industry was concerned with its own self-preservation.

³⁷ W. Gordon Jones, Chairman, Investment Dealers Association of Canada. "Letter to Chief Executive Officers of Member Firms of the Investment Dealers Association of Canada," 2 February 1982, 2.

³⁸ Dennis Slocum, "Midland defers plans for merger," Globe and Mail, 2 March 1982, B14.

³⁹ Joint Industry Committee, "Report of the Joint Industry Committee on Diversification of Securities Firms and Their Holding Companies," May 1982.

Given these "fundamental considerations" the JIC concluded that securities firms should be permitted to diversify in a way that was "consistent with fundamental considerations of public policy."⁴⁰ The JIC, purporting to speak for the public interest, determined that these fundamental considerations revolved around:⁴¹

- the requirement for users and suppliers of capital to have a range of choices in their financial decision-making; choices would be undermined if securities and banking-type institutions were permitted to operate in each other's "territory;"
- the preservation of the integrity of the individual firm's capital; and
- sufficient disclosure to the clients of individual firms so that they are able to judge the significance of the risks of the outside activities of the firm.

The JIC concluded that a number of restrictions on the diversification of securities firms was necessary:⁴²

- securities firms should not be permitted to engage in the activities of chartered banks, trust and mortgage loan companies, or life insurance companies; the determining factor of any "real" blurring of the financial pillars would be whether the securities firm required a license under the statutes that govern these aforementioned institutions. This provision would permit the securities dealers to continue, for example, to use their clients' credit balances -- even though these credit balances were similar to deposits in banks or trust companies -- to finance the firms' inventory of securities;
- in order to preserve the integrity of the capital of the securities firm, diversification should only be permitted through holding companies;
- each firm's clients should be able to determine just what outside activities the organization is engaged in;

⁴⁰ JIC Public Ownership "Report," 5.

⁴¹ JIC Public Ownership "Report," 5-6.

⁴² JIC Public Ownership "Report," 6-7.

- securities firms should be permitted to network with other financial institutions in a way that would permit cross-selling of the others' financial products; and finally,
- cross-ownership of securities firms and other financial institutions should be permitted up to a threshold level of ten percent.

The key recommendation in this Report was the prohibition of a complete blurring of the four pillars of the Canadian financial system. The industry still treasured both its monopoly position in the capital markets and its capture of the securities regulators. A blurring of the pillars would surely dilute the power of the industry elites when pitted against those of the banking industry. The industry of course argued that the blurring of the pillars would limit the choices that were then available to the suppliers and users of capital and therefore the current structure of the financial system was in the "public interest."⁴³ The argument had to be couched in terms of the public interest because stressing its own narrower interests would not enjoy the same legitimacy.

The OSC and the JIC Diversification Report

The OSC convened hearings on the JIC Diversification Report during the summer of 1982. "No transcript of the testimony during the public hearing [was] prepared"⁴⁴ and as a consequence the analysis of this episode will depend exclusively on the submissions of a number of key interests. The range of opinion spanned the continuum from that proposed by the JIC Diversification Report to a regime of complete openness with respect to ownership and the industry's capacity to undertake other financial and non-financial business.

The submission by the federal Director of Investigation and Research under the Combines Investigation Act addressed the issue from the premise

⁴³ JIC Public Ownership "Report," 20.

⁴⁴ James C. Baillie, "Outline of Closing Oral Argument of Counsel for the Self-Regulatory Organizations at the Hearing on Institutional and Public Ownership of, and Diversification By, Securities Dealers," 9 September 1982.

that it is in the public interest to foster competition over the greater part of economic activity. This view implies that competition should be reduced only in exceptional cases. Since free entry to and exit from any industry are essential elements of competition, entry/exit should be restricted only in exceptional cases.⁴⁵

More generally the Director was critical of the OSCs stance because

The Commission's concerns echo those expressed by various industry committees over the past decade. The basis of these concerns, however, is never made clear. In fact it appears that public ownership, including institutional and non-resident ownership do not threaten either the professionalism or independence of the industry. Whatever the degree of public ownership of securities firms, the officers and directors must satisfy the qualification requirements of the OSC. Furthermore, any public owners including institutions or non-residents holding a significant interest in a securities firm must be approved by the OSC. The existing qualification requirements for all decision-makers (i.e., officers and directors) assures the continuation of the current level of professionalism in the industry even if there are no restrictions on the degree of public ownership.⁴⁶

The Director was essentially coming at the questions of ownership, entry and diversification from the perspective of the neoclassical economists' paradigm. That is, economic efficiency flows from the free movement of capital (i.e., unimpeded entry and exit) and not from unnecessary restrictions on entry and exit and diversification. Indeed, restricting diversification had the effect of isolating the industry from a conventional competitive environment which imposes the social cost of inefficiency on the economy and discourages efficient practices.⁴⁷

The Director concluded

⁴⁵ Director of Investigation and Research Combines Investigation Act, "Submission by the Director of Investigation and Research Combines Investigation Act to the Ontario Securities Commission on the Issues of Institutional Ownership of Securities Dealers, Diversification by Securities Dealers, and Non-Resident Ownership Restrictions," July 1982, 1.

⁴⁶ Director of Investigation and Research Combines Investigation Act, "Submission, 1982," 6-7.

⁴⁷ Director of Investigation and Research Combines Investigation Act, "Submission, 1982," 16-17.

...that refraining from imposing restrictions on investment in the Canadian brokerage industry will not damage the health of that industry, the financial sector or the overall economy. On the contrary, it is particularly important that capital can flow freely both into and out of the industry to ensure that the capital base will be sufficient for the industry to carry out its primary functions and to ensure that the capital base is flexible enough to serve the needs of the Canadian securities markets.

...it is particularly important that the normal competitive processes, which require the free flow of capital, are strong enough to ensure that the industry operates efficiently. This requires that approved investors be permitted to gain financial control of securities firms in order to discipline managers to operate in a manner which protects the interests of both clients and investors in the firm. I am not aware of any special characteristics of this industry that makes it uniquely unsuited to operating with the normal separation of owners and managers.⁴⁸

The paradigm employed by the Director can be considered "perfectly" rational if the values surrounding economic efficiency and competition are adopted by the state's decision-makers. But the Director had put aside any considerations of political efficiency in his sweeping challenge of the OSCs concerns during the period spanning almost a decade and a half. These economic arguments were not the ones that carried the day for the regulators and elected officials because the political costs of doing so were just too high.

The Submission of the Canadian Bankers' Association (CBA), by contrast, was of the self-serving genre that had so characterized the policy advice which had been typical of the investment dealer industry since 1969. The CBA believed that

Diversification, which would result in a co-mingling of securities and non-securities functions without addressing the conflict of interest and competitive inequality issues in the financial system at large, would not be in the public interest. As a result, we feel that such diversification should not be allowed to take place unless the issues which have traditionally

⁴⁸ Director of Investigation and Research Combines Investigation Act, "Submission, 1982," 32-33.

given rise to segmented financial markets are addressed and resolved in a coordinated fashion by all financial institution regulators.⁴⁹

The CBAs basic objection to the JIC recommendations was that it was easier for an investment dealer to engage in the business of banking than it was for a bank to engage in the securities business, because, it will be recalled, nowhere is the business of banking defined. So from the perspective of the securities industry, when engaging in activities that are traditionally associated with banks, there would nonetheless be no activity which would trigger a licensing requirement under the Bank Act.

The banks already argued that the dealers, by holding and paying interest on their customers' credit balances, were impinging on the deposit-taking activities of banking-type institutions; similarly in the case of the issuance of commercial paper by the dealers.

In order to avoid such anomalies within the Canadian financial system, the CBA recommended a complete review of the functions of financial institutions in the Canadian market.

In our view, any conclusions which may be arrived at should be seen in the context of a wide-ranging look at the business and powers of all financial intermediaries. Unless there is a full understanding between federal and provincial authorities, the ad hoc broadening of the powers of some intermediaries will only accentuate competitive inequities which already exist.⁵⁰

The "academic" perspective varied. Professor Laurence Booth, acting as a consultant to the OSC, argued that

It is the duty of the regulatory commission, where public interest has decided that minimum professional standards should exist, to set the professional standards in the public interest and not the interests of those in

⁴⁹ The Canadian Bankers' Association, "Institutional Ownership and Diversification in the Securities Industry: A Submission to the Ontario Securities Commission," July 1982.

⁵⁰ The Canadian Bankers' Association, "Institutional Ownership and Diversification in the Securities Industry: A Submission to the Ontario Securities Commission," July 1982, 5.

the industry...I do not see any impact on the professional standards in the brokerage industry of ownership by a financial institution.

The concern of the securities industry to restrict public ownership on grounds of professionalism is difficult to understand. All firms, regardless of industry, are concerned about the quality of their product, whether their product is a service or a physical economic good. The marketplace assesses the quality and price of their product and determines whether the firm should continue in business. If an outside owner forces a securities firm to lower its professional standards, then if the price of those services is unchanged, then the firm will go out of business.⁵¹

Professor David Shaw, in his testimony, supported the separation of functions in the financial services industry. It was his view "that to permit unrestricted ownership, particularly by the restricted businesses, would result in lessened and not more competition..."⁵²

Booth's model of market behavior and his analysis had an important influence on the summation of the OSCs Counsel at the Hearings. Indeed, Counsel to the OSC⁵³ -- Purdy Crawford -- was surprisingly critical of the posture which the securities industry had presented. Crawford at the outset of his summation suggested that there was a contradiction in the underlying premise of the industry in approaching the questions of ownership, entry and diversification. On the one hand, the industry, in its submissions, suggests that the development of the securities industry should occur under conditions of

⁵¹ Laurence D. Booth, "Submission to the Ontario Securities Commission," 15.

⁵² David C. Shaw, in Ontario Securities Commission, "Report to the Minister of Consumer and Commercial Relations Regarding: (I) Institutional Ownership of Securities Dealers Registered Under the Securities Act and (II) Diversification Into Other Businesses by Securities Dealers Registered Under the Securities Act," 31 December 1982, 15.

⁵³ Purdy Crawford, Tory, Tory, DesLauriers & Binnington, "Outline for Submissions to be Made by Purdy Crawford to the Ontario Securities Commission and the Superintendent of Brokers of British Columbia and, as Observers, the Chairman of the Alberta Securities Commission, the Chairman of the of the Saskatchewan Securities Commission and the Vice-Chairman of the Commission Des Valeurs Mobilières Du Quebec on September 20, 1982, with Respect to Institutional Ownership of, and Diversification by, Securities Dealers," 10 September 1982.

competition. On the other hand, he noted, the JIC proposals would have the opposite effect by creating barriers to entry with the 10 percent ownership restriction.⁵⁴

The basis of Crawford's argument for the inability of the Canadian industry to compete effectively, both among themselves, and with the other financial institutions which comprise the financial system, was founded in the academic research which had been presented at the hearing. Thus, the relatively small size of the Canadian securities industry vis-a-vis the other financial institutions comprising the Canadian financial system, compared to the US industry, was largely a consequence of the fact that Canadian firms did not have the same access to capital as was the case for the US industry. Broader access to capital would enhance the relative position of the Canadian securities industry.

Crawford also noted that the representatives of the industry

In particular, Messrs. Howe, Kniewasser & Brunet in cross-examination were unable to provide cogent answers as to how a securities firm's "professionalism" could be compromised by a[n] institutional investor holding more than 10% of the voting securities of a securities firm. We are not aware of any evidence to date which would indicate that the "professionalism" of the securities industry in the United States has been compromised by institutional ownership or by wide public ownership.⁵⁵

From the perspective of the OSCs Counsel, the optimum manner in which to preserve the integrity of the securities industry was through effective supervision by the regulatory authorities. These regulations should deal with the educational requirements of the industry's representatives who provide advice to investors, and with the registration requirements of individual firms. These regulations, along with continuous supervision by SROs and securities commissions would ensure the trustworthiness and professionalism of the industry.

On the question of diversification Crawford argued that

⁵⁴ Purdy Crawford, "Outline for Submissions...", 8.

⁵⁵ Purdy Crawford, "Outline for Submissions...", 1982" 13.

One reason the securities industry proposes limits on diversification by securities firms into other financial businesses appears to be a concern that other financial intermediaries will in turn eventually be permitted to diversify into areas of activity traditionally carried out by securities firms...the securities industry did not want to take on this sort of competition.⁵⁶

That assessment was consistent with the pattern of analysis and the recommendations which the industry brought forth over the course of the preceding decade. Indeed, as was noted earlier, if the industry's recommendation on diversification was accepted, firms would be free to engage in businesses in which they had no comparative advantage. In this same spirit, Crawford pointed out the adverse consequences of limiting the dealers to a 10 percent participation in the so called restricted businesses (banking, trust and loan, and insurance) not only because such restrictions would thwart competition, but also because it would inhibit the realization of economies of scale in technological developments -- the costs of which were very high.⁵⁷

Crawford's recommendations to the OSC hearings were contrary to the wishes of the industry:

- there should be no limitations on ownership when a securities firm decides to go public because such constraints interfere with free market forces;
- there is no justification for limitations on ownership owing to risks of undermining the industry's professionalism;
- there should be a phase-in period during which firms should be able to both strengthen their capital base and thwart attempts at outside control. After a seven year phase-in period, however, individual ownership of a securities firm (including by another financial institution) could exceed 10 percent;

⁵⁶ Purdy Crawford, "Outline for Submissions...", 28.

⁵⁷ Purdy Crawford, "Outline for Submissions...", 35.

- after the phase-in period there should be processes in place to approve investors who hold more than 10 percent of the voting shares;
- a holding company structure should be used for outside ownership in the securities industry.⁵⁸

Crawford attempted to reinforce the OSCs earlier contentions which gave rise to the inquiry in the first place. With respect to the diversification issue he concluded that

We do not believe there has been any compelling evidence at this hearing which indicates that allowing diversification by securities dealers as principals into other financial businesses should be prohibited. Where a securities dealer desires to get into these areas of activity and is willing to compete on equal terms with existing competitors in these businesses the regulators should not erect barriers to the securities dealer who desires to compete with other financial intermediaries. Thus the mere fact that business activity may trigger a licensing requirement should not prohibit a securities dealer from carrying on that activity so long as the securities firm holding company is willing to have its non-securities subsidiary regulated under the statutes affecting the non-securities business activity.⁵⁹

Thus the Counsel to the OSC made the following recommendations with respect to diversification.⁶⁰

- securities dealers should be permitted to engage in other areas of business including financial business as principals or agents;
- where permitted by statute securities firms should be authorized to make investments in the trust, loan, insurance and banking industries greater than 10 percent;
- diversification should be carried out only through holding companies or other entities separate from the securities firm.

⁵⁸ Purdy Crawford, "Outline for Submissions....," 19-24.

⁵⁹ Purdy Crawford, "Outline for Submissions....," 36-37.

⁶⁰ Purdy Crawford, "Outline for Submissions....," 37.

Naturally the securities industry was disappointed by the recommendations contained in the OSC Counsel's submission. James C. Baillie, Counsel to the SROs, in correspondence to the SROs Steering Committee on ownership and diversification noted that those advocating a more liberal regime than the industry

have had greater impact than we expected. I do not anticipate that the administrators would go as far as Mr. Crawford recommends, but his approach may lead them to dictate changes they might not otherwise have done...

As to institutional ownership, my proposal would be to stress again the need for barriers, putting greater emphasis on flexibility of choice for investors than on retention of professionalism as the reason. The irreversible consequences of allowing equity participation of over 10% by outside investors should be stressed. As to the seven-year provision, my proposal would not be to oppose it in principle, but to say that the rules should contain no sunset clause: they should be put in place without such a built-in feature, but with a clear understanding that they will be reviewed after seven years...And it should be stressed that it is essential for the restrictions on diversification to be congruent with those on institutional ownership, for otherwise the more restrictive rules can be avoided by careful planning.⁶¹

The main thrust of Baillie's closing oral submission to this OSC hearing was that the separation of the four pillars of the Canadian financial system should persist. In an important sense, this was a self-serving assertion because the main point Baillie was making was that with the exception of one academic economist as well as the Federal Director under the Combines Investigation Act few

witnesses cast doubt on the prediction made by the securities industry that if the major financial institutions, particularly the banks, were to be permitted to acquire control of securities firms, the securities industry would soon become dominated by the institutions.⁶²

⁶¹ James C. Baillie, "Letter to C.R. Younger, Executive Vice-President and Director, Dominion Securities Ames Limited," 13 September 1982.

⁶² James C. Baillie, "Outline of Closing Oral Argument..." 9 September 1982, 6.

The remainder of Mr. Baillie's submission, on behalf of the SROs, repeated what was already reported in the discussion contained in the JIC Report on Ownership and Diversification -- and it was not terribly persuasive. Indeed, it was apparent from Baillie's earlier noted comments to the members of the SRO Steering Committee that the industry's arguments had apparently lost a good deal of their punch. Baillie was correct in his assessment: the arguments of the free-market traders had begun to shift the conventional thinking in the OSC because there were now real questions about whether the industry, given the industrial structure it was proposing, could adequately service the capital investment requirements for the Canadian economy.

The MSE - QSC Task Force: Yet Another Judgment

In October 1982, an MSE/QSC joint task force on diversification and on the participation of financial institutions in the ownership of securities firms reported on essentially the same matters that had been considered by the OSC.⁶³ The latter had not as yet delivered its report.

This Committee comprised members of the private financial sector -- with the exception of one academic economist. The ideological location of this report was at odds with the direction in which the Quebec authorities and industry had earlier been heading. Five of the eight members of the Task Force, including the co-chairman were representatives of "national" banks or investment dealers.

Not only did the Committee subscribe to the principle of separation of function -- a principle which the Parizeau Report had discarded over a decade earlier -- but recommended that all financial institutions should be prohibited from holding any participating shares in securities firms. The Task Force found no rationale for the 10 percent rule -- ownership should either be permitted or prohibited in the case of banks, trust and loan companies and insurance companies. On the other hand, it supported the 10

⁶³ Task Force on Diversification and on the Participation by Financial Institutions in the Ownership of Securities Firms, "Ownership and Diversification of Securities Firms in Canada," Submitted to The Montreal Exchange and La Commission Des Valeurs Du Quebec, October 1982.

percent rule as it applied to individuals. The self-serving character of this stance by the Task Force is reflected in the following statement.

All other things equal, the limit makes it more difficult and more expensive for a securities firm to raise equity from "outside" interests. But is this an expensive barrier? We do not think so. The industry is currently confronted with much tougher hurdles, but has no problems with raising capital. The main losers, if any, from this constraint would be the current holders of securities firms' capital. Yet there is every reason to believe that they, as a group, subscribe to the 10% rule. Indeed, this rule was adopted by all the JICs formed by the industry since 1970 and always received the industry's endorsement. Such acceptance is a good indicator of the relatively small cost of this measure.⁶⁴

The logic of this analysis is difficult to comprehend.

The OSC "Decision" on Ownership and Diversification

Despite the OSCs apparent more liberal view of institutional ownership of and entry into the securities industry, as expressed by its Counsel, Mr. Crawford, the Commission's recommendations to the Minister of Consumer and Commercial Relations⁶⁵ were not nearly as forward looking as Mr. Crawford had implied they would be. In the case of institutional ownership, the memorandum to the Minister, after reviewing the evidence that had been presented at the hearings, suggests that the Commission was unable to reach a unanimous conclusion. As a consequence, its compromise was

that the regulations to the Securities Act be amended to incorporate the parameters of the OSC Policy 3-62 as conditions for registration...⁶⁶

⁶⁴ Task Force on Diversification and on the Participation by Financial Institutions in the Ownership of Securities Firms, "Ownership and Diversification of Securities Firms in Canada," 16.

⁶⁵ Ontario Securities Commission, "Report to the Minister of Consumer and Commercial Relations Regarding: (I) Institutional Ownership of Securities Dealers Registered Under the Securities Act and (II) Diversification Into Other Businesses by Securities Dealers Registered Under the Securities Act," 31 December 1982.

⁶⁶ Ontario Securities Commission, "Report to the Minister," 31 December 1982, 20.

It will be recalled the OSC Policy 3-62 was implemented after the IDA had objected to the OSC's original policy intentions following the SROs review of the institutional ownership issue during the late Fall of 1981. The essence of these recommendations were:

- that no financial institution could have any interest in any class of voting or participating shares of an investment dealer;
- that no single investor who is not an officer of the firm can own more than 10 percent of the firm; and
- that not less than 40 percent of the firm's directors must be industry members registered under the Securities Act.

Once again the industry's influence on the policy decisions of the main regulator in Canada has been demonstrated, despite an apparent willingness of the OSC to waver and move away from the industry's position to one that was just -- at least as measured by Mr. Crawford's reasoning at the Hearing.

On the question of diversification, a majority of the Commission concluded that investment dealers should not be allowed to invest in other financial institutions, while a minority were of a view that a 10 percent equity position was acceptable. Agency relationships between a dealer and another financial institution would be permitted; and, furthermore, dealers would be permitted to diversify into non-financial businesses through a holding company apparatus so long as there were no cross-guarantees or cross-assurances. This latter restriction would avoid the possibility of an adverse impact on the dealer's capital or professionalism.⁶⁷

An important influence on the thinking of the OSC on these matters came from the testimony of Mr. William Kennett, the federal Inspector General of Banks -- the regulatory authority of chartered banks in Canada. In keeping with the federal government's policy, as expressed in the recently amended Bank Act, he stated that

⁶⁷ Ontario Securities Commission, "Report to the Minister," 31 December 1982, 20-21.

It will be observed that there will be a common factor linking the previous Bank Act, the White Paper and the present Bank Act. This factor is a policy which recognizes the common participation of various groups of financial institutions in our financial system, but identifies and respects the differences in the main function performed by each group. Each group has a 'core' function, e.g. 'underwriting' for investment dealers, 'fiduciary activities' for trust companies, 'commercial lending' for banks, 'insurance' for insurance companies. Also the policy recognizes the benefits to be obtained by controlled competition that permits these institutions to offer supplementary services which compete to some extent in the core area of the other groups. For example, trust companies do some commercial lending, banks do some dealing in securities, investment dealers trade in foreign exchange and assist in financial intermediation. All groups working together, constitute the Canadian financial system.⁶⁸

The OSC announced publicly its decision regarding the institutional ownership and diversification of investment dealers on January 8, 1983.⁶⁹ The basic thrust of the ownership and diversification policy was the same as that outlined to the Minister at the end of December. Deposit-taking financial institutions and insurance companies would be prohibited from investing in securities dealers and other outside investors should be limited to a 10 percent participation. According to the OSC, its stance on these issues

...minimizes the potential conflicts of interest and assures investors of the special regulatory protections and oversight provided through specific laws applicable to each kind of financial institution.⁷⁰

The OSCs concern was that if other financial institutions were permitted to diversify into the investment dealer industry they "could quickly become a dominant factor."⁷¹ The OSC was also concerned about its own position within the regulatory

⁶⁸ William Kennett, "Submission of the Inspector General of Banks," in Ontario Securities Commission, "Report to the Minister...", 31 December 1982, 10 and in James C. Baillie, "Outline of Closing Oral Argument...", 9 September 1982, 6.

⁶⁹ Dennis Slocum, "OSC against bank, trust company stake in brokers," Globe and Mail, 8 January, 1983, B1.

⁷⁰ Dennis Slocum, "OSC against bank, trust company stake in brokers," Globe and Mail, 8 January, 1983, B1.

structure. That is, an investment dealer industry dominated by chartered banks' ownership could threaten the survival of the OSCs regulatory apparatus -- which could reasonably be taken over by the federal authorities under the auspices of the Inspector General of Banks or Superintendent of Insurance. Indeed, the main opposition to a national securities commission came "from provincial administrators, particularly Ontario, but evidently in other provinces as well..." The views of Ministers responsible for financial regulation in their provinces "are understandably stronger than those expressed by a number of provincial premiers who appear ready to include regulation of the securities market as a matter for discussion in future constitutional conferences."⁷²

But the ability of the OSC to keep the banks out of the investment dealer business would be short lived as the banks were, at this time, preparing the case to enter into the discount brokerage business. For the time being, however, the dealers did have the capacity to raise additional capital from non-financial industry sources and to diversify into non-financial businesses. This was a major step forward when seen from the perspective of the Moore Report and the subsequent studies it parented.

In the midst of the debate in Ontario surrounding whether the chartered banks should be allowed to provide a discount brokerage service to its clients, the QSC decided to allow banks into the investment dealer business. The Quebec Commission, in revealing its decision, noted the tendency towards the globalization of markets and the cross-ownership of securities firms in the United States.⁷³ Andre Saumier, Quebec Chairman of the IDA noted the decision could mean "a massive transformation of business in Canada. Ultimately, the stock exchange could be controlled by the banks."⁷⁴ More generally, however, this decision coming as it did in the midst of a profound challenge by the banks

⁷¹ Dennis Slocum, "OSC against bank, trust company stake in brokers," Globe and Mail, 8 January, 1983, B1.

⁷² Ronald Anderson, "Time not propitious for a securities body," Globe and Mail, 3 June 1982, B2.

⁷³ Canadian Press, "Problems seen in ruling on investment dealers," Globe and Mail, 18 June 1983, B16.

⁷⁴ Canadian Press, "Problems seen in ruling on investment dealers," Globe and Mail, 18 June 1983, B16.

into the domain of the dealers through the discount brokerage business did not receive much attention from the securities industry. It will be recalled that a joint MSE - QSC Study of the diversification did not support such a policy decision.

Conclusion

It was increasingly apparent that the debate surrounding the liberalization of entry and ownership requirements was carrying on too long. The lengthy debate had resulted in a broadening out of the issues around securities industry liberalization. Over time, as a consequence, the issue of liberalization encompassed more actors and interests, whose opinions and pressure were beginning to be heard by the state's policy-makers. Indeed, the process of change, while slow, had gathered a certain momentum in the face of modernization elsewhere in the industrialized world.

First, we saw that within the JIC the traditional consensus among industry actors was beginning to break down on the issue of diversification. Despite the partial erosion, however, it was only the weight of the IDA which managed to induce the Ontario authorities to succumb to its view -- one of sustaining the preferential position of the industry vis-a-vis potential competitors. *Second*, the gulf between Quebec and Ontario was finally reaching the level of practical decision-making where both government's showed some signs of accommodation on the diversification rules. *Third*, within the OSCs own advisory structures strong and rational voices of change were beginning to be heard -- although they were still not being heeded.

While policy change in respect to ownership and entry in the securities industry was still being stifled there was a clear consensus that the need for capital in the Canadian economy was enormous. Moreover, there was some question among industry members about the capacity of the industry to meet those needs as it was then structured and capitalized. The desire of a number of firms to "go public" was a manifestation of the uncertainty surrounding the industry's prowess. Although there were a number of prominent firms and individuals who did not concur with the majority of the indigenous industry, their voices were gaining authority. Nonetheless, the fundamental overarching relationship between industry and the OSC still reflected the capture phenomenon.

Thus the fundamental questions still remained: Could real change occur? Could the powerful elites sustain their historical influence in Ontario?

CHAPTER NINE

THE UNRAVELLING OF A RESTRICTIVE REGULATORY REGIME

Introduction

The early spring of 1983 can be identified as the period during which the final unraveling of the restrictive regulatory apparatus surrounding the investment dealer industry in Ontario began. It was at this time that the Daly Gordon Securities Company proposed a joint venture with the Lambert Brussels Corporation. This enterprise would have had the effect of establishing a wholly owned subsidiary -- Gordon Capital -- which would operate in the institutional- unregulated market (known as the exempt market on the "street"). The purpose of this joint venture was not only "to get around the Ontario's 10% limit on foreign participation in Canadian investment firms,"¹ but also to allow Gordon Capital to exploit Lambert Brussels' international connections and to provide a source of new capital for the firm.² As well, given the regulatory liberalization which was taking place in Quebec under the leadership of Parti Quebecois Finance Minister Jacques Parizeau, Gordon Capital wanted to be able to take advantage of Quebec's less restrictive apparatus without jeopardizing its registration in Ontario. Daly Gordon would own 60 percent of the new firm but would hold 90 percent of the votes on the Board of Directors while Lambert Brussels would hold the remaining 10 percent of the votes for its 40 percent share.³

¹ Amy Booth, "Deal stirs up the investment world," The Financial Post, 7 April 1984, 1-2.

² Lambert Brussels had affiliations with both Power Corporation and Drexel Burnham Lambert of New York.

It is the purpose of this chapter to show how this rather benign event produced a policy dynamic -- seemingly founded on the momentum of a policy learning process which had been in train for many years.⁴ Indeed, this event produced a rather dramatic and unanticipated wholesale liberalization of the regulatory apparatus. Indeed, some of the key actors involved in the policy-decision making process progressively altered the way in which they viewed and valued the regulatory situation and the way they thought appropriate to reform it. For the OSC particularly, the inevitability of change was becoming more heightened with each episode of inquiry and deliberation.

The Daly Gordon -- Lambert Brussels Experiment

During this period dealers who were operating in the "institutional market" -- a market characterized by large dollar transactions, private placements, foreign primary distributions -- were not required to register with the OSC, nor were they required to comply with the capital requirements of the OSC and the SROs in respect of that portion of their business.⁵ It was in this environment that Daly Gordon was proposing to divide its business into two segments: one which would be regulated and the other which would be exempt from Ontario's restrictive regulatory apparatus.

Daly Gordon had a reputation on the "street" as an aggressive firm that never paid much attention to the unwritten "old boys club" rules of Bay Street. This firm introduced the "bought deal"⁶ to Canada which had the effect of liberating primary issuers from traditional and long standing relationships with other dealers.⁷ However, Daly Gordon

³ Amy Booth, "Deal stirs up the investment world," The Financial Post, 7 April 1984, 1-2.

⁴ The concept of policy as a learning process was first explained by Sir Geoffrey Vickers, The Art of Judgement (New York: Basic Books, 1965).

⁵ The "exempt market" in Canada was a term used to characterize that portion of the business of securities dealers which did not require registration with the OSC. That is, transactions in excess of \$100,000 were deemed to be taking place with sophisticated traders -- institutions -- who did not require the "protection" of the "know your client" rules of the Ontario regulators. Thus, if a dealer wanted to establish a business in Ontario and deal only with large institutions in amounts exceeding this \$100,000 threshold level, such firms would not be required to register (i.e., obtain a license) from the regulator to conduct its business -- or to be a member of the IDA. This was an important "loophole" in the Ontario regulatory apparatus and one which Daly Gordon was proposing to take advantage of. It was also a regulatory feature which did not have the wholehearted support the JIC.

was not the sole detractor in respect of the existing regime and not the only firm to believe that an offshore partner could be an important element in strengthening domestic firms. For example,

...Arguing that a capital base of between \$100 million and \$150 million is necessary to compete against large foreign dealers, McLeod's Taylor says he wants ownership restrictions eased so that firms can find 'associates with deep pockets.'

Under existing restrictions Taylor says he 'can't duplicate the same aura, eminence and power of international dealers and banks.'⁸

On the other side,

Wood Gundy chairman Ted Medland strongly disagrees with his competitors that more capital is the key to a bigger share of the international market... instead dealers should be improving their international sales forces. 'Canadian dealers have been squeezed out of issues because they don't have the capacity to place abroad.'⁹

More generally, the understanding on the "street" was that

The exemptions from the registration requirements of the Act not only have an impact upon the ability of the Government to implement ownership policies but also affect the ability of the Commission to regulate activities generally which impact upon the capital markets. It is possible for any person or company, whether a resident or a non-resident, whether a financial institution or not a financial institution to carry on activities

⁶ Recall that traditionally primary issues of securities are underwritten by a banking group sometimes as large as 20 dealers. In the bought deal environment, one dealer takes on the full responsibility (liability) of selling the issue to institutional accounts. Daly Gordon was aggressive in this regard by reducing the fees and commissions that would have to be incurred by borrowers by as much as two-thirds. See Jacquie McNish, "The reshaping of Bay Street," Financial Times of Canada, 14 May 1984, 1.

⁷ Jacquie McNish, "The reshaping of Bay Street," Financial Times of Canada, 14 May 1984, 1.

⁸ Jacquie McNish, "The reshaping of Bay Street," Financial Times of Canada, 14 May 1984, 1.

⁹ Jacquie McNish, "The reshaping of Bay Street," Financial Times of Canada, 14 May 1984, 1.

relying upon the exemptions from registration and thereby operate generally outside the ambit of the Commission.¹⁰

In any event, the Daly Gordon proposal was rejected by the TSE and it was likely that Gordon would appeal the decision to the OSC.¹¹ This sparked the overture to the tumultuous events that would lead to a wholesale change in the regulatory apparatus surrounding the securities industry. It was initiated on May 2, 1984 when the OSC announced that

Accelerated change in the structure and regulation of the financial services sector has caused the Commission and the SROs to undertake an immediate, considered policy review of the adequacy and relevance of the regulations governing the ownership of securities firms, particularly insofar as such regulations may impact on access to capital by, and the competitive strength of, the securities industry. The policy review will include a consideration of the impact of the exemptions from registration upon the Commission's ability generally to regulate the activities of participants in the capital markets.¹²

In calling for the policy review, the Chairman of the OSC, Peter Dey, wanted to broaden the scope of future change arising out of the review. Indeed, Dey was not enamored with existing restrictive regulatory apparatus, nor was he 'happy' with the self-serving behavior which had characterized the industry's past interactions with public policy makers. However, the opportunities for regulatory reform would be circumscribed by the Ontario Government's commitment "to preserving Canadian control of the securities industry and to limiting the involvement of financial institutions as investors in securities firms."¹³ Moreover, the Commission's stress on coordinating its efforts with those of the JIC -- in such important matters as setting the research agenda -- continued to

¹⁰ Ontario Securities Commission, "Policy Review: Competitive Position of the Securities Industry in Domestic and International Financial Markets," Press Release, 2 May 1984.

¹¹ Dennis Slocum, "Daly Gordon plan raises ownership questions," Globe and Mail, 7 April 1984, B1; and, "Rules roadblock halts Daly Gordon venture," Globe and Mail, 13 April 1984, B1.

¹² Ontario Securities Commission, "Policy Review:" Press Release, 2 May 1984.

¹³ Ontario Securities Commission, "Policy Review:" Press Release, 2 May 1984.

signal the regulator's inability to develop, on its own, images of the securities industry without the intervention of the industry itself. Thus, as was the case as early as the Moore Report, the industry continued to locate itself so that it could forcefully influence the character of issues which would be examined by the public regulatory authorities, although at this point in history the OSC was not as willing a participant in such an enterprise. Indeed, Peter Dey suggested that "The ownership restrictions may restrict activities of Canadian issuers who want to expand," while Ed Waitzer, retained as outside Counsel to the OSC, indicated that "Ownership restrictions may be dangerous to the industry's evolution."^{14 15}

Subsequently, in June of 1984, the OSC issued a "Preliminary Issues Paper" which outlined the primary matters of concern to it in its policy review. These concerns were much broader than just the Daly Gordon proposal and would include:

1. the sources and quality of capital that will be available to the domestic securities industry to handle future growth, innovation and competition with other providers of financial services;
2. whether and to what extent non-resident, institutional or other non-industry participation in the domestic securities industry is necessary or desirable; and
3. to the extent outside participation is permitted, how and to what extent such activities should be regulated by the Commission.¹⁶

With respect to the issue of capital, the OSC's primary concern was with the adequacy of access to "meet emerging market challenges." With respect to non-industry participation, the OSC reiterated its commitment to "preserving a strong domestic securities industry as a key sector of the Canadian economy." However, given that overarching objective, the OSC suggested that it was willing to consider the ways in

¹⁴ Jacque McNish, "The reshaping of Bay Street," Financial Times of Canada, 14 May 1984, 1.

¹⁵ Waitzer was appointed Chairman of the OSC beginning in 1994.

¹⁶ Ontario Securities Commission, "Securities Industry Policy Review: Preliminary Issues Paper," 29 June 1984.

which the underwriting and full service brokerage functions could be reconciled with new forms of business relationships which had been emerging within the financial services industry such as joint ventures, agency networking, entry of non-financial institutions and the introduction of new products which link the various entities comprising the four pillars.

The OSC also expressed concern about the influence of the existing regulatory regime on competition within the domestic securities industry, about whether registered firms, with obligations under the Securities Act, can compete on a level playing field with those firms who perform essentially the same roles but are exempt from registration, and about the capacity of the domestic firms to provide access by Canadian borrowers to the international capital markets.

In respect to the final point, the OSC noted that "With the advent of full price competition in April 1983, the Commission's primary instruments for regulating securities industry structure became ownership restrictions and registration requirements." The OSC indicated its intention to identify the least restrictive, but still effective regulatory framework, but focus particularly on the merits of recalibrating the exempt status provisions of the Securities Act and examining the impact of the existing restrictions on entry and ownership arrangements on access of market intermediaries and borrowers to the global capital market.¹⁷ The seemingly less restrictive regulatory philosophy reflected directly the more liberal views of the OSC Chairman and the agency's outside legal counsel.¹⁸

It is important to recall that these matters would be considered by the OSC against the background of the ownership liberalization rules which were put in place in Quebec the previous summer. Thus, for the Commission, not only were the issues of more than a decade ago again being considered, but the context of inter-provincial competition to supply financial market policies was still present. Indeed, the OSC was still running to

¹⁷ Ontario Securities Commission, "Securities Industry Policy Review: Preliminary Issues Paper," 29 June 1984.

¹⁸ Based on confidential interviews.

catch up to regulatory developments in Quebec while subjected to pressures to preserve the "monopoly" rents of the Ontario based industry.

We now turn to the Joint Securities Industry (JSIC) Report. This was the first shot in the battle which would ultimately upend the insulated position which the domestic securities industry enjoyed. Following the typical pattern of such probing, the JSIC Report ultimately set the agenda for the OSCs inquiry.

***Report of the Joint Securities Industry Committee:
An Assessment by the Flat Earth Society***

The JSIC Report¹⁹ was written in response to the OSCs decision to review its policies with respect to ownership, entry and capitalization in the Ontario Securities Industry. The drafting Committee was directed by Ted Medland, then Chairman of Wood Gundy, and the Report itself was written by James Baillie of the legal firm of Tory, Tory, Deslauriers & Binnington. Mr. Baillie, it will be recalled, was a former Chairman of the OSC.

The Report which was produced by the JSIC had the characteristics typical of such documents over the previous fifteen years. It attempted to set out the case for a situation which at best would preserve the status quo, but ideally it called for a more restrictive apparatus to effectively eliminate what little competition emanated from non-industry participants (i.e., foreign firms, banks, trust companies and other members of the four pillars framework.) In the case of foreign firms, the JSIC Report targeted the "exempt provisions" of the Ontario Securities Act. The JSIC Report notes that

The regulatory concerns are with the exempt transactions and exempt provisions of our securities laws that allow firms which are not subject to securities legislation to participate as market intermediaries in a range of important types of transactions including any transaction (retail or institutional) in Canadian or foreign government debt, and private

¹⁹ Joint Securities Industry Committee, "Regulation and Ownership of Market Intermediaries in Canada," Report of the Joint Securities Industry Committee on behalf of the Alberta, Montreal, Toronto and Vancouver Stock Exchanges and the Investment Dealers Association of Canada, 19 September 1984.

placements of any securities with institutions. These exemptions can be relied upon by completely unregulated firms to carry on an active securities business, and by regulated financial intermediaries to expand into market intermediation activities.²⁰

The JSIC presumed that expansion of "exempt-type" activity "would occur more frequently"²¹ than in the immediate past and was of the opinion that such participation in the industry was not only unnecessary but also undesirable.

Entry into the securities business by unregulated firms can be prejudicial to investors and result in unequal treatment for securities firms, which operate under capital adequacy tests, ownership restrictions, educational rules, and know-your-client and suitability for investment rules. Such entry is further prejudicial to retail investors, since transactions must be designed to qualify for the exemptions, which means that in large part they bypass the retail market. But it is not only retail customers who benefit from regulation; experience amply demonstrates that regulatory protection is required even by sophisticated investors and that it is essential to the health of the marketplace.²²

It was the view of the JSIC that the existing four pillars framework, plus the access to foreign markets which Canadians enjoyed, provided users of financial services with sufficient choice within the overall financial services industry. It was the JSIC's desire to preserve this range of choice. Without any substantive analysis to support its position the JSIC suggested that continuing to permit financial intermediaries and exempt firms to encroach on the business of the traditional investment dealers would:

- facilitate concentration and thus suppress competition in the financial services industry and erode the range of choice available to users of these services; in any event, capital in the industry is adequate and turnover of capital from seniors to juniors is adequate;

²⁰ Joint Securities Industry Committee, "Report," 19 September 1984, 4.

²¹ Joint Securities Industry Committee, "Report," 19 September 1984, 4.

²² Joint Securities Industry Committee, "Report," 19 September 1984, 4.

- set the stage for conflicts of interest within those financial institutions providing services which cross the boundaries of the four pillars; and,
- impair the quality of markets if both financial intermediaries and market intermediaries offered overlapping services.

The "modus operandi" of the industry -- its values or appreciative system²³ -- still had not diverged from its traditional stance on this occasion. That is, the industry, in revealing its objectives for regulatory policy surrounding the investment dealer industry, set up a "straw-person" such that the only model that would satisfy its precepts was that of the JSIC. It will be recalled that at the outset of this tale, it was the Moore Committee which developed such a model which only could be satisfied within the then existing protected industry structure. The JSIC's policy objectives were that:

- the securities industry should be controlled by Canadians;
- the four pillar structure should be preserved;
- networking among market and financial intermediaries should be permitted in order to facilitate the development of new products;
- all participants involved in the business of securities should be subject to regulation in order to ensure both investor protection and a level playing field among the markets' participants; and finally,
- Canadians should continue to have access to international markets.²⁴

The business and political backdrop against which the securities industry developed these objectives was marked by increasing globalization of trade in goods and services, private sector deregulation and government privatization, an enhanced reliance on private markets to perform the economic allocation function, and an increasing rhetoric

²³ A term used by Sir Geoffrey Vickers in *The Art of Judgement*, 70-71. He sees the appreciative system as a net of reality and value concepts which bear upon decision-making by policy actors.

²⁴ Joint Securities Industry Committee, "Report," 19 September 1984, 3.

and influence of the neo-conservative movement not only in Canada, but generally throughout the OECD area. The domestic securities industry in Canada was resisting these tendencies. Indeed, the industry thought that the Canadian securities industry should somehow merit special treatment when it came to trade in financial services.

Seen in the context of the Committee's belief that Canadian investors and users of capital should continue to have access to the international financial markets, these restrictions might be said to involve the danger that other jurisdictions may limit, or deny, access by Canadian securities firms to their local markets because of the lack of reciprocity...In the Committee's view, the considerations that dictate separation of functions in Canadian domestic securities markets are so important that they should not be diluted through a desire to assure other countries that their firms are receiving full access to those Canadian markets.

...For example, the United Kingdom not only permits but encourages the entry of foreign firms, but the Bank of England does not permit foreign-owned institutions to lead in the distribution of new issues within the domestic sterling capital market unless 'in the Bank's view there are reciprocal opportunities in their domestic capital markets for equivalent UK-owned institutions.' There is also the possibility that considerations of reciprocity may constrain the availability of membership under the new rules to govern the London Stock Exchange...*the Committee believes that there are relevant and significant differences that should dissuade these countries from applying considerations of reciprocity in this aspect of their relations with Canada.* Their economies are larger than Canada's; they lack the same proximity to the massive capital markets of the United States; and, most importantly, under the present rules and the rules proposed in this Report, non-residents are allowed very considerable access to the Canadian markets, although subject to restrictions to preclude their direct involvement in the domestic markets. *The Committee believes that government and regulatory authorities representing Canada in other countries should continue to press for maximum flexibility for Canadian firms in those countries but Canadian rules should reflect Canadian objectives rather than accepting models arrived at in other jurisdictions.* [Italics added]²⁵

²⁵ Joint Securities Industry Committee, "Report," 19 September 1984, 22-23.

It is apparent that the substance of the arguments used by the industry had not advanced very far during the long period that had elapsed since the Moore Committee published its Report. The industry continued to argue that its capital was adequate and that is why it had survived. It fails to acknowledge that an important part of the explanation for its success was the fact the industrial structure designed by the SROs shielded its constituents from "real" competition. This protection was enforced by the coercion of the state. Indeed, it is exactly this consideration which was behind the OSC Chairman's decision to reconsider the regulatory framework for the Ontario securities industry. Equally unsettling was the industry's suggestion that it should receive special treatment in the major financial centers in the world in the absence of any reciprocity being conceded by Canada.

Tom Courchene characterized the JSIC Report in the following terms:

In all my writings in the various areas of public policy I do not think that I have ever seen a document that has served to crystallize the issues in a policy area as effectively as does the Medland Report. From the vantage point of economic analysis the Medland Report rivets attention not only on the perennial issue of regulation-cum-protection vs. competition but as well on whether the ultimate role of regulation is to serve the public interest or the interests of those being regulated.²⁶

The OSC Hearings: The Industry - Regulator Debate

Overview

The OSC hearings were held during November and early December, 1984, in Toronto. Securities regulators from a number of the other provincial securities commissions -- including those from Quebec, Alberta and British Columbia -- were invited by the Ontario authorities not only to attend the hearings but to participate in the questioning of witnesses.

²⁶ Tom Courchene, "A Really Secure Industry or a Real Securities Industry," Centre for the Study of Canadian Economic Policy, Working Paper 84-01, 28 November 1984, 11.

The overarching impression ones gleans from the 2,200 pages of transcripts confirms the earlier noted conclusions regarding the lack of first hand knowledge of the securities business by the OSC and, moreover, the less than adequate capacity of the primary Canadian securities regulator to analyze the operating apparatus of the industry. Very frequently the line of questioning of the OSC Commissioners was mired in the "micro" detail of the industry to the extent that they seemed to miss the "big picture." Austin Taylor had earlier summed up the situation this way:

My reservation as to the likelihood of beneficial change is rooted in my belief that our political masters and their appointed bureaucrats have an abysmal lack of understanding of the marketplace, how it operates, the benefits arising from its operation, who provides what service to whom and of the interaction and interdependence of one service to another service. Aside from politicians' indifference to and/or ignorance of the marketplace there are in Canada, at least two further obstacles in the path of our achieving beneficial change and they are, first, that the appointed regulators or administrators of each of the four pillars, by the very nature of their positions, human nature being what it is, are likely to be advocates of the business interests and aspirations of the segment they regulate sometime to the detriment of the capital market as a whole. Secondly is the ever-present constitutional tug-of-war between our two senior levels of government -- a scene that is more often than not noted for confrontation rather than for a spirit of co-operation in the pursuit of national benefit.²⁷

In the Fall of 1984 Austin Taylor went further in his criticism of both his colleagues in the industry and the regulatory apparatus surrounding the Canadian securities industry.

I criticize...the industry of which I am a member, as I am of the opinion that we have used the regulation of the securities industry to our advantage, rather than to that of the consumer and user of our services, by building protective measures around the Canadian Securities Industry to the virtual exclusion of competition...²⁸

²⁷ Austin G.E. Taylor, "Structure by Default: Canada's Approach to its Capital Market," Business Quarterly, Summer 1984, Volume 49, Number 2, 27.

To this be added...

The recommendations contained in the Joint Industry Report are in my opinion likely of little consequence and assistance to the November hearing, as the JSIC Report advocated either a status quo approach to the issues to be examined or a tightening of existing rules to the exclusion of competition. We at McLeod find this report to be disappointing, self-serving to the existing securities industry, anti-competitive, and definitely not in the interest of either the development of the Canadian capital market nor the consumers of financial services in Canada in light of the changes that have occurred elsewhere in the world of financial services. It is a classic case of ostrichism.²⁹

The Commissioners relied extensively on their external legal counsel -- who at one time or another had worked in a similar capacity either for a member firm in the industry or for one of the SROs. The JSIC, as noted earlier, was represented by James Baillie, a former chairman of the OSC.

On balance, the hearings provided little in the way of "new" information to help the primary regulator of the securities industry in Canada arrive at conclusions which would result in a regulatory apparatus different from the one already in place.

...The Industry Committee was able to assemble some of the *best* [italics added] minds within the industry and extended resources in formulating a well thought through proposal.

The Commission doesn't have those kinds of intense resources to bring to bear and Commission Counsel were in effect instructed to attempt to create a process that would act as a surrogate. In that regard we took several steps: firstly the Commission and Counsel released several issue papers... Commission Counsel also arranged for meetings in New York and London with a view to ensuring that outside participants were aware of the

²⁸ Austin G.E. Taylor, "Financial Services: The Changing Environment," Speech to the Financial Times - Southam Business Editors Conference, 15 October 1984, 6.

²⁹ Austin G.E. Taylor, "Financial Services: The Changing Environment," Speech to the Financial Times - Southam Business Editors Conference, 15 October 1984, 9.

proceedings taking place here and in order to gain some understanding of developments in those markets.³⁰

The *modus operandi* of the hearings gave the lead role to the representatives of the JSIC. This occurred through a mechanism by which the JSIC tabled a series of questions which the OSC agreed would be posed to every witness coming before the hearing.

...the Joint Securities Industry Committee, recognizing the limitations upon their right to ask questions, posed a series of questions that should be put to interested parties that have taken a position on particular issues, so we will ask those questions...³¹

For the first time, at the outset of the hearings, the ambiguity of the OSCs position became apparent. On the one hand, the Commission's Counsel noted that "There is no question that the domestic securities industry is competitive and efficient, as are domestic markets"³² but on the other suggested that it was not clear "that the industry is well positioned for world scale competition"³³ and that "in the process of re-casting the regulatory framework by its proposals the industry did seek to erect new barriers..."³⁴ "...Hence, while Commission counsel recognize concerns implicit in the Joint Industry submission, we have chosen to focus on the leadership role of the Commission and other securities administrators, that might be served beyond the strict jurisdiction of securities administrators, as well as that jurisdiction, all in the interests of serving the core function of securities regulation,... which...is capital market efficiency."³⁵

³⁰ Edward J. Waitzer, Opening Statement of Commission Counsel to the Ontario Securities Commission's Securities Industry Review, "Transcript of Ontario Securities Commission: Securities Industry Review, Public Meeting," 19 November 1984, Volume 1, 13.

³¹ Peter Dey, Chairman, Ontario Securities Commission, "Transcript of Ontario Securities Commission: Securities Industry Review, Public Meeting," 20 November 1984, Volume 2, 194-195. The context for this excerpt was Mr. Dey's explanation to Mr. James Connacher about the way in which the hearing would be conducted.

³² Edward J. Waitzer, Opening Statement of Commission Counsel to the Ontario Securities Commission's Securities Industry Review, 19 November 1984, in "Transcripts," Volume 1, 14.

³³ Edward J. Waitzer, Opening Statement, 19 November 1984, in "Transcripts," Volume 1, 15.

³⁴ Edward J. Waitzer, Opening Statement, 19 November 1984, in "Transcripts," Volume 1, 15.

³⁵ Edward J. Waitzer, Opening Statement, 19 November 1984, in "Transcripts," Volume 1, 15.

The character of the submissions and the substance of the testimony and/or evidence at the OSC hearing can be divided into four categories:

- (i) the JSIC, which supported a generally more restrictive regime which for the most part represented the larger mainstream firms in the industry. The industry's position has already been outlined, and there was little if any new "grist for the mill" from this source at the OSC hearing;
- (ii) a small number of larger mainstream firms who thought that the indigenous members of the industry could survive in a more liberalized entry and ownership environment. The leader in this regard of course was Gordon Capital with support from McLeod Young Weir;
- (iii) the foreign owned firms which thought that the restrictions on the growth of their capital should be removed so that they could compete with the indigenous firms on a level playing field. Indeed, the US owned firms suggested in both their submissions and in testimony that there could be political retaliation if the rules governing ownership were not liberalized; and
- (iv) the users of capital who generally supported a more liberalized regulatory regime.

While one can classify the submissions to the OSC according to this typology, the arguments put forward in most of the submissions converged on the idea that entry and ownership rules in the Canadian securities industry should be liberalized. Of course this convergence occurred because most of those making representations to the OSC did not support the position taken by the JSIC in its Report.

Just before the commencement of the OSC hearings, Peter Dey, the OSC Chairman, in an address to the Montreal Society of Financial Analysts, suggested that the Quebec authorities had already come up with answers to the issues which were then confronting the Ontario regulators. Indeed, Mr. Dey suggested that the OSC review "...will have to assess the impact of the Quebec position, particularly on ownership..."³⁶

Quebec had, for some time been marching to a different tune. Under the leadership of Jacques Parizeau, its provincial Minister of Finance, major structural adjustments were already under way in the financial services industry. In that province, the ultimate goal was "one-stop" shopping at any financial institution -- although it was yet to be determined how the banks would fit into this model.³⁷

The OSCs Opening Position

Mr. Dey's opening remarks to the Hearing, in a subtle way, echoed sentiments which supported the generalities of the arguments put forward by Gordon Capital. While it was the case that the Commission would focus on the issues associated with the presence of non-residents and other financial institutions in the securities industry, and the criteria for the registration of securities firms with the OSC, the overarching objective was to ensure that any remedies proposed by the OSC should enhance both the efficiency of the capital markets and the public interest.³⁸

The Chairman expressed a narrow interpretation of the meaning of competition and of efficiency with respect to capital markets. Competition for the Chairman and the commissioners seemed to relate to the idea of "many" firms in the industry -- but not how the firms related to one another and to their clients. Competition among market intermediaries, while a necessary condition for an efficient market, was not in itself a sufficient condition. Indeed, the Director of Investigation and Research Combines Investigation noted in his submission to the OSC (to be reviewed later) that "Historically and in the present situation...other concerns emerge that are in measure predicated on an implicit and erroneous concept of how competitive markets operate."³⁹

³⁶ Robert Gibbens, "OSC to consider Quebec's securities rules," Globe and Mail, 15 November 1984, B8.

³⁷ Barry Critchley, "OSC probe will change rules of securities game," The Financial Post, 17 November 1984, 27.

³⁸ Ontario Securities Commission, Opening Remarks of the Commission Chairman to the Ontario Securities Commission's Securities Industry Review, 19 November 1984, in "Transcripts", Volume 1, 3.

³⁹ Director of Investigation and Research Combines Investigation Act, "Submission to the Ontario Securities Commission on the Issues of Regulation and Ownership of Market Intermediaries in Canada," November 1984, 2-3.

The Commission's Counsel, on the other hand, seemed to have a more traditional interpretation of competition.

The general objectives of securities regulation have, in Ontario, been subordinated to some degree by overriding concerns about the hazards of undue domination of the domestic securities industry by non-resident firms or domestic financial institutions.

A concern for competition policy and the potential resultant efficiency gains need not run contrary to the investor protection objectives of securities regulation. Indeed, the ultimate objectives of competition and regulation are congruent in that they both attempt to maximize market efficiency and encourage business responsiveness to consumer preferences.⁴⁰

Indeed, the outside Counsel reminded the Commissioners of the views expressed more than a decade ago by a number of influential Canadian nationalists.

The Gray Report commented on the undercapitalization of the domestic securities industry and suggested that this must inevitably affect its ability to assume risk and engage in entrepreneurial activity. In the absence of vigorous competition within the industry and from other parts of the financial sector and because of their limited capital, the Gray Report suggested that most securities firms felt little need to protect their market position by taking risks and providing new kinds of financing services. Accordingly, the Gray Report suggested that entry of non-resident firms might be encouraged in order to improve liquidity and competition in domestic capital markets.⁴¹

As we will see, the Commission's understanding of these issues would be broadened as the Hearing proceeded.

⁴⁰ John M. Stransman and Edward J. Waitzer, "Commission Counsel Submission to the Ontario Securities Commission in respect of its Securities Industry Review," 15 November 1984, 3.

⁴¹ John M. Stransman and Edward J. Waitzer, "Commission Counsel Submission" 15 November 1984, 7.

The most substantive component of the remarks of the Commission's counsels, in their opening statement to the Hearing, addressed the question of universal registration that had been raised by the JSIC. It will be recalled that the JSIC wanted to have those dealers operating in the exempt market register with the OSC -- but non-residents under the existing criteria were not permitted to be registrants. The Commission counsel suggested that universal registration could be seen not only as a barrier to entry, but also as an obstacle to competition within the industry. Universal registration, it was argued, should only be adopted to facilitate investor protection -- if current regulatory instruments were inadequate -- but not to protect a particular form of industry structure. In any event, the Commission's counsel was opposed to "omnibus requirements which may inadvertently erect barriers to competition."⁴²

Having said that, it was noted that a survey by users of capital and of the services provided by the industry suggested that they "feel that the domestic industry would benefit by additional capital and are limited by the existing capital base in the range of services that they can provide."⁴³ This view echoed that of a number of Canadian-owned securities firms and all of the foreign owned subsidiaries operating in Canada. Furthermore, OSC Counsel was concerned that restrictions on entry and ownership had created an incentive for firms in the industry to merge in order to enhance their capital bases, but as a consequence concentration in the industry had increased and the range of choices available to users of capital had diminished.⁴⁴

The evidence then was that the industry could not adequately serve its client base with its existing capital structure. Indeed, the JSIC submission was the only one, among the 30 or so which were received, which tried to make the case that industry capital was adequate and that services provided to users of capital was satisfactory.

⁴² Edward J. Waitzer, Opening Statement of Commission Counsel, 19 November 1984, in "Transcripts," Volume 1, 43.

⁴³ Edward J. Waitzer, Opening Statement of Commission Counsel, 19 November 1984, in "Transcripts," Volume 1, 46.

⁴⁴ John M. Stransman and Edward J. Waitzer, "Commission Counsel Submission to the Ontario Securities Commission in respect of its Securities Industry Review," 15 November 1984, 60.

The OSC Counsel envisaged two possible models to deal with the capital adequacy question and ownership restrictions:

- (i) permit non-resident ownership up to a maximum of 50 percent of the voting shares of a firm. In such a situation the OSC would want to ensure that new capital enters the industry rather than precipitating a substitution of non-resident capital for domestic capital which would occur through a straight takeover of a Canadian firm by a foreign owned firm or by non-residents;
- (ii) adopt the Quebec model whereby outside participation in the industry would be examined on a case-by-case basis according to pre-announced criteria.⁴⁵

It is interesting, because for the second consecutive occasion, the outside Counsel to the Commission, with the help of the Commission Staff, and not the Commission staff itself, was rethinking the structure of the securities industry.⁴⁶ This was a further indication of the OSCs inability to fully come to grips, in an independent fashion, with a future vision of the securities industry.

Gordon Capital Reiterates its Position

Gordon Capital, whose initiative to form an alliance with an offshore firm sparked this OSC hearing, in its submission, used the reasoning rooted in the public interest argumentation to support its wish for liberalized ownership and entry. Indeed, there were a number of questions put forth in its submission which, if answered with the "economists rationality," would result in the endorsement of Gordon's proposed arrangement. The first question put forward was "Should regulation of the securities industry be designed to protect the domestic industry from competition or should it be designed to enable the industry to compete effectively?"⁴⁷ The firm answered the question in the following fashion:

⁴⁵ John M. Stransman and Edward J. Waitzer, "Commission Counsel Submission," 15 November 1984, 68-70.

⁴⁶ It will be recalled that Purdy Crawford had made a number of forward looking comments to the hearings on securities industry diversification.

It is time for the domestic industry to become less insular, to look outward, to resist the 'easy fix' of hiding behind protectionist regulations and to seek the capability of attracting capital and expertise to enable it to compete effectively as a representative of Canadian issuers and the general public in all capital markets.⁴⁸

A particularly damning question with respect to capital adequacy posed by Gordon was "even if capital is 'adequate,' is more capital bad; and bad for whom?"⁴⁹ Gordon's answer was predictable:

...the proposition that capital is adequate will only be supported by those who have a vested interest in maintaining the status quo. Gordon capital believes that an enlarged capital base can be productively employed by the Canadian Securities Industry without surrendering our industry to foreign or non-industry domination.

Without going through the details of the Gordon recommendations, the bottom line view of the firm was that

Regulations which have in fact operated as a straight-jacket to impede the ability of the Canadian Industry to grow and compete effectively both domestically and internationally must be significantly relaxed. Regulation hereafter in the 1980s and 1990s should be deliberately designed to stimulate the Industry in a concerted effort to compete and should no longer be designed to insulate the Industry and its present members from competition both from within and without.⁵⁰

⁴⁷ Gordon Capital Corporation, "Regulation: A Security Blanket or Straight-Jacket?" Submission to the Ontario Securities Commission with respect to Policy Review: Competitive Position of the Securities Industry in Domestic and International Financial Markets, November 1984, 4.

⁴⁸ Gordon Capital Corporation, "Regulation: A Security Blanket or Straight-Jacket?" Submission to the Ontario Securities Commission, November 1984, 5.

⁴⁹ Gordon Capital Corporation, "Regulation: A Security Blanket or Straight-Jacket?" Submission to the Ontario Securities Commission, November 1984, 14.

⁵⁰ Gordon Capital Corporation, "Regulation: A Security Blanket or Straight-Jacket?" Submission to the Ontario Securities Commission, November 1984, 36-37.

McLeod's Position: A Minority View Within the Domestic Industry

Another of the key national securities firms which took a position on certain elements contrary to that of the JSIC, was McLeod Young Weir Limited. Its principal officers, Austin Taylor, Chairman and Thomas Kierans, President had both been vocal in the past regarding their dissatisfaction with the then existing regulatory regime. Essentially, the view at McLeod was that the ability to develop an industry consensus on how it should be restructured was quite remote and

...should one emerge, it would likely focus on means of restricting change. In McLeod's view, resisting change is neither in the industry's nor in the long term interests of Canada's capital markets.

In McLeod's view, the securities industry primarily must adapt to changing market forces, not to seek protection from them. McLeod believes that a response which seeks to preserve the status quo through reinforced and extended regulation could have grievous long term consequences. Liberalization we believe, is essential.⁵¹

McLeod's submission⁵² to the OSC was rooted in a stylized property rights argument and its critique of the existing regulatory regime in its formal submission confirmed that a consensus among the industry leaders regarding regulatory reform would not be possible. Indeed, on virtually every major element of the JSIC Report, McLeod took a contrary viewpoint.

The firm's overarching position was that regulatory reform in Canada's securities industry was lagging behind the evolution of the domestic and international financial markets and consequently inhibiting the ability of the Canadian industry to compete adequately in them. The salient factor here was the industry's inadequate access to capital. Indeed, the McLeod view was that "securities firms should have unrestricted access to

⁵¹ Thomas E. Kierans, President McLeod Young Weir letter to Peter Dey, Chairman, Ontario Securities Commission, Response to OSC Preliminary Issues Paper, 5 November 1984.

⁵² McLeod Young Weir Limited, "Regulation and Its Effect on the Competitive Position of the Canadian Securities Industry in Domestic and International Financial Markets," Submission to the Ontario Securities Commission, 5 November, 1984.

capital, in whatever form and whatever source. Restrictions should be applied only if (a) there are over-riding public interests, and (b) those interests outweigh the potential detrimental impact of restricting access to capital."⁵³ As was noted earlier, developments in the securities business, such as bought deals, were impinging on firms' capital and thus limiting the services that could be provided to clients -- in both domestic and international markets. Indeed, the firm did not believe that the "current sources of capital for securities firms...are adequate to meet the demands and opportunities of the future...It is our opinion that existing ownership restrictions...could effectively prevent Canadian securities firms from effective participation and competition in international financial securities markets."⁵⁴

The other salient feature of the JSIC Report to which McLeod objected was that of limiting the activities in the exempt market. McLeod maintained that the exempt market

is important to the development and enhancement of our capital markets and the Canadian economy. No one can deny that it is not in the best interests of issuers and suppliers of capital to have the freedom of choice to implement their financial objectives with minimal regulatory constraint. This market has been superbly efficient and effective. To restrict the ability of existing players and new entrants to participate in the exempt market must be examined with care.⁵⁵

The only caveat which McLeod placed upon its view of participation in the exempt market was that the ownership provisions for these participants should be the same as those for registered securities firms. In order to overcome the current ownership restrictions, McLeod would permit non-residents, and banks to own up to forty percent of Canadian firms (and thus of those firms set up operate in the exempt market), although individual banks would be limited to 10 percent each -- reflecting the current Bank Act

⁵³ McLeod Young Weir Limited, Submission to the Ontario Securities Commission, 5 November, 1984, 16.

⁵⁴ McLeod Young Weir Limited, Submission to the Ontario Securities Commission, 5 November, 1984, 1.

⁵⁵ McLeod Young Weir Limited, Submission to the Ontario Securities Commission, 5 November, 1984, 33.

restriction. Other financial institutions would be allowed to own up to 100 percent of a securities firm. The restrictions on ownership of non-industry participants contained in the JSIC position would be eliminated.

Thus, in summary, the McLeod model would only have regulations where they were deemed to be in the public interest and would comprise the following key elements:

- Canadian ownership controls;
- continuation of the separation of functions provided by the traditional four pillars; and,
- the relaxation of restrictions on access to capital.

Kierans amplified on the underlying precepts in his firm's regulatory model at the Hearings.

McLeod's approach is based, quite simply, on its carefully considered opinion that there exists presently a coincidence of objectives among, one, standards of fairness; two, the dictates of the public policy formulation process; and, three, the long-term interests of the industry itself, as a whole.

Dealing with fairness first, McLeod believes that the industry is competitive and does serve its clients well, but McLeod also recognizes that new sources of competition have advanced these standards in some areas, even further, and that to ignore the contributions and the aspirations of a Salomon or a Great Lakes or a Gordon Capital, is both counterproductive and wrong.

Dealing secondly with the dictates of the public policy formulation process, McLeod believes that the core issues in this case are, one, competition; two efficiency; three, domestic-versus-foreign control; four, concentration and bank domination; and, finally, five, ensuring that the regulatory structure does not unnecessarily, given the overriding public interests, obstruct the industry's ability to grow domestically, to assume a position of greater significance internationally and to respond in as numerous and diverse ways as can be devised to accommodate the pervasive pressures of change, domestic and international.

McLeod is concerned in this case that domestic concerns about industry, i.e., owner-operated ownership, and national concerns about the foreign ownership influence have become so refined as to drive the entire public policy equation, as opposed to assuming an appropriate weighting, within the total matrix.

Put bluntly, trade-offs among all objectives must occur if the balanced totality is to be realized. In this case, ownership considerations and objectives, within limits, must be liberalized if a balance among the other public policy objectives, specifically competition and efficiency, are to be achieved.

The McLeod model is nothing, if not pragmatic and incremental. Where we believe that further consideration or investigation is warranted or where jurisdictional considerations mandate, a go-slow approach is recommended, but we do believe that the case for liberalization in the regulated area and the maintenance of the loose reign in the exempt area is both compelling and urgent.

Dealing with the long-term interests of the industry, as a whole, McLeod believes that any endeavor by established firms such as itself, to vest their interests, by obstructing new sources of domestic and international competition, or by constraining options to source capital, shall ultimately prove counterproductive.

The challenge is best met, we believe by reinforcing one's competitive edge and not by resisting change.

As a firm, we are quite honestly somewhat discomforted by the pace of change and the challenges posed. Life was much more predictable before technology integrated the markets of the world and new players developed new competitive thrusts.

Nonetheless, we are confident of our ability to respond and to grow and we believe a regulatory climate which is somewhat more responsive within which we can work is needed.⁵⁶

⁵⁶ Tom Kierans, Testimony before the Ontario Securities Commission, Securities Industry Review, Volume 10, 3 December 1984, 1435-1438.

McLeod was among the first of the *national* securities firms in Canada to break with the generalized industry views regarding a "proper" regulatory regime which was portrayed in the JSIC Report. It was for this reason that McLeod's position was so important. The firm could have easily adopted the self-serving position of the industry in general, and attempt to argue for a regulatory apparatus which would preserve the monopoly rents for the indigenous firms -- and the costs would be absorbed by the users of capital collectively. However, it should be noted that McLeod was not advocating, at this time at least, the wholesale freeing up of the ownership restrictions -- it was just advocating a higher ceiling on outside ownership that would be permitted by the JSIC.⁵⁷

The Non-Resident Owned Firms are Steadfast

The positions of the foreign owned firms expressed at the Hearings were not significantly different from what they had been saying since the issue first came to the public policy stage in 1969-70. Almost twenty such firms presented briefs and universally they sang from the same song book.⁵⁸ As had been the case frequently in the past, the position articulated by the JSIC became the focal point of the submissions by the non-resident owned firms.

The *first* point to note from the critique by the non-resident owned firms was the overwhelming disapproval of the JSICs recommendation to tighten the ownership restrictions which were already burdensome to these firms. There was a general feeling that against the background of the globalization of financial markets, Canadian firms were undercapitalized to compete effectively. In such an environment users and suppliers of capital would suffer a welfare loss in the absence of opening up the indigenous industry to a capital inflow and to the enhanced competition that would be provided by the unrestrained presence of foreign owned firms operating in Canada. Thus the bottom line here was that the foreign owned firms were opposed to the JSIC proposal that would have them register with the OSC even to undertake "exempt" market activity. This would have effectively excluded the foreign firms from operating in anything but a marginal way in

⁵⁷ McLeod views were not unrelated to its own position. Shearson Lehman, a large New York firm, already had a minority interest in McLeod, and the latter may have been looking for ways to increase Shearson's equity position.

the Canadian market because, as the rules presently stood, only Canadian firms could become registrants.

Second, the formal submissions were highly critical of the narrow, nationalistic "world view" which was embedded in the JSIC Report. Merrill Lynch Canada was particularly indignant.

...the JSIC Report appears to be regressive and protectionist in intent and effect. With limited exceptions, the JSIC Report not only opts for the status quo. It goes beyond that position to propose the withdrawal of long-standing exemptions on grounds that are not convincing and which supporting evidence is lacking.⁵⁹

⁵⁸ See for example Bache Securities Inc., "Submission to the Ontario Securities Commission in Respect of Its Policy Review of the Regulations Governing the Ownership and Registration of Securities Firms," 5 November 1985;

Merrill Lynch Canada Inc., "Submission to the Ontario Securities Commission in Respect of its Policy Review: Competitive Position of the Securities Industry in Domestic and International Financial Markets," November 1984;

Morgan Stanley, "Re: Joint Securities Industry Committee Report on the Regulation and Ownership of Market Intermediaries in Canada," 5 November 1984;

Edward I. O'Brien, President, Securities Industry Association, "Submission," 2 November 1984;

Merrill Lynch Capital Markets, "Submission to the Ontario Securities Commission with Respect to its Policy Review," 5 November 1984;

First Boston Canada Inc., "Re: Regulation of Market Intermediaries," 5 November 1984;

Shearson Lehman/American Express Inc., "Submissions," 1 November 1984;

Salomon Brothers Inc., "Request for Comments in Response to the Report of the Joint Securities Industry Committee," 5 November 1984;

John C. Whitehead, Senior Partner, Goldman Sachs & Co., "Submission," 5 November 1984;

S.G. Warburg & Co. Ltd., "Submission with respect to regulation and ownership of market intermediaries in Canada," 5 November 1984;

CIBC Limited, "A Presentation by CIBC Limited to the Securities Industry Policy Review," November 1984;

T. Ohtake, Senior Vice President, Nomura Securities Co., Ltd., "Re: Securities Industry Policy Review, 5 November 1984.

...it urges the OSC to regulate securities activity that is now unregulated because it is already regulating other securities activity. It asserts, without supporting evidence that sophisticated investors can no longer take care of themselves now that there are more of them and that they need to be protected by new government regulations governing whom they can deal with and under what circumstances.⁶⁰

The mandate [of the OSC] has never been to protect individual intermediaries within the domestic markets from competition with others and it would be clearly regressive if the power to regulate were to be turned to such purposes at this time.⁶¹

The Securities Industry Association, in its brief, demanded reciprocity from the OSC in light of the freedom of entry to the US market which had been granted to Canadian dealers.⁶² In this regard, Michael Sanderson, Chief Executive Officer of Merrill Lynch Canada noted in his appearance before the OSC that

...The United States is no longer a balance of payments surplus country. It is inconceivable they [the Administration and the Congress] will continue in these circumstances to allow the continued entry of goods and services into their market if they feel there is an absence of essential reciprocity.⁶³

The basic recommendation of the foreign owned firms was to allow all firms in the securities industry to be on the same footing as the Canadian owned firms. This boiled down to permitting the non-resident owned firms to have the same access to capital as the indigenous firms. Furthermore the non-resident firms, in general, wanted to preserve their capacity to operate in the exempt market with or without full registrant capacity. The

⁵⁹ Merrill Lynch Canada Inc., "Submission....," November 1984, 3.

⁶⁰ Merrill Lynch Canada Inc., "Submission....," November 1984, 18.

⁶¹ Merrill Lynch Canada Inc., "Submission....," November 1984, 24.

⁶² Edward I. O'Brien, President, Securities Industry Association, "Submission," 2 November 1984, 4.

⁶³ Michael Sanderson, Chief Executive Officer, Merrill Lynch Canada, Appearance before the Ontario Securities Commission, Securities Industry Review, Public Meeting, 21 November 1984, Volume 3, 325.

continued restraint of competition, because of the nationality of ownership, was counter to the trend of liberalization in most of the world's developed financial markets.

The Users of Financial Services: Powerful Voice for Change

The Canadian borrowers who use the services of the investment dealers to assist them in such activities were represented by the Corporate Finance Committee of the Financial Executives Institute (FEI).⁶⁴ The position of the FEI was remarkably similar to that of the non-resident owned dealers -- and for that reason was particularly damaging to the propositions which had been put forth by the indigenous industry. The basic points in the FEI submission, while not new, are worth citing briefly:

- by recommending the imposition of additional constraints on foreign owned firms, the JSIC was ignoring the international trends of liberalization and market globalization;
- the JSIC Report failed to acknowledge and/or appreciate the growing concentration in the Canadian securities industry -- through mergers and acquisitions -- and the fact that this phenomenon was likely to continue given trends in the global financial services industry and the undercapitalization of the industry. The FEI was of the view that the only reason the domestic industry could argue that its capital was sufficient was because the industry generally avoided risky activities;
- the only firm providing competition and thus innovation in the domestic industry was Gordon Capital -- and this was just not good enough. The FEI thought that non-industry participation was necessary to enhance competition. Financial intermediaries and non-residents should -- over time -- be permitted to own up to 49 percent of an investment dealer.
- it should be the exempt institutions who provide advice on whether additional regulation is required in the area of exempt transactions and not the investment dealers.⁶⁵

⁶⁴ Mitchell T.G. Graye, Chairman, Corporate Finance Committee, Financial Executives Institute, "Re: Submission of the Corporate Finance Committee of FEI Canada on Securities Industry Policy," 5 November 1984.

This was a particularly damning indictment of the domestic industry inasmuch as the FEI utilized many of the same arguments which had been put forth by the non-resident owned securities firms. It thus highlighted once again the self-serving nature of the reasoning that continued to be put forward by the securities industry in Canada. The credibility of the arguments were increasingly being called into question.

The Director of Investigations Combines Investigation Act: A Persistently Strong Counterpoint for the Dealers

The JSIC received no support for the reasoning in its Report from the Director of Investigation and Research Combines Investigation Act (Director). Effectively, as was the experience when the OSC was considering the deregulation of broker commissions, the Director refuted virtually every proposition put forward by the industry to further insulate it from effective competition.

...the JSIC advocates measures which would protect the industry against competition and thus disregards the importance of competition for the efficiency of the capital market. Further, the facts required to support the submission of the JSIC is so far absent.⁶⁶

The criticism by the Director of the JSIC Submission touched on all of the key issues:

- competition in the industry would be facilitated by the entry of foreign-owned firms and thus the restrictive foreign ownership controls should be removed⁶⁷;
- competition in the securities industry would be facilitated by allowing firms ready access to all available forms of capital because existing constraints hinder competition

⁶⁵ Mitchell T.G. Graye, Chairman, Corporate Finance Committee, Financial Executives Institute, "Re: Submission...", 1 - 3, 5 November 1984.

⁶⁶ Director of Investigation and Research Combines Investigation Act, "Submission to the Ontario Securities Commission on the Issues of Regulation and Ownership of Market Intermediaries in Canada," November 1984, 6.

⁶⁷ Director of Investigation and Research Combines Investigation Act, "Submission...", 26.

in the industry.⁶⁸ George Lerner, testifying at the Hearings on behalf of the Director concluded that

ownership requirements cannot be rationalized on the grounds of preserving or encouraging an effective competition structure. They are plainly and simply anticompetitive regulations that have the effect of preventing entry in a market which otherwise has few natural entry barriers.⁶⁹

- the JSICs argument that market efficiency would diminish because of the continued presence of the non-resident owned firms in the exempt market appeared to be unfounded. Unless the JSIC can demonstrate how such an eventuality could arise, the current rules surrounding the exempt market should not be changed;⁷⁰ and
- it was not apparent to the Director that the preservation of the separation of functions (i.e., the four pillars) was essential for there to be "meaningful choice" in the Canadian financial services industry. Users of the financial system, the Director claimed, made choices among products and services and not among the institutions. From this perspective, therefore, ties between financial and market intermediaries were desirable as was the presence of foreign-owned market intermediaries. Even the Gray Report, the Director reminded the OSC, suggested that Canadian financial market competition and efficiency would be enhanced by the presence of foreign-owned securities firms in Canada.⁷¹

OSC Commissioner Iacobucci was not completely satisfied with the economist's perspective which the Director's representatives brought to the Hearings. Iacobucci expressed his misgivings in a fashion that had been reflected earlier in the discussion of economic versus political efficiency.

⁶⁸ Director of Investigation and Research Combines Investigation Act, "Submission....," 29.

⁶⁹ George Lerner, Oral Testimony before the Ontario Securities Commission, Securities Industry Review, 4 December 1984, Volume 11, 1732.

⁷⁰ Director of Investigation and Research Combines Investigation Act, "Submission....," 26.

⁷¹ Director of Investigation and Research Combines Investigation Act, "Submission....," 45.

I understand that you are coming at this from purely an economics viewpoint rather than trying to reflect other kinds of issues that might be factored into the task before us. But there seems to be accepted policy in Canada, expressed policy in Canada that foreign dominance and foreign influence over our markets has to be watched and has to be and indeed in many cases regulated.

I guess the concern that I have in listening to the economic model that is being presented, is that it is presenting that side of the picture and there is of course a dispute within the economic model as to what should dominate even within that model.

But here we are listening to representation from the Director of Combines, a very important federal official and also part of the public policy of our country, is a scheme of regulation involving foreign investment in Canada, the Foreign Investment Review Agency, and all of the rulings and regulations that flow from that kind of approach.

I know you can't comment on that, but it seems to me you have got to acknowledge the role that this Commission finds itself in, do you not, namely, trying to balance what you think is appropriate for an economic model for a country with what might be called political or other policy concerns that relate to the question that we have before us.⁷²

George Lermer, in response to Iacobucci stated that

I do think the political winds are changing a little bit, but certainly in terms of responsibility between a politician and an economist on these questions, I find it difficult to accept that this is a non-economic question, this is a political nationalistic question, the Gray report and the Watkins report and all these reports were couched in terms of, 'Look, our economy is being battered around because of the branch plant economy and its ownership has a negative economic impact on us and that's why we need to interfere and intervene,' and of course there is the cultural lead and the cultural reasons for nationalism and other sorts of subsidies for the CBC, etcetera. to obtain nationalist goals.

⁷² Dean F. Iacobucci, Commissioner of the Ontario Securities Commission, Oral observation before the Ontario Securities Commission, Securities Industry Review, 4 December 1984, Volume 11, 1776-77.

But when we speak about protecting manufacturing and service industries, that is usually being done on the grounds that we are going to see improved economic performance in the country and not simply for some objective about ownership; at that stage the economist has a responsibility at least to advise on the costs and implications.

So it seems to me there is an economic link on the political question and that doesn't respond to how a Commission should deal with the political imperative, but it does respond by saying economists should advise on economic costs and consequences and that it is essentially what we have done before and here.

We can't comment on the value of any objective, but we can see there are costs to the objective and there are trade-offs and speaking individually and personally, I did not favor the Foreign Investment Review Agency legislation either.⁷³

Commissioner Iacobucci's contention raises the general question of just what the function of a regulatory commission is and particularly that of the OSC. The Commissioner seemed to be more concerned about the overarching "political" -- what is acceptable to political masters at the level of governance -- and less to regulation as part of public administration. For public administrationists the point is clear: the role of political adjudication, Iacobucci's concern, is properly lodged with the representatives of the people and not with appointed representatives of elected officials⁷⁴. Indeed, as Schultz points out, the function of regulation in our system of governing has assumed important political significance.

As the regulatory function evolved, it increasingly assumed political relevance that transcended the traditional rationale of insulating politicians from controversial, no win political issues.⁷⁵

⁷³ George Lerner, Oral Testimony before the Ontario Securities Commission, Securities Industry Review, 4 December 1984, Volume 11, 1779-80.

⁷⁴ Richard Schultz, "Regulatory Agencies and the Dilemmas of Delegation," in The Administrative in Canada, ed. O.P. Dwivedi (Toronto, University of Toronto Press, 1982).

⁷⁵ Richard Schultz, "Regulatory Agencies and the Dilemmas of Delegation," 92.

Thus, just as the Director had effectively explained the weaknesses in the industry's arguments during the OSCs consideration of the issues surrounding the liberalization of the process of determining broker commissions in 1982, so did the Director play a comparable role on this occasion. He focussed the Commission's attention on how self-serving the JSICs recommendations had been, but more than that had effectively turned the basic precepts of the industry's traditional protectionist and/or nationalist arguments on their head such that the anticipated outcomes of alternative policy strategies considered by the JSIC would be the exact opposite that had been conveniently and opportunistically projected. The values that had been adopted by the industry, and accepted by the regulators were becoming increasingly more difficult to defend. The credibility of the JSICs insular stance was being effectively undermined.

Tom Courchene: An Academic Economist's Perspective

Tom Courchene, who for practical purposes had no particular axe to grind with the OSC with respect to the regulatory regime, except for advancing his ideas regarding the "proper" role of financial regulation,⁷⁶ was very critical of the JSIC recommendations.⁷⁷ For Courchene the issue was not whether the capital of the securities industry was adequate, but a question of access to capital. The policy ought to be one of allowing "maximum capital access subject only to an" overriding public interest."⁷⁸ This overarching point of view mirrored that of the OSC during the hearings on the liberalization of stock broker commissions. Furthermore, Courchene suggested that the basic stand by the JSIC reflected the underlying precepts of the Stiglerian stance that "experience shows that all too frequently regulation serves not the public interest but the interest of those being regulated."⁷⁹ Against the background of that normative statement

⁷⁶ At the outset of his appearance before the OSC Courchene noted that "I am representing no one...I am here as a Professor of Economics from the University of Western Ontario and one who is interested in public policy." See Ontario Securities Commission's Securities Industry Review, 19 November 1984, Volume 7, 954-956.

⁷⁷ Tom Courchene, "A Really Secure Industry or a Real Securities Industry," Centre for the Study of Canadian Economic Policy, Working Paper 84-01, 28 November 1984.

⁷⁸ Tom Courchene, "A Really Secure Industry or a Real Securities Industry," 1.

⁷⁹ Tom Courchene, "A Really Secure Industry or a Real Securities Industry," 1.

about the public philosophy surrounding regulation in general, Courchene suggests that the focus of financial regulation should be on assuring full disclosure and consumer protection, avoiding conflicts of interest, assuring institutional solvency, avoiding undue concentration, and nurturing an environment conducive to competition and efficiency in the industry.⁸⁰ The recommendations of the JSIC, were of course, painstakingly at odds with these normative precepts.

The capacity of the Canadian securities industry to realize Courchene's objectives required a liberalization of the rules surrounding access to capital. The industry's capital was probably inadequate to accommodate its information and technological requirements and the innovations in finance such as the "bought deal."

The only solution which would accommodate these requirements was, for Courchene, unfettered access to capital. He suggested

that the OSC should adopt [this approach] as its *underlying reference point*...The emphasis would be on *justifying a restriction of ownership as being in the public interest*. This is where the onus of proof has to lie. The principle adopted by the OSC in phrasing the issue for the Green Line decision is also appropriate here -- 'the presumption that any action is permissible unless it can be demonstrated to be contrary to the public interest.' Therefore, even though [this model] is not likely to emerge as a viable *end result*, it has much to commend it as the *starting point* for the OSC deliberations.⁸¹

Among the alternative models for liberalizing capital access for firms in the securities industry Courchene thought that the McLeod scenario was located sufficiently close to the middle of the road as to be a viable compromise among the regulators and the industry.⁸² This scenario, it will be recalled, would permit the general public, non-residents, financial institutions and the banks, to hold equity positions in the firms up to specified limits (either in existing governing legislation or in new regulations) -- but not

⁸⁰ Tom Courchene, "A Really Secure Industry or a Real Securities Industry," 21-39.

⁸¹ Tom Courchene, "A Really Secure Industry or a Real Securities Industry," 52.

⁸² Tom Courchene, "A Really Secure Industry or a Real Securities Industry," 49-51.

up to majority ownership for an individual group. This proposal would govern the regulated sector, but the "exempt" sector regulations would continue to apply.

These changes were absolutely essential according to Courchene because

the nature of the markets for capital is rapidly changing. Technology is a driving force, so is the rapid integration of domestic markets into a global capital market. My underlying approach to this challenge is straightforward: *we must aim to be world class*. We stand to be passed by if we choose to become 'regional brokers' within an integrated world capital market. The regulatory process must accommodate, not frustrate, those who desire to grow and innovate both domestically and internationally.

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

Finally...In the present set of hearings it is clear that *competition is paramount*. This is not to say that one abandons concern with respect to the other legitimate rationales for regulation. Rather their role is to act as constraints in terms of how far and how fast one can achieve the paramount goal...Hence the issue is not one of whether one increases foreign investor access but rather by how much. Likewise investor protection must always be an important goal, but it is not the paramount goal this time around.⁸³

Counsels' Summations: Change vs. Less than the Status Quo

The difference in strategy between closing remarks of the Counsel to the JSIC and that of the Counsel to the OSC are as stark as the positions taken by Courchene and the mainstream dealers in the securities industry.

⁸³ Tom Courchene, "A Really Secure Industry or a Real Securities Industry," 53-54.

James Baillie, the JSICs Counsel, reiterated the timeworn arguments for protecting the preferred position of the indigenous firms. Indeed, Baillie appeared troubled by the position of the influential economists -- Courchene and the representatives of the Director of the Combines Investigation Act. He appeared concerned because "the economic models that were presented to [the Hearing] did not properly take into account how this securities industry is structured and what this industry is all about."⁸⁴ From Mr. Baillie's perspective only the SROs have the right answer -- and not only those directly associated with the securities industry. Mr. Baillie drew an analogy from the legal profession and it is important to quote that analogy so that what informs the industry's beliefs is apparent. Baillie asked the OSC Commissioners to

assume for a moment that you *gentlemen* are not the Ontario Securities Commission but you are addressed with a proposition that institutional investors are so sophisticated that lawyers, that people who are giving them legal advice, should not be fettered by these Law Society rules that say you have to pass a Bar examination and be articulated, and so forth; institutional investors are a sophisticated group and they should be able to get their legal advice where they look for it; and, if they are satisfied that somebody with a grade-school education can give them the legal advice they need, they should be allowed to get it there.⁸⁵

This is a rather narrowly based argument for the JSICs Counsel to put forward. It appears that from the purview of the legal profession not only are the views of economists not valid, they are not valid because they have not been sanctioned by a monopolistic or oligopolistic SRO. There is not a standardized test to sanction "reasonableness." Moreover, it appears that it is only the legal profession which properly understands social, business and legal structures. Other paradigms apparently have no standing in the eyes of the legal profession -- and thus they can be dismissed. The real point that Baillie failed to make, or omitted, was that the various disciplines, informed as they are by different paradigms must search out compromises. Indeed, Baillie suggested that the economists'

⁸⁴ James Baillie, Closing Comments before the Ontario Securities Commission, Securities Industry Review, 7 December 1984, Volume 14, 2086.

⁸⁵ James Baillie, Closing Comments before the Ontario Securities Commission, Securities Industry Review, 7 December 1984, Volume 14, 2087.

arguments were "just not relevant to the securities industry."⁸⁶ It was not surprising that the OSC, dominated as it was by legal professionals was unable to successfully employ economists for any reasonable length of time. "The two cultures think too differently."⁸⁷

However, the compromise which eluded Mr. Baillie, was sought out by the legal counsel to the OSC -- Mr. Waitzer -- in his closing remarks to the Commission. Indeed, Mr. Waitzer recognized the emerging trends -- globalization -- in the securities industry and the requirement for a change in the regulatory paradigm which had dominated the securities regulators up until this time.

Investor protection has been the historic mandate of the Commission. During the course of the meeting, a variety of investor protection concerns were raised. Some fell away, others became clearly unrelated to the main focus of the meeting or derivative in the sense that they are manageable, once the key issues are resolved by the Commission; and professionalism is probably a good example of that.

Competition and efficiency appears to be the emerging mandate for the Commission. I suppose the traditional regulatory focus was to mitigate competitive forces in order to preserve the structure of the financial markets; if anything, increasingly the aim is to increase competitive forces and let the structure adapt as efficiency requires.

...we could also urge caution in delegating competitive and efficiency-related issues to self-regulatory organizations. Unlike investor protection concerns, competitive and efficiency concerns raise real or perceived conflicts of interest and for that reason we recommend that the commission should deal with those issues, at least in the first instance...⁸⁸

Essentially the bottom line of Waitzer's comments echoed those of both the Director of the Combines Investigation Act and Tom Courchene. The Director's

⁸⁶ James Baillie, Closing Comments before the Ontario Securities Commission, Securities Industry Review, 7 December 1984, Volume 14, 2088.

⁸⁷ Observation made in confidential interview.

⁸⁸ Ed Waitzer, Closing Comments before the Ontario Securities Commission, Securities Industry Review, 10 December 1984, Volume 15, 2161-63.

arguments were derived from the "rational person" argument found frequently in the economics literature; Courchene's arguments were rooted in the questioning of the viability of the indigenous industry in a status quo environment. The OSC Counsel did not overtly define the key forces which pushed him to support a more market based system of exchange and competition in the industry. He noted

Essentially the Commission should avoid trying to create ideal models or ideal norms for the marketplace but rather allow firms the freedom to respond to market opportunities without restraint, except to the extent that where the relaxation of existing restraints or the failure to impose new regulation, might severely prejudice other regulatory objectives, the Commission is then faced with a balancing task.⁸⁹

Conclusion

It is interesting to reflect on the evidence presented to the Ontario Securities Commission at its Hearings on entry and Ownership. It is interesting because the substance of the evidence that was presented for its consideration -- the appreciative system -- had effectively not changed for almost seventeen years. The majority of the members of the domestic securities industry were working to protect its "monopoly" position and the accompanying rents, while the foreign-owned firms were struggling for recognition and a "level playing field" upon which to compete with the domestically owned firms.

The script for the Hearing was remarkably similar to that of the discount brokerage episode. The domestic industry was lined up on one side, the foreign owned firms (taking the place of the banks in this contest) on the other side, and the Director of Investigation and Research, a few academics and two indigenous firms, savaging the idea that the state should be supporting restrictive entry and ownership rules in the absence of a clear justification that such public policy was in the interests of the general public.

⁸⁹ Ed Waitzer, Closing Comments before the Ontario Securities Commission, Securities Industry Review, 10 December 1984, Volume 15, 2166.

The main difference in the scripting this time around was that the policy environment had changed. The existing environment, which had only been anticipated in the earlier episodes, was now a reality. The domestic industry was under pressure -- both in Canada and internationally. Moreover, this time around, the solidarity within the industry was continuing to erode and as well the industry elites began to see their influence within the policy community evaporate.

The OSC, on the other hand, gave the appearance of having learned the significance of the demand for liberalization of the entry and ownership regime over the years, but nonetheless was still constrained by the basic precepts surrounding the industry's structure that had been enunciated in 1972 -- the separation of functions within the financial services industry (the four pillars) and the requirement of majority Canadian ownership of the industry. Virtually all of the advice received by the OSC -- other than that from the indigenous industry participants -- took some account of these basic precepts, but on balance recommended that market forces and the public interest carry the preponderance of weight on the Commissions's final determination. This was influential advice, and the Chairman, Mr. Dey, whose sympathies lay with this side of the argument did not, as we shall see, ignore that advice in crafting his report.

CHAPTER TEN

A TIME FOR CHANGE: THE OSC REPORT AND THE DECISION

The Ingredients Shaping The OSC Decision

The Commission, in its deliberations,¹ attempted to fashion a balance between the wishes of the securities industry and the requirements of the users of capital and the services provided by the industry. Just as the OSC had done in 1982, when it concluded that chartered banks should be permitted to enter the discount brokerage business, the justification for its "new" position on entry and ownership would be rooted both in its perception of the public interest and in the precepts of the government's policy which had been enunciated in 1971.

In addition to Chairman Dey's overarching liberalization inclinations there were two overriding values which the Commission relied upon to shape its conclusions:

- (i) Ownership of securities firms must remain substantially Canadian. This policy dated back to Premier William Davis who pronounced on this subject in the spring of 1971; and,
- (ii) The financial system should be organized into four pillars, with each pillar providing a distinct service to its clients.²

¹ Ontario Securities Commission, "A Regulatory Framework for Entry Into and Ownership of the Ontario Securities Industry," A Report of the Ontario Securities Commission to the Minister of Consumer and Commercial Relations, February 1985.

² Ontario Securities Commission, "A Regulatory Framework for Entry....," February 1985, 12-13.

In fairness to the OSC, it should be noted that the "four pillars" provision of its overarching precepts were not totally within its control. That is to say, federal legislation surrounding the financial intermediaries, particularly the chartered banks, prohibited the full fledged participation of these institutions in the business of the securities industry -- either directly or through subsidiaries in Canada. However, it will be recalled that Quebec permitted ownership structures which were prohibited by federal legislation. This raised the question about just how far the Commission should be prepared to move from the industry's demands regarding entry and ownership.

With respect to the foreign ownership question, it is interesting to note that the federal government's April 1985 discussion paper did not make an issue of it; indeed, at the outset it stated that "the government proposes to leave the present rules unchanged."³ On the surface at least, the federal government appeared to be less concerned about the foreign ownership principle than was the Ontario government -- whose policies were rooted not only in a period when opposition to foreign ownership was a fashionable policy idea, but also when the prevailing public philosophy was one of protecting the indigenous securities industry from real market competition.

With respect to the issue of the public interest, and its influence on the character of the policies supplied by the OSC, the regulatory authority indicated in its Report that its involvement in the debate surrounding the separation of functions

...has been in pursuit of a definition of the public interest as it exercises its discretion to determine who can participate in the capital markets and on what terms. The Commission discharges this responsibility by expanding or contracting in appropriate circumstances the registration requirements and the conditions of registration in the Act.

Some have argued that in the exercise of its discretion, the Commission should construe the public interest with reference solely to investor protection concerns. Therefore, it is argued that the only criterion which should be applied by the Commission in determining who should

³ Department of Finance, "The Regulation of Canadian Financial Institutions: Proposals for Discussion," (Ottawa: Minister of Supply and Services Canada, April 1985), 5.

participate in the capital markets is investor protection. Based on this approach, it would be inappropriate for the Commission to contract the registration exemptions in order to extend the ownership restrictions into the exempt market for reasons other than investor protection reasons. However, others would argue that the Commission should take into account concerns about the extent of the involvement of financial institutions and non-residents in the capital markets regardless of investor protection considerations. This difference in approach requires some elaboration on the Commission's mandate.

The Commission does not believe that investor protection is its sole criterion in defining what is in the public interest. The Commission believes that its broad responsibility in regulating the capital markets is to create a regulatory environment which encourages the efficient functioning of the markets. The only limitation upon the Commission's discretion in achieving this environment is that the Commission should be mindful and cognizant of expressed Government policy, such as the policy of maintaining a substantially Canadian-owned securities industry. The regulatory environment is achieved through the administration of the Act, which involves the exercise of discretion in circumstances such as those referred to above, and through the development of amendments to the Regulations and the Act for consideration by the Government and the Legislature.

...the Commission wishes to emphasize that in achieving the efficient functioning of the market there is one constant, and that is an acceptable level of investor protection. It is obvious that investors make capital markets and if investors do not feel that they are being treated fairly in participating in the capital markets, the efficient functioning of the capital markets will be in jeopardy. Fair treatment of investors through an acceptable level of investor protection is the principal ingredient in achieving efficient markets. But efficient markets also turn on other factors. Obviously, there must be securities for investors to trade. Therefore, issuers must have confidence that the regulatory environment is balanced between the needs of investors and the needs of issuers to raise capital on reasonable terms.

The efficient functioning of the capital market also requires that both investors and issuers have confidence in market intermediaries...we believe that confidence in market intermediaries...turns on such considerations as who owns the market intermediary. To cite an obvious example, ownership

of a market intermediary by a financial institution might give rise to actual or perceived conflicts of interest which, unless properly regulated, could reflect negatively upon the industry structure and ultimately detract from the efficient functioning of the market. Who can own a market intermediary or who can set up a securities firm is therefore an important part of the regulatory framework for the capital markets.⁴

These are the ingredients which shaped the OSC's decision on the entry and ownership criteria for the Ontario securities industry. It is important to reemphasize that these criteria are rooted in policies which had protected the securities industry from the competitive forces of the international market place for some fifteen years and as a consequence it would not be surprising for the OSC to act in anything but an incremental fashion while at the same time trying to continue to supply policies favorable to the indigenous industry. Indeed, the OSC was afraid to anger the industry elites, and as a consequence its political masters, by moving in any manner but incrementally.⁵ The OSC thought that its recommendations had been taken in the context of a "free market" approach. That is, the OSC thought that its recommendations reflected the idea that the forces of competition should be the determining factors of who could act as a market intermediary, and that any restrictions imposed on market intermediaries were only those required to achieve the overarching public policy objectives.⁶ The OSC was of the view that its recommendations, outlined below, would provide adequate access to capital. The general thrust of the recommendations was that the restrictions then in place were unnecessarily limiting, and a relaxation of them was appropriate -- except for those applying to the exempt market.

The key provisions of the entry and ownership regulatory model proposed by the OSC were as follows:

- (i) Non-residents, including any individual non-resident may own up to 30 percent of an Ontario registered firm providing that there is one industry investor -- or a

⁴ Ontario Securities Commission, "A Regulatory Framework for Entry....," February 1985, 20-23.

⁵ An observation based on confidential interviews.

⁶ Ontario Securities Commission, "A Regulatory Framework for Entry....," February 1985, 25.

group of industry investors voting as a block -- who owns in excess of 50 percent of the firm. If the latter provision is not present, then foreign ownership would be limited to a 10 percent share.

- (ii) Wholly owned subsidiaries of offshore securities dealers would be permitted to register in Ontario as full service dealers. However, firms in this category could not have capital in excess of 1.5 percent of the total capital of the industry. Moreover, the total capital of all of the firms in this "foreign dealer" category (including the grandfathered firms already operating in Ontario) could not exceed 30 percent of the total capital of the industry. According to the assumptions contained in the OSC Report, this provision could result in the establishment of 15 foreign owned firms in Canada each with about \$15 million of capital.⁷
- (iii) Financial institutions would be permitted to own securities dealers according to rules which parallel those for non-resident investment in Canadian firms. Thus, a financial institution could own up to 30 percent of a securities firm subject to the limitations of the 50 percent - 10 percent "rule" outlined above for non-residents.
- (iv) The exempt category for institutions and for transactions in excess of \$97,000 would be removed. Only firms registered in Ontario would be permitted to act as underwriters and full service brokers -- although trading in government securities would continue to be exempt from OSC regulation.
- (v) Non-resident owned firms who wished to distribute Canadian securities outside Canada would not have to be registered and thus would not be regulated in Canada.
- (vi) Non-resident owned firms facilitating the raising of funds outside Canada would not be required to register in Ontario.

⁷ The OSC Report assumed that the capital of resident firms was about \$700 million and that the foreign owned dealers would utilize the maximum that would be permitted to them. In such a circumstance industry capital would be about \$1 billion, of which \$300 million would be available to the foreign owned dealers. Each foreign owned firm could have \$15 million in capital. Ontario Securities Commission, "A Regulatory Framework for Entry...", February 1985, 28. Ontario Securities Commission, Press Release, 18 February 1985.

Before evaluating the proposal put forward by the OSC it is useful to briefly compare its regulatory model with that advocated by the JSIC. With respect to non-resident participation in the Ontario securities industry, the industry committee wanted to retain the 10/25 rule. In the case of direct entry of foreign owned firms into the Canadian market, there was nothing in the JSIC proposals which would facilitate such activity. Indeed, the JSIC wanted to maintain the existing restraints on capital growth for the grandfathered firms. In the case of the equity participation of financial institutions in the securities industry -- especially the chartered banks -- the JSIC proposed that no individual non-industry investor could own more than 10 percent of a firm and at least 40 percent of the directors of the firm must be industry members. In relation to the exempt market provisions, the JSIC advocated their elimination, which because of the ownership requirements in the SROs, would have effectively eliminated any possibility of effective non-resident participation in the Ontario securities industry.

The Rationale Behind the OSCs Recommendations

To the OSCs credit there was an important recognition that the policy environment had changed since the overarching issues of entry and ownership had been seriously examined in 1972 following the fall-out from the Moore Report. Nonetheless, the Commission continued to operate at a disadvantage with respect to the information and analysis about the securities industry which was available to it. Indeed, members of the JSIC, during this period, acknowledged that the industry had such a monopoly -- although it was not adequately understood by the Committee that such a condition was an important component in the industry's arsenal which allowed it to capture the provincial regulatory authority.⁸ As a consequence, the OSC could not supply policies which were *fundamentally* different from those already in place.

The precepts of the public interest, the globalization of financial markets, and the threats from the more liberal environment in Quebec were the key factors which led the OSC to provide recommendations to the provincial government which -- along the decision continuum from the status quo to fundamental change -- could be seen as only an

⁸ Based on confidential interviews.

incremental shift in its policy stance. It is not to suggest that incremental change should be judged in a negative fashion. However, in this situation, with the policy environment having already changed fundamentally, the effects of an incremental supply of policy could be deleterious to the social welfare. The OSC, however, felt constrained by political considerations to only act incrementally. On its own, it would have recommended more dramatic changes to the entry and ownership apparatus.⁹

The OSC acknowledged this phenomenon of incrementalism on a number of occasions in its Report:

- (i) On the issue of non-resident participation in the Canadian capital markets the OSC notes that the 30 percent level was "cautious"¹⁰ and that its "position is not materially different from the industry's position."¹¹
- (ii) On the issue of direct entry by non-resident firms the OSC acknowledged that its "model is the cautious approach."¹² Indeed, the Commissioners stated such quite clearly -- but in conditional terms reflecting their uncertainty about how...

We think that it might be possible for all restrictions on new entrants to be dropped without impairing the ability of the domestic industry to thrive and remain substantially Canadian. However, we have chosen to proceed incrementally and cautiously in relaxing the restrictions on direct entrants. While the 30% investment provision addressed the needs of existing firms to have access to fresh capital and fresh ideas, the direct entry provisions address the needs of the marketplace to be more open to the capital markets outside Canada and to be exposed to more diverse investment opportunities which will come as a result of the commitment of new capital and new expertise to the marketplace.¹³

⁹ Based on confidential interviews.

¹⁰ Ontario Securities Commission, "A Regulatory Framework for Entry....," February 1985, 40.

¹¹ Ontario Securities Commission, "A Regulatory Framework for Entry....," February 1985, 40.

¹² Ontario Securities Commission, "A Regulatory Framework for Entry....," February 1985, 40.

¹³ Ontario Securities Commission, "A Regulatory Framework for Entry....," February 1985, 43.

In adopting this approach on direct entry, the OSC indicated that its model mirrored the federal Bank Act "which allows a limited number of foreign-owned banks to carry on business in Canada, each with a limit on capital."¹⁴ However, the OSC failed to indicate that Canadian banks were already world class institutions in terms of size, competitive ability and sophistication. Indeed, there was no need for the federal government to insulate these indigenous institutions from foreign competition. The same, however, could not be said of the securities industry. The OSC's reasoning was not well founded -- but the analogy was convenient for its argumentation and for its incremental approach.

The Industry Stumbles on an Unsuspecting Champion

The OSC's incremental approach was supported by the Ontario Task Force on Financial Institutions,¹⁵ whose final report was published in December 1985. The Task Force, under the Chairmanship of Professor Stefan Dupre, suggested that the 30 percent foreign participation in the domestic industry, recommended by the OSC, was perhaps too large a share to start with. Tom Kierans, in an appearance before the Task Force suggested that the industry could "live" with that recommendation, but perhaps 15 percent might be a better place to start.¹⁶ More generally, the tenor of the sections of the Task Force Report dealing with the securities industry seemed to reflect an era that had long since past. The Task Force seemed to suffer from the same innocence and unstudied naivete as the OSC. On this point the Task Force was sympathetic to Kierans musings and noted that

Such apprehensions in our view, are not to be dismissed as mere expressions of narrow self-interest. The capacity of the domestic industry to withstand competition from foreign entrants is a basic consideration in the conduct of international relations. When that industry is the securities

¹⁴ Ontario Securities Commission, "A Regulatory Framework for Entry...", February 1985, 43.

¹⁵ The mandate of the Task Force was "to examine the organization and operation of financial institutions in Ontario and determine what pressures on the financial system may require attention from the government. Ontario Task Force on Financial Institutions, Final Report: A Report to the Honorable Monte Kwinter, Minister of Consumer and Commercial Relations (Toronto: December 1985), 1

¹⁶ Ontario Task Force on Financial Institutions, Final Report, 110.

industry, great weight must be attached to the fact that there exists a formal declaration of policy that this industry must have domestic capacity to meet Canadian needs.¹⁷

The Task Force provided no supporting arguments for its position other than the fact that an industry participant suggested that a less "profound" participation by foreigners in the domestic market would be more desirable than a more "profound" participation. It is interesting that the Task Force relied on Tom Kierans as the advocate for such a compromise when all along he had been a maverick within the industry advocating a more open regulatory regime. Indeed, Kierans' firm, McLeod, Young, Weir had supported the conclusions of the OSC Report. Nonetheless, the Task Force opted for a 20 percent maximum threshold level of investment for non-industry investors in domestic securities firms -- including non-residents.

The Task Force seemed especially concerned that the entry of banks into the industry, to the extent of a 30 percent participation, could have the effect of driving the structure of the Canadian financial system towards the universal bank model. The Task Force was fearful that a universal banking system could lead to underdeveloped financial markets. Unfortunately, the Task Force relied on the German model to draw its conclusions rather than making the distinction between credit and market base financial systems. The German financial system was one rooted on a credit system administered by commercial bank hierarchies,¹⁸ while the Canadian system was rooted in market hierarchies. It was unlikely that a market based system could regress to a credit based system. Indeed, the evidence suggests that a credit based system such as the one in Germany is converging a the market based system.

Where the Task Force had a contribution to make was in highlighting the linkage between the decisions which the Ontario Government had to make about entry and ownership in the securities industry and the free trade negotiations with the US. The Task Force suggested that

¹⁷ Ontario Task Force on Financial Institutions, 110.

¹⁸ See John Zysman, Government Markets and Growth for a discussion of alternative mappings of financial system organizations.

it would not be in the interests of Canada to make voluntary concessions as to foreign entry when talks are being proposed on enhanced trade in services. It is unlikely that any voluntary concessions would give Canada a better bargaining position at such talks. Pending the necessary deliberations, any changes in existing policy with respect to foreign entry should be held in abeyance.¹⁹

As will be discerned below, the Ontario Government chose to ignore this "bit" of advice.

The Industry Reaction to the OSC Decision

Not surprisingly, the Canadian members of the domestic securities industry did not rejoice when the OSC published its recommendations in the winter of 1985. The successor Committee to the JSIC -- the Securities Industry Capital Markets Committee (SICMC) -- released its "quick" assessment²⁰ of the OSC Report on February 19, 1985, just one day after the OSC submitted its report to the Minister of Consumer and Commercial Relations. The SICMC found much to object to in the Report, but unfortunately its criticism of the regulatory model put aside all the known benefits of a developed financial structure in favor of yet again self-serving and self-interest seeking reasons.

The SICMC's critique of the recommendation focussed on two broad points:

- the consequences of the participation of financial institutions in the securities business; and,
- the impact of non-industry ownership on the securities industry.

First, in the case of the participation of financial institutions, the Committee was concerned that if the institutions captured more of the financial intermediation business than they already had, the efficiency of the financial markets would be reduced. That was not valid for the reasons noted in the discussion of the Task Force Report above. More

¹⁹ Ontario Task Force on Financial Institutions, 110.

²⁰ Securities Industry Capital Markets Committee, "Recent Developments in the Securities Industry in Ontario," 19 February 1985.

precisely, the SICMC was concerned that its "power," broadly defined, would diminish with the involvement of the banks in the securities business. *Second*, the Committee asserted that intermediation through financial institutions muffles monetary policy. That is, to the extent that institutions do not trade in financial markets, the markets will become illiquid. However, the money market is deep and liquid in Canada, and it is through that channel that monetary policy manifests its cutting edge as major financial institutions make the necessary liquidity adjustments to their portfolios in the market. The SICMC then contradicts itself by suggesting that intermediation through financial institutions contributes to market volatility as institutions attempt to maximize returns. *Third*, the Committee cited the well worn but fallacious rationale that the participation of financial institutions in the business of market intermediaries would encourage concentration and therefore enhance the economic consequences of institutional default. The lack of credibility of this critique further undermined the legitimacy of the indigenous industry's argumentation.

The critique of the proposal to enhance participation of non-industry investors in the securities business was not new. As was pointed out in an earlier chapter, the blurring of the four pillars model can result in amplification of the scope for conflicts of interest. The SICMC was concerned that the participation of non-industry investors would further heighten the prospects for conflicts of interest because *first*, financial intermediaries already offer a range of alternative financial services to clients, and *second*, non-financial corporations with dealer affiliates who raise funds in the securities markets for their parent could be in a compromising position.²¹

While these criticisms may have been valid, the Committee suggested no means of overcoming this potential threat. The regulatory literature, however, is replete with suggestions for "Chinese Walls," arms length dealings, and such. Once again, it was not in the interests of the industry to propose solutions which would ultimately diminish or eliminate the value of its rents.

²¹ Securities Industry Capital Markets Committee, "Recent Developments in the Securities Industry in Ontario," 19 February 1985, 5.

Finally, the Committee was concerned, perhaps "panicky,"²² about the prospects of foreign based firms entering the Canadian marketplace. The SICMC attempted to argue that the presence of foreign based firms would diminish competition in the Canadian securities industry and not enhance it because foreigners would take over Canadian firms thus increasing concentration in the industry. The logic of that argument, even to the extent that the takeovers occur, is not obvious because the foreigners would only replace the domestically owned firms. The number of firms in the industry would remain the same. To the extent that the new firms are better capitalized, competition in Canada would likely expand, and not likely contract. It was not apparent that enhanced concentration of activity in the market, if it occurred, would necessarily impinge on market efficiency.²³

To this critique, the IDA added its concern that the OSC would be assuming a large discretionary role for itself²⁴ -- thus blunting the power of the SROs. It was not fair, according to the IDA, for the OSC to assume that it could manage such a complicated national system. The IDA suggested the need for a national securities regulator.²⁵ Generally, these ideas were clearly not sufficiently developed -- but plainly symptomatic of the industry witnessing the erosion of its power.

The SICMCs use of the public interest paradigm to support its critique of the OSCs Report was mirrored by a number of prominent individual members of the securities industry. For example, J. Christopher Barron, Chairman of Cassels Blaikie & Co. Limited in commenting on the proposed 30 percent participation of foreigners in domestic firms, noted that

²² A term used by many individuals in the course of confidential interviews.

²³ In retrospect that turned out not to be the case. Canadian capital markets are among the most liquid and efficient in the OECD area.

²⁴ Kniewasser did not elaborate on this point, but presumably he was referring to the OSCs potential power to control entry and foreign ownership in the securities industry -- powers it did not hold at the time. The SROs were the regulators of these matters. See Allan Robinson, "OSC plan would bring power," Globe and Mail, 19 February 1985, B13.

²⁵ A.G. Kniewasser, "A Preliminary Analysis of the Ontario Securities Commission Report," Investment Dealers Association of Canada, 22 February 1985, 2.

It is my opinion that the 30% will be an adequate holding to influence control of member firms. This will lead to member firms making decisions which are not necessarily as biased toward the Canadian interest as would have been the case previously. I also suspect that the consultative role which member firms have held in relation to provincial and federal governments will be significantly diminished since in the eyes of those governments that large ownership will be representative of a pipeline to foreign investors or institutional holders.²⁶

First, it is indeed a fallacious argument for a member of the securities industry to suggest that industry participants put the national interest above their own interests -- especially above their potential profits. It has never been the case that the members of industry put the national/public interest ahead of their own or their clients' interests (except perhaps in wartime -- and even that can be debated). *Second*, the provinces and the federal government value their contacts with members of the off-shore industry. The provinces had conducted much of their market borrowings in the foreign markets and the advice and contacts for which the large foreign owned firms were well known was seen as valuable by these borrowers. Indeed, the contacts with the big institutional investors were important to sovereign borrowers because it was in those portfolios where an important part of the debt of the provinces and central government was lodged.

Barron went on to say that the foreign owned firms

will all arrive on the scene simultaneously in order to obtain access through the limited capital total and thus we will have a dramatic effect on the salaries and structure of the existing industry...the impact of 20 firms setting up business in Canada will be awesome.²⁷

The tone of Mr. Barron's memorandum suggested that there was a certain disbelief within the industry that the regulators, with the concurrence of the government, could be

²⁶ J. Christopher Barron, Inter Office Memorandum, "Ontario Securities Commission Proposals Regarding Entry and Ownership in the Ontario Securities Industry," Cassels Blaikie & Company Limited, 22 February 1985, 1.

²⁷ J. Christopher Barron, Inter Office Memorandum, "Ontario Securities Commission Proposals Regarding Entry and Ownership in the Ontario Securities Industry," Cassels Blaikie & Company Limited, 22 February 1985, 2.

acting contrary to the perceived interests of the industry. Indeed, Baron concluded his note by observing that "one might suspect that the Ontario Government would be sympathetic and anxious at this time to be seen to be taking decisive action, at least in this area."²⁸

Francis B. Lamont, the Deputy Chairman of Richardson Greenshields of Canada Limited, in his assessment of the OSC Report suggested that

The logical result of the Commission's recommendations is thus to open the Canadian Industry to unlimited competition for clients and resources from foreign firms, while restricting capital sources for Canadian firms only, and this result is clearly unsatisfactory. One reasonable alternative is to adopt in broad measure the recommendations of the Joint Industry Committee (The Medland Committee) made to the Commission in the course of its hearings. The second alternative would be to remove all capital restrictions (other than those relating to integrity and competence) so that existing Canadian firms could compete fairly for capital and protect their position from predatory practices. The former alternative has the advantage that it would promote the potential role of other Canadian financial institutions to evolve rather than to expose the investment industry to foreign participation only.²⁹

There were virtually no flattering remarks for the OSC Report from any corner of the industry. James Pitblado, Chairman of the SICMC noted that "It's a massive change to the structure of the industry...It's a little bit like slow death." Phillip Holtby, President of Midland Doherty described "the existence of a voting trust in a public company as a joke."³⁰

On the other hand, the users of the capital markets, the banks and some foreign owned dealers were satisfied with the progress suggested in the Report.³¹ Salomon Brothers indicated that the "OSC had been very constructive,"³² while Jeffrey Lane, vice-

²⁸ J. Christopher Barron, Inter Office Memorandum, "Ontario Securities Commission Proposals Regarding Entry and Ownership in the Ontario Securities Industry," Cassels Blaikie & Company Limited, 22 February 1985, 2.

²⁹ Francis B. Lamont, Deputy Chairman & Director, Richardson Greenshields of Canada Limited, "Response to Ontario Securities Commission Report," 11 April 1985, 4.

³⁰ Allan Robinson, "Reaction is muted to OSC plan," Globe and Mail, 20 February 1985, B6.

chairman and chief operating officer at Shearson Lehman Brothers in New York, and at the time a ten per cent owner of McLeod Young Weir, suggested that the proposed changes to the entry and ownership rules "wouldn't cause everyone to jump." The Report was seen "as an interim measure that will bridge the way to a free-market approach."³³

Finally, Gordon Capital, the company which had precipitated the OSC Study in the first instance, was split on its opinion of the Report. Donald Coxe, the firm's Director of Research said that "We think it's a very courageous document. The Canadian financial industry is world class and the viability of world centers is related to their openness."³⁴ On the other hand, Neil Baker, a director of Gordon Capital suggested that the proposals would "wreak havoc on the industry...This may be an appropriate policy for the 1990s, when the entire industry has grown to sufficient status to compete effectively with both the domestic and international competition. [We] favor a middle of the road approach to foreign ownership -- somewhere between the position of the OSC and the securities committee."³⁵

Paul Guy, the chairman of the Quebec Securities Commission, indicated the proposed rules were "a step in the right direction."³⁶ Quebec, it will be recalled, was already several steps ahead of Ontario in deregulating the entry and ownership requirements in its own securities industry.

³¹ Barry Critchley and Sonita Horvitch, "Moving to loosen securities reins," Financial Post, 23 February 1985, 1-2.

³² Barry Critchley, "Foreign firms are looking at us," Financial Post, 2 March 1985, 3.

³³ Andrea Gordon, "OSC report opens the door wider," Financial Times of Canada, 25 February 1985, 11.

³⁴ Allan Robinson, "Lobbyists choose sides on bid to open the securities industry," Globe and Mail, 11 March 1985, B1.

³⁵ Dennis Slocum, "Havoc seen from OSC proposal," Globe and Mail, 30 May 1985, B6.

³⁶ John Soganich, "OSC blueprint makes some see red," Financial Post, 2 March 1985, 3.

The Industry Escalates the Pressure on the Government

The SICMC consolidated its objection to the OSC Report in a letter to Premier Frank Miller on May 14, 1985. The letter contained no new arguments with respect to the industry's position -- that of protecting its "monopoly" status in order to preserve the public interest. The SICMC noted in part that

If implemented, the OSCs recommendations will inevitably result in the de-Canadianization of the domestic securities industry and a consequent loss of influence and control over the domestic financial market. The proposed rules jeopardize the independence and integrity of the securities industry by creating a regulatory environment which would compel securities firms to shop for alliances with financial institutions, corporate conglomerates and others who have not made a full-time professional commitment to the industry. This, in turn, could lead to a greater institutionalization of the securities markets and a concomitant reduction in the efficiency and liquidity of our secondary markets. Moreover, the OSCs proposals legitimize the activities of unregulated dealers, thereby exposing investors to unnecessary risks and exposing the capital market to the problems of investor confidence inherent in active participation by organizations that are not subject to regulatory oversight and control. We are convinced that the system which would emerge would undermine important public policies and would fail to be responsive to the interests of the Canadian public.

We therefore, urge the Premier to:

- forgo any action on the OSCs recommendations relating to direct foreign entry and increased ownership of securities firms by non-residents, financial institutions and other non-industry investors;
- recommend to Cabinet the immediate enactment of regulations adopting the domestic non-industry ownership rules established by the self-regulatory organizations, as amended by the recommendations of the JSIC; and
- recommend to Cabinet the immediate enactment of regulations imposing a universal registration requirement on all organizations engaging in market intermediation activities in Ontario.³⁷

Thus just as the industry had done during and immediately after the preparation of the Moore Committee Report some sixteen years earlier, it argued for the preservation of its special position in the Canadian securities market. The factors it argued against -- for example, the institutionalization of the financial markets -- were just what was required to make Canadian market intermediaries and markets more viable. The industry seemed to discount persistently the dramatic changes that were occurring across global capital markets. Only in retrospect was it apparent that the changes that would come about were a natural evolution and indeed, Canadian capital markets would acquire the efficiency and liquidity from the structural changes which the indigenous industry opposed. The Canadian market intermediaries would be pulled along the changing path -- to accommodate the requirements of the global capital market participants, especially the Americans -- whether they agreed with the changes or not. The "real" question was: would state autonomy be sufficient to implement the required changes -- changes which would be in the long-term interest of the industry itself?

The Commission's rebuttal to all this rhetoric was summarized in Peter Dey's comment: "There is a mood in the commission that our industry should participate in the internationalization of the capital markets. We think the restrictions on non-resident investment in Canadian firms are too strict."³⁸ Period. Moreover, there was a desire within the leadership of the Commission to ensure that Toronto remained a viable financial center.³⁹

Another Impulse for Change: A New Chairman of the OSC

At about the time that the SICMC delivered its letter of "complaint" to Premier Miller the provincial government was completing the arrangements to appoint Stanley Beck as Chairman of the OSC to replace the retiring Chairman Peter Dey -- under whose

³⁷ James B. Pitblado, Chairman of the Securities Industry Capital Markets Committee, "Letter to the Honorable Frank S. Miller, Premier and President of the Council, Government of Ontario," Toronto, 14 May 1985, 14-15.

³⁸ Barry Critchley and Sonita Horvitch, "Moving to loosen securities reins," Financial Post, 23 February 1985, 1-2.

³⁹ Based on a confidential interview.

leadership the OSC Report had been written. Mr. Beck was formerly Dean of the Osgoode Hall Law School and had been a part-time Commissioner at the OSC for ten years.⁴⁰ In his very first comment on the OSC proposals, Beck stated that "I don't regard our report as chiselled in stone, it's a matter for debate. I think there is going to be some opening up, it's just a question of how much and with what controls."⁴¹

Shortly after his appointment as Chairman of the OSC, Stanley Beck made his first public address to the Joint Meeting of the Business Law and Real Property Law Subsection of the Canadian Bar Association. The topic of Mr. Beck's speech was "the changing nature of our Canadian financial system and some of the proposals for change."⁴² In this talk Beck provided a thorough discussion of the internationalization of capital markets which had been evolving in recent years, and outlined the scope of the deregulation of capital markets which had already taken place in the major financial centers of the world -- particularly London and New York. He bemoaned the fact that the Canadian investment dealers had not been full participants in this process and underscored the potential negative consequences of this development. Indeed, there was nothing really new in this element of Mr. Beck's remarks, but more substantive, from a public policy perspective, was his diagnosis of the reasons for the relative decline -- in a global context - of the Canadian industry. Mr. Beck noted

...in short, securities dealers registered in Ontario are protected from both foreign and domestic non-industry ownership by regulations under the Securities Act and the rules and regulations of the self-regulatory organizations, primarily the Toronto Stock Exchange and the Investment Dealers Association of Canada.⁴³

⁴⁰ Andrea Gordon, "The tough job facing Stanley Beck," Financial Times of Canada, 20 May 1985, 12.

⁴¹ Andrea Gordon, "The tough job facing Stanley Beck," Financial Times of Canada, 20 May 1985, 12.

⁴² Stanley Beck, Chairman of the Ontario Securities Commission, "Remarks to the Joint Meeting of the Business Law Subsection and the Real Property Law Subsection of the Canadian Bar Association," 12, June 1985, 1.

⁴³ Stanley Beck, "Remarks to the Joint Meeting..." 12 June 1985, 9.

That Canada has been well served by its capital markets is, to me, unquestionable...that the pace of change is dramatic, and that we are truly moving towards international capital markets with international trading, international distribution and international regulation.

The central question to me is, what will best facilitate Canadian participation in these international markets while, at the same time, best serving the needs of domestic issuers and investors?

In my respectful opinion, the [SICMC] Committee's response to the OSC Report fails to take account of these broader questions.

The Committee's preferred position, so far from looking outward to the reality of today's capital markets, would result in a turning inward of the securities industry, with a move towards greater regulation and protection.

Surely that cannot be the right prescription for the reality of today's and tomorrow's capital markets.⁴⁴

...one would think that the demands of dealing in the international market, the high cost requirements of technology and expansion, and the rising use of bought deals, will all require a greater capital base in the future.

The capital base is clearly adequate for a few in the industry, but whether it is adequate for the industry as a whole, or adequate to move the industry into the global markets of the future, is a real question.⁴⁵

In any event, capital adequacy, as such, ought not to be the issue. As Thomas Courchene has noted, it is not the role of a regulatory authority to implement policy on capital access on the basis of the owners' notion of capital adequacy.

Regulatory policy ought to be to allow maximum capital access, or maximum availability of capital, subject only to any overriding public interest -- in this case, majority Canadian ownership.

⁴⁴ Stanley Beck, "Remarks to the Joint Meeting..." 12, June 1985, 15.

⁴⁵ Stanley Beck, "Remarks to the Joint Meeting..." 12, June 1985, 16.

I would argue that the Canadian securities industry is smaller, less well capitalized and more parochial than would otherwise have been the case if it had operated in a more open internationally competitive environment.⁴⁶

Canadian investment dealers should occupy a more significant place in international markets than is currently the case.

It is arguable that internal protection and the benefits it has brought to the industry, have hampered external growth and development. There has not been an impetus to expand and seek markets beyond the protected market.⁴⁷

From a public policy perspective there is little that is obscure about the character of policy that Mr. Beck would supply. Mr. Beck can be seen as the first OSC policy entrepreneur in the matter of ownership and entry in the investment dealer industry. Indeed, over the fifteen year period which we have reviewed, Mr. Beck was the only OSC Chairman to publicly take an unequivocal stand on the costs and benefits of past public policy vis-a-vis entry and ownership in the Canadian securities industry -- although his predecessor had similar predilections. The basic impetus for change (liberalization) in the regulations surrounding the industry, from Beck's perspective, was that the industry was being threatened. In the past, a small group of powerful industry elites had successfully influenced the state to provide protective policies to the industry.⁴⁸ In short, in the past the state did not want to pick a fight with the industry because the OSCs capacity to analyze the consequences of a different set of regulatory policies was clearly inadequate to challenge these industry elites who were advising the very highest levels of the provincial Conservative government.⁴⁹ The election of a Liberal provincial government in 1985, however, altered the structure and channels of influence with respect to public policy surrounding the securities industry.

⁴⁶ Stanley Beck, "Remarks to the Joint Meeting..." 12, June 1985, 17.

⁴⁷ Stanley Beck, "Remarks to the Joint Meeting..." 12, June 1985, 19.

⁴⁸ Based on a confidential interview.

⁴⁹ Based on a confidential interview.

Mr. Beck reiterated his views in October when he addressed the Ontario District Council of the IDA. On that occasion he noted that his involvement with the securities industry in the period since he became OSC Chairman had "served to strengthen my belief that some opening in the Canadian industry is essential to its future health and vitality."⁵⁰ He went on to explain that

we live in a new global financial environment driven by technology, institutionalization of savings, increased volatility and a free market culture. It is an environment that is almost totally different from the segmented, regulated and protected environment that partially characterizes the Canadian scene.

I appreciate that Toronto is not New York, London or Tokyo and that we are not a major international financial centre. But we are a major financial centre, and the centre of one of the world's most efficient and highly developed capital markets. In my view, it is essential that there be a measured opening of our markets to foreign entry and domestic financial institutions.

...The task before us all is to allow for an opening that will permit Toronto to maintain its rightful place at the top of the tier behind the New York/London/Tokyo axis, and to progress as a dynamic and innovative capital market. I firmly believe that this can be done within the spirit of the OSC industry report, while maintaining an essentially Canadian-controlled securities industry in the service of the Canadian economy.⁵¹

Mr. Beck, in his first six months as Chairman of the OSC had instituted a major reorganization of this regulatory body in order that it be much better placed, than in the past, to deal effectively with the challenges facing the Canadian securities dealers. Indeed, in a response to a quote from Galbraith regarding the "life cycle" of regulatory agencies which suggested that the OSC should now be in the arms of the securities industry (essentially the Bernstein thesis) Beck suggested that "the Commission has never been

⁵⁰ Stanley Beck, Chairman of the Ontario Securities Commission, "Remarks to the Annual Dinner Meeting of the Ontario District Council of the Investment Dealers Association of Canada," 30 October 1985, 10.

⁵¹ Stanley Beck, "Remarks to the Annual Dinner Meeting..." 30 October 1985, 11.

more vigorous, has never been as well staffed, nor had a surer sense of the problem and challenges facing it than it does today"⁵² thus suggesting that the OSC had moved along the continuum from capture to independence -- contrary to what would have been predicted by Bernstein "life cycle/capture" thesis.

Regarding the OSCs low level or nonexistent capacity to understand and analyze the changes that had been taking place in both the structure of the industry and the capital markets, Mr. Beck confirmed that

We have hired within the last two months our first Economist, and I am hopeful of creating a new Division of Capital Markets of which economic and policy analysis will be a central part. A Capital Markets Division is, in my view, essential to the future operations of the Commission, given the rapid pace of change in financial services -- we must have greater internal ability to understand what is going on around us. Within the Division, we intend to add a Market Regulation capacity, something the OSC has always lacked. We require the capacity to monitor Exchange and Dealer operations and to make decisions as to the appropriate regulatory stance in the face of the internationalization of markets and twenty-four hour global trading.⁵³

Mr. Beck's forward looking vision of the securities industry and capital markets were repeated again in November when he spoke to the University of Western Ontario Business School Club of Toronto. Much of relevance in his remarks were initially made public in May, but he concluded his talk on this occasion with a sense of frustration.

The changes that are taking place in our capital markets call for realistic assessment and imaginative solutions. The system has had enough reports and prescriptions for renovation. While governments ponder, economic reality continues to forge change. It is time to recognize that reality and to fashion a co-operative regulatory structure in support of a national financial system.⁵⁴

⁵² Stanley Beck, "Remarks to the Annual Dinner Meeting..." 30 October 1985, 1.

⁵³ Stanley Beck, "Remarks to the Annual Dinner Meeting..." 30 October 1985, 2.

⁵⁴ Stanley Beck, Chairman of the Ontario Securities Commission, Remarks to the Western Business School Club of Toronto, "The Evolving Nature of Canada's Capital Markets," 21 November 1985, 25.

Working Behind the Scenes at the Bank of Nova Scotia⁵⁵

While Stanley Beck was preaching the merits of competition and openness for the Canadian securities industry, the Bank of Nova Scotia (BNS) had quietly established a Government Relations Department to address the pressing public policy issues with which the BNS was confronted. The group was headed by senior bank personnel, and included a future president of the Canadian Bankers Association.

The first research task undertaken in this department was a study of the services that chartered banks in Canada "should" be able to offer their customers. While the examination was generic, it was looking at the issues from the perspective of the BNS so that recommendations could be made to the bank's management committee. The upshot of this study, which included direct surveys of the bank's client base, was that there was great demand for "one stop shopping" by the customers of the financial services industry. For the BNS this meant that there was a need to obtain the powers of trust companies, mutual funds and investment dealers. Indeed, in the face of an aging population, the BNS had to enhance its presence in the retail sector of the financial services market. Moreover, during this period the bank's customers were already purchasing Government of Canada Treasury Bills from the BNS branches, and the bank was introducing tiered savings accounts.⁵⁶

On the corporate side of the bank's business, the large US dealers, such as Goldman, Lehman and Salomon, operating in the exempt securities market, were whittling away at the BNS's corporate loan business. In addition, the European universal banks were also providing a good deal of competition to the bank.

Concurrent with this enhanced level of competition, the banks generally were saddled with the developing country (LDC) debt problem. This was a drag on their balance sheets. Thus, the BNS concluded that it must enhance its powers if it was to

⁵⁵ The contents of this section are based primarily on confidential interviews.

⁵⁶ With a tiered savings account, the rate of interest earned depended on the amount on deposit with the bank. This, plus the treasury bill purchases were a symptom of enhanced sophistication of the retail customer.

strengthen both its balance sheet and income flow. The BNS decided it would find a way to get into the securities business.

Secretly, then, the BNS began to develop plans to open a full service brokerage firm in Quebec -- where entry rules, as noted earlier, had already been liberalized. The Chairman of the OSC, Mr. Beck, and Minister of Financial Institutions, Mr. Kwinter, continued on the path to liberalize the entry and ownership provisions in Ontario.

Decision I: The First Slice⁵⁷

Given the numerous cross-currents at work during this period: the high profile stance taken by Stanley Beck with respect to the need for reform of the regulatory framework surrounding entry and ownership of the Canadian securities industry; the threats to the legitimacy and survival of indigenous Ontario industry in the absence of change⁵⁸; and, in the face of the globalization of financial markets, it became apparent that the elites of the industry were losing their influence within the government of Ontario.

The new Liberal government wanted to ensure that the capital market in Toronto remained vital and prosperous and thus Mr. Beck was not acting without the concurrence of Mr. Kwinter. Indeed, together, the Chairman and the Minister⁵⁹ had visited the world's major financial centers in order to convince themselves that a liberalization of the entry and ownership requirements in Ontario was the proper course to follow. Both officials, having consulted with the largest securities firms in Tokyo, London and New York, were convinced that unless Canadian firms increased their capitalization Toronto would become a "backwater" in financial world circles. In this regard, it should be stressed that at the political level, the driving force for change was the perceived need to ensure that Toronto

⁵⁷ The most important portions of the discussion in this section are based on confidential interviews.

⁵⁸ Premier David Peterson had expressed some concern to Stanley Beck that many key Ontario firms would move their Head Offices to Montreal in the absence of a concerted liberalization in Ontario. Mr. Beck never thought that this threat was great -- but it was persistently lingering in the background.

⁵⁹ The Minister was another policy entrepreneur who quickly learned the benefits of an open and competitive securities industry versus the cost of a status quo policy on entry and ownership.

maintained its position as an important financial center. For the politician this meant preserving the employment and capital investment associated with the securities industry. It also meant that those firms who would be allowed to enter the industry would have to have deep pockets. For the Minister and the OSC Chairman, this meant that the banks would have to be given access to the securities business. Moreover, the Ontario officials, aware as they were of the lengthy period of time the federal government already had been studying and debating financial services reform, were convinced in their own minds that the federal government would not announce any changes soon.

The Minister was certain that he had to move quickly. His plan was presented to the provincial Cabinet. Most cabinet members were indifferent to Mr. Kwinter's proposal, and it was not clear that Mr. Peterson, the Premier, fully understood the profound character of the changes that his minister was proposing. There was certainly no debate of the issue among cabinet members.

The Minister met with the banks, bilaterally, over the course of the spring in an effort to determine the degree of interest which the banks had in getting into the securities business and the degree of ownership of existing firms which the banks required to make it worth while to them. The consultations were held at the highest levels with the banks. The banks seemed to be content with the OSC's recommendation of a 30 percent interest.

In the case of the BNS, their meeting with the Minister was held in around mid-May. Although they were convinced of the Minister's sincerity to initiate a change in the ownership requirements, they were also convinced that whatever change would occur, it would be a long time in coming.

On June 10th, 1986, in the evening, the Minister invited the elites of the securities business to a meeting at the King Edward Hotel in Toronto to inform them of his pending announcement regarding the liberalization of entry and ownership provisions for the investment dealer industry. According to participants in that meeting, there was pandemonium in the room. Many dealers thought that "the end of the world was near" -- although there was also some support for the measures to be publicly announced the following day.

On June 11, 1986 the Ontario Minister of Financial Institutions, Monte Kwinter, announced in the Provincial Legislature that

the Government has decided to adopt in principle the main recommendations of the Report of the Ontario Securities Commission with respect to entry into and ownership of the securities industry.

These recommendations will allow limited participation by foreign securities firms, and by domestic financial institutions and non-financial investors.

These measures are designed to ensure the growth of Toronto as a major centre of international finance, while maintaining the essentially Canadian character of the securities industry.

...We will also be opening the industry to Canadian financial institutions -- banks, insurance companies and loan and trust corporations. We believe that domestic investment in the securities industry is desirable and should be encouraged. While we have set a 30 per cent ownership limit for non-resident investors, we are prepared to discuss allowing Canadian financial institutions to obtain an even higher ownership level.

Our major financial institutions are world-class players and their entry into the securities industry is, in our view, essential to the growth of Toronto as an international centre. At a minimum, we will be permitting them to own up to 30 per cent of a securities firm.

It is our preference that domestic financial institutions be allowed to enter the securities market at the same time as changes come into effect for non-resident companies.

To permit ownership of securities firms by these institutions, to the levels contemplated in this new policy, will require amendments to the various provincial and federal statutes governing their investment and corporate powers.

...we will introduce enabling amendments to the loan and trust corporations act and the insurance act as a priority matter; and we would encourage the federal government to expedite amendments to its relevant statutes, including the Bank Act.

We hope early changes to federal legislation will be forthcoming.⁶⁰

The federal authorities were incensed by this preemptive move of the Ontario Government without first giving the appropriate minister advance information regarding its intended action -- which would overlap federal jurisdiction. Moreover, it was well known that the federal government was in the midst of preparing a Green Paper on financial reform, and this measure would be seen as preempting the flexibility for policy development of the senior level of government.

Barbara McDougall, Minister of State for the Department of Finance, was informed only on the day Kwinter made his statement in the Legislature. She and her senior officials were furious. This anger was exacerbated by the fact that both Ministers were from that same area of Toronto -- their federal and provincial ridings overlapped -- and they had already cooperated on many matters of public policy. Mr. Kwinter called her from his car just before the announcement was to be made in the legislature. Not only was the federal government given extraordinarily short notice but Kwinter stated in a follow-up letter that

It is our present intention to have the new entry and ownership rules in place by January 1, 1987. Concerns have been expressed by the banks and others that unless appropriate amendments to relevant Federal statutes have been enacted by that date, they could find themselves at a competitive disadvantage.⁶¹

The rationale for this liberalization seems clear. Indeed, there were numerous "historical" events that had foreshadowed it. Especially crucial was the rapid international globalization of markets that was already in train and the clear lack of adequate capitalization of the individual firms in the industry. The new policy entrepreneurs had learned that these phenomenon had threatened both the viability of the domestic industry and Toronto as a financial center.

⁶⁰ Monte Kwinter, Minister of Financial Institutions, "Statement in the Legislature Re: Entry and Ownership of the Securities Industry," 11 June 1986.

⁶¹ Monte Kwinter, Letter to Barbara McDougall, 10 June 1986. The letter was received on 11 June 1986 -- after the phone call noted in the text.

Robert MacIntosh's explanation of the Ontario Government's decision to liberalize the ownership and entry apparatus -- based as he suggests on retaliation by the provincial government for the federal decision to permit international banking centers (IBC) in Montreal and Vancouver but not Toronto -- trivializes all of the events that preceded the Ontario liberalization decision and ignores the paucity of activity that would in any event be associated with an IBC.⁶² Indeed, there was not one shred of evidence uncovered among the many official documents reviewed and interviews held to suggest that the IBCs had any role to play at all in the decisions of Mr. Kwinter or advice provided by Mr. Beck.

The securities industry, resigned as it then was to the change that was on the horizon began, at Mr. Beck's request, to organize itself to assist the OSC to draft the regulations required to implement the Ontario government's policy.⁶³ While the industry naturally agreed to help the OSC, it was not without some trepidation about the process. Mr. Kniewasser, writing to Mr. Fell, the Co-Chairman of the industry committee on the OSC regulations said

Mr. Kwinter, Mr. Davies and Mr. Beck may prefer to fashion their own consultative arrangements. Although this is not the best option from a public policy point of view, it would not surprise me, in view of the conflicting advice they have been getting from the Self-Regulatory Organizations and from Member firms. You will recall that all SROs approved the recommendations made by the Taylor, Medland and Pitblado Committees. Individual firms, unfortunately, have consistently made vigorous and apparently effective recommendations to the contrary. As we get into the substance of drafting regulations with the OSC, we will quickly be confronted with major policy decisions which will be divisive within the securities industry. Your Committee, whether organized on an industry basis or a joint industry basis, will, therefore, face the same problems as its predecessors. This is not fatal, but it is discouraging and we should recognize the problem and deal with it as best from the outset.

⁶² Robert MacIntosh, *Different Drummers: Banking and Politics in Canada* (Toronto: MacMillan Canada, 1991), 268-269; Louis Rasminsky and William Lawson, "Report to the Minister of Finance on International Banking Centres," June 1985.

⁶³ Stanley M. Beck, Chairman, Ontario Securities Commission. Letter to Messrs. Anthony S. Fell (Dominion Securities Pitfield) and Donald H. Page (Midland Doherty) dealing with "Consultative Committee on Entry Into and Ownership of the Securities Industry in Ontario," 19 June 1986.

Thus, we have further evidence that the elites had lost a good deal of their clout within both the political and bureaucratic apparatuses. The elites within the industry were traditionally able to deal with the so-called "dissidents" within their group through their ability to directly influence the decisions within the machinery of the government. Such power had apparently evaporated.

Indeed, in the process of consultation surrounding the drafting of regulations the SIRC proposed to the OSC more stringent rules regarding the 30 per cent participation by foreign firms, a restraint on the growth of retained earnings of foreign firms, an increase in the degree of ownership of domestic firms by financial institutions to 50 per cent from the proposed 30 per cent, and a delay in the implementation of all of the proposed changes until the appropriate federal legislation -- particularly the Bank Act -- was amended.⁶⁴ Mr. Beck's response, on behalf of the OSC, was not supportive of the industry's position. Mr. Fell forwarded Mr. Beck's letter to the IDA members via Mr. Kniewasser. Fell's letter said in part:

From the results of our meeting and by the tone of the OSC letter, it is evident that the Commission has very little sympathy with our concerns and are only prepared to make very modest adjustments to the original proposals [in the Dey Report].

It is now proposed to have a meeting of the full SIRC Committee...on Thursday, September 4th to review the response we have received from the OSC and to decide what our next move should be. It has been suggested that it might now be appropriate to invite Stan[ley] Beck and others to our Thursday meeting about mid-morning so that they can hear firsthand of our concerns.⁶⁵

Thus, not only were the key industry actors fighting a rear guard action against the modernization of the entry and ownership regulations, it was also confronted, for probably

⁶⁴ The industry's position was outlined in a letter from Stanley Beck to Messrs. Fell and Page, the Co-Chairmen of the SIRC. See Stanley Beck, Chairman of the Ontario Securities Commission, Letter to Anthony Fell and Donald Page, 22 August 1986.

⁶⁵ Anthony S. Fell, Co-Chairman - SIRC Committee, Letter to Mr., Andrew Kniewasser, President, Investment Dealers Association, 25 August 1986.

the first time in its history, with a rather pugnacious regulatory authority. The capacity of the industry to continue directing its regulator was crumbling. The life cycle had virtually completed its evolution -- from initial capture to seemingly independence. On November 5, 1986, after the SIRC Committee had completed its consultations with the Chairman of the Ontario Securities Commission, an internal IDA memorandum by Mr. Kniewasser summarized and editorialized on the proposed regulatory situation. He noted in part:

The Association's members have not had an opportunity to examine and reflect on Mr. Kwinter's proposals. I would expect that very few of them will be happy with the arrangement, although some larger firms will undoubtedly conclude that they can live with this arrangement and that some thing along this line is inevitable.⁶⁶

The model that would be proposed by Mr. Kwinter would be essentially that of the OSC Report -- although it would be more forward looking. That was to say, it would propose further liberalization -- in time -- beyond that contained in the original Report. Thus, the limits of permitted investment in Canadian dealers would rise from 30 per cent to 50 per cent between 1987-88 and January 1, 1989 for non-residents, financial institutions, and others. During the 1987-88 period, investors would have the option of negotiating the acquisition of up to 50 per cent on January 1, 1989.⁶⁷ The SIRC had been pressing for some time because it was "now evident that a significant majority of the firms which have taken an interest in this matter strongly favor increasing the outside ownership limit from the proposed 30 percent level to 50 percent for both domestic Canadian investors and foreign investors."⁶⁸

⁶⁶ A.G. Kniewasser, "Securities Industry Review Committee," 5 November 1986, 1.

⁶⁷ Appendix to A.G. Kniewasser, "Securities Industry Review Committee," 5 November 1986.

⁶⁸ Anthony S. Fell and Donald H. Page, Co-Chairmen of the SIRC, Memorandum to the Ontario Securities Commission on "Entry Into and Ownership of the Securities Industry," 17 October 1986, 4. Apparently the industry "had some difficulty working out its position. Each investment dealer is motivated by its own self interest and what it intends to do over the next five years...In general, the larger the firm, the greater the support for raising the foreign ownership level." Barry Critchley, "Dealer ownership rules take new turn," Financial Post, 10 November 1986, 8.

The BNS Finds its Window of Opportunity

On June 13, 1996, just two days after Mr. Kwinter had made his startling announcement, Mr. Robert McIntosh, the President of the CBA resumed the chartered bank's's lobbying campaign on the federal government to amend the Bank Act in order to expand the powers of the industry. In a letter to Barbara McDougall, Mr. MacIntosh said in part

Our sense of urgency arises from the fact that Ontario intends to implement its proposals by January 1, 1987. Unless the Government of Canada gives a clear signal that it will respond with comparable permissive amendments to the Bank Act, the banks will be unable to undertake any sort of strategic planning with respect to the to the securities industry. This could put them at a severe disadvantage and further tilt the playing field away from the federally supervised banking industry.

You are doubtless aware that Mr. Kwinter's statement included the following phrase:

'and we would encourage the federal government to expedite amendments to its relevant statutes, including the Bank Act.'

From a policy point of view, it would seem to us that it should not be difficult for the Federal Government to respond positively to this gesture, inasmuch as you have gone on record in the Green Paper in the following words:

'In recent years, a number of provincial governments have been reviewing their policies for this (securities) sector and in the process have considered the possibility of greater participation of financial institutions. The federal government does not want to interfere with provincial policies in respect of the ownership of securities dealers and therefore, proposes to allow investment in securities dealers' equity by financial holding companies, to the extent permitted in the various provincial jurisdictions.'

It is possible that this new initiative of the Government of Ontario may have side effects on Canada's bilateral trade negotiations with the United States. However, there has also been new financial legislation in Quebec and other provinces, and there may very well be new financial legislation

from time to time within the United States as well, all of which has some bearing on the trade negotiations. In our opinion, it will not be possible to suspend the process of changing financial legislation and regulation until the completion of international trade negotiations.

We are faced with a serious challenge to the concept of a level playing field and an equitable and balanced financial system. On behalf of the chartered banks, I want to express our urgent concern to obtain appropriate enabling legislation in the Bank Act.⁶⁹

On June 24, 1986 Mr. MacIntosh wrote a second letter to Barbara McDougall. The purpose of this letter was to propose two alternative draft amendments to the Bank Act which were designed to address the banks' concerns about the Ontario Government's new securities industry ownership policy. The letter said in part:

The CBA prefers the amendment set out in option #1 since this amendment, if enacted, would clearly permit banks to own all or any of the issued and outstanding shares in an investment dealer. The amendment in option #2, on the other hand, is drafted in a manner that would permit the federal government to establish ownership restrictions that are consistent with corresponding provincial government restrictions on the ownership of securities firms. Under no circumstances, however, should the option #2 amendment be used to impose ownership restrictions on banks that are more severe than corresponding provincial restrictions...

We strongly urge you to amend Bill C-103 to permit banks to own more than 10 per cent of a securities dealer in accordance with the Ontario government's new policy on the ownership of securities firms.⁷⁰

On June 26, 1986 Barbara McDougall responded to Mr. MacIntosh's two letters. Because of its historical importance in the process of broadening out the ownership of the Canadian securities industry, and indeed, because it was the instrument that gave the BNS

⁶⁹ R.M. MacIntosh, Letter to The Honorable Barbara J. McDougall, P.C., M.P., Minister of State (Finance), 13 June 1986.

⁷⁰ R.M. MacIntosh, Letter to The Honorable Barbara J. McDougall, P.C., M.P., Minister of State (Finance), 26 June 1986.

the go-ahead to establish a wholly owned investment dealer in Quebec, the letter will be quoted in its entirety:

Dear Bob:

Thank you for your letter of June 13, 1986 regarding the proposals made by the Honorable Monte Kwinter, Minister of Financial Institutions, in respect of the ownership of investment dealers in the Province of Ontario. I fully understand the sense of urgency that the banks feel in obtaining clarification of the federal government's intended policy respecting their participation in the securities market. Moreover, I appreciate your concern that decisions on this score not be postponed until resolution of the international trade talks or the completion of the full review of financial sector policy in general.

For your part, you will undoubtedly appreciate the fact that the Ontario proposals present major policy issues for the federal government. While the proposals are broadly consistent with the acceptance of greater financial industry integration that was proposed in the federal government's 1985 Green Paper, the Ontario government's announced approach does not address a number of key issues that are of concern to me. For example, it leaves open important questions of inter-company transactions (the self-dealing issue), conflicts of interest, and the approach to supervision of financial groupings that include both federal and provincial companies.

The federal government is making good progress in the review of financial sector policy and the Estey Report will complete the information base needed for action. At this particular moment, however, the federal government is not in a position to put forward any specific proposals regarding the participation of federally regulated financial institutions in securities-related activities.

Nevertheless, it is possible to make clear the principle that will guide the federal government's policy in this respect: we will not want to see federal institutions, including banks, put at a disadvantage with respect to securities activities. Moreover, in respect of the timing considerations, *I should point out that the banks have a provision for temporary investments which provides some flexibility to take initiatives in the short term.*

It goes without saying that this matter is receiving my full attention and that clarification of federal policy will be forthcoming at the earliest possible time.^{71 72}

This letter was just what the BNS had been waiting for. Not only was the BNS surprised to learn of its contents, in retrospect many Department of Finance officials did not even know of its existence and found it rather astonishing that the Minister would write such a letter.⁷³ According to the BNS's legal counsel, which included James Baillie -- the former Chairman of the OSC, Counsel to the IDA and the JIC, and author of the Moore Report -- this two year investment provision could be interpreted in two ways: (i) ministerial approval could be obtained prior to entering into the investment, and (ii) ministerial approval would only be required if the bank wanted an extension beyond the initial two years of its investment. The BNS found the opening it had been looking for -- and chose the latter interpretation.

In August 1986 Andre Berard, Chairman of the Executive Council of the Canadian Bankers' Association (and President of the National Bank of Canada) wrote to Michael Wilson, the Minister of Finance about the chartered banks position regarding Ontario's proposal on the ownership of investment dealers. Again, because of the importance of this letter, much of it is quoted below:

⁷¹ The Honorable Barbara J. McDougall, P.C., M.P., Minister of State (Finance) Letter to R.M. MacIntosh, President of the Canadian Bankers' Association, 26 June 1986. Italics added.

⁷² Mr. MacIntosh, in his book Different Drummers: Banking and Politics in Canada did not acknowledge the existence of this letter, which the Minister had addressed to him directly. Instead, MacIntosh suggests in his book that the Minister of Finance took the decision to allow banks to enter the securities business at a meeting among the chief executives of the "big six banks" at the Chateau Montebello in Quebec on October 19, 1986. Information obtained in confidential interviews suggested that the decision in the Department of Finance to broaden the powers of the banks in order that they could enter the securities business had already been taken at the time the June 26, 1986 letter had been sent. "There would have been no point in inducing the banks to enter the securities business through the temporary investment provisions if their powers were not to be expanded permanently. The Montebello meeting was a non-event." Also, Mr. MacIntosh suggested that Minister Wilson arrived at the meeting via helicopter. In fact he arrived via seaplane from a cottage vacation near Toronto!

⁷³ Based on confidential interviews.

Domestic Ownership

The considered opinion of the banking industry is that 30% ownership in an existing investment dealer would not represent sufficient interest for the banks to participate in the securities industry in Ontario. Given the pace of developments in international capital markets, it seems to the banks that Canadian financial policy should aim at ensuring the competitive efficiency of our financial institutions. The combined strength of capital reserves and market intermediary skills which are to be found in chartered banks and investment dealers, if brought together, would help to ensure an effective Canadian participation in world financial markets.

The increasing integration of function, which has been taking place at an accelerated pace globally, and most notably in the United Kingdom, seems likely to provide a major threat to the competitive position of Canadian banks. The Canadian banks have recognized the need to integrate these functions and are doing so outside Canada. The Canadian regulatory environment is hampering this effort domestically.

We have, therefore, come to the view that the banks should at present be authorized to own up to 100% of an investment dealer, either by way of acquisition of an existing firm or by establishing a wholly-owned de novo subsidiary. We note that the Government of Ontario is proposing to authorize 100% foreign-owned investment dealer subsidiaries, and it is only reasonable that domestic financial institutions should have no less authority in this regard than a foreign owner.

Foreign Ownership and Reciprocity

The chartered banks support the concept of increased foreign ownership and competition in the securities industry. Having in mind the current bilateral trade negotiations with the United States, and the increasing attention being paid to reciprocity by the United Kingdom and other countries, we believe that reciprocity should be a major consideration in determining foreign participation in the securities industry.

Implementation

As the former Minister of State (Finance) indicated in her letter of June 26, the banks may resort to the temporary investment provisions of the Bank

Act to participate in the securities industry. This is an interesting suggestion and we are grateful to have it. At the same time, because of the size of the investments involved, that provision to be helpful in practice would have to be supported by an indication from government that it intended to introduce appropriate amendments to the Bank Act in the near future. It would seem to us appropriate and desirable that the federal government give such indication at this time.

We hope that banks will not, for technical or other reasons, be disadvantaged relative to other domestic financial institutions or foreign investors by any undue delay in the enactment of enabling legislation. For this reason, we were pleased to learn in the letter of June 26 from the former Minister of State (Finance) that the federal government did not intend to allow federally incorporated institutions, including banks, to be disadvantaged in the securities industry. Indication from the federal government at this time that it intended to amend the Bank Act in respect of the business powers of banks would be an effective way of ensuring competitive equity.⁷⁴

Competitive Federalism: The Central - Quebec Government Axis

During the latter part of October 1986 the BNS met again with the Minister of Financial Institutions, Mr. Kwinter, to get an update on just how close the Ontario Government was to implementing the details associated with his statement in June. The BNS was made aware of the negotiations between the OSC and the industry. The BNS was convinced that implementation of a plan was still quite a way off. The bank decided it must move quickly before word of its own plans leaked out -- either to its competitors or to the federal government. Quebec had already granted the BNS a licence to open a full service investment dealer and all the legal work had been completed.⁷⁵

In mid-November, at about the time the industry and the OSC thought that their consultations had produced a workable model for entry and ownership in the Canadian securities industry, the Bank of Nova Scotia announced that it had established a wholly

⁷⁴ Andre Berard, Chairman of the Executive Council of the Canadian Bankers' Association, Letter to The Honorable Michael Wilson, P.C., M.P., Minister of Finance, 8 August 1986.

⁷⁵ Based on confidential interviews.

owned full service investment dealer subsidiary -- Scotia Securities Incorporated -- which would be registered in Quebec.⁷⁶ Publicly, Ramsay Holmes, the first Chairman of Scotia Securities⁷⁷ stated that the Bank of Nova Scotia had decided to move into the Quebec securities market because "Quebec's legislation does not put restrictions upon the ownership of securities dealers. It only requires that owners of securities firms are appropriately qualified."

The Bank decided not to wait for regulatory changes because it sees a distinct threat in the growing 'securitization' of global financial markets -- corporations issuing securities internationally to raise funds rather than borrowing from their banks. As a result, Canadian banks see large chunks of business that traditionally was theirs moving offshore to companies such as Nomura Securities of Japan as well as Goldman Sachs and Merrill Lynch, both of New York.⁷⁸

It appears the bank was encouraged by Ottawa, which didn't want federally incorporated institutions, such as chartered banks, shackled by restraints governing their operations -- at the same time as provincial institutions are being deregulated.⁷⁹

According to Holmes, "We have had some suggestions that it [the federal government] would be receptive to an initiative such as this."⁸⁰ This move by BNS had the effect of reinforcing the Ontario Government's concern about sustaining the viability of the Toronto based industry.

⁷⁶ Patricia Lush, "Scotiabank stretches law in new venture," Globe and Mail, 13 November 1986, B1.

⁷⁷ Barry Critchley and Sonia Horvitch, "Scotiabank scores a first," Financial Post, 17 November 1986, 36.

⁷⁸ Patricia Lush, "Scotiabank stretches law in new venture," Globe and Mail, 13 November 1986, B1.

⁷⁹ Barry Critchley and Sonia Horvitch, "Scotiabank scores a first," Financial Post, 17 November 1986, 36.

⁸⁰ Barry Critchley and Sonia Horvitch, "Scotiabank scores a first," Financial Post, 17 November 1986, 36.

Officials in neither the federal nor the provincial governments had any advance warning that the BNS was about to take the action it did. The bank did try to inform officials on November 11, just before the official announcement, but November 11 being a government "holiday" officials could not be reached. When officials subsequently did find out they were of course shocked. But the "damage" to rational policy planning, decision-making, and implementation had already been done. Federal and provincial officials then had to act quickly to salvage the situation.

Thus, the federal-provincial and inter-provincial dynamics took grasp of the processes to liberalize entry and ownership in the Canadian investment dealer industry. This was competitive federalism as Albert Breton would have envisaged it.⁸¹

Decision II: Phased but Total Liberalization

Between the mid-November BNS announcement and early December, a series of frantic meetings took place between the Ontario and federal ministers and officials. The federal government was uncomfortable with the situation surrounding Scotia securities and still angry about Ontario's preemptive move in June. However, Mr. Kwinter offered an "olive branch" to Mr. Hockin (the new Minister of State for Finance with responsibilities for the financial services reform file) -- "but not an apology" -- and the two governments were able to work out a compromise to open up the investment dealer industry to both chartered banks and foreign investors. The agreement had apparently been negotiated directly between Mr. Kwinter and the federal Deputy Minister of Finance, Mr. Stanley Hartt, and not between Kwinter and Hockin, as was widely believed. Mr. Hockin, did not seem to have his heart in the negotiations with the Ontario officials.⁸²

On December 3, 1986 the Canadian Press Wire Service reported the following:

⁸¹ See Albert Breton, Royal Commission on the Economic Union and Development Prospects for Canada, Report (Volume 3), (Ottawa: Minister of Supply and Services, 1985), 486-526

⁸² Based on confidential interviews

percent threshold level was required to ensure that there would not be undue influence on the firm by "unqualified" persons:

- reducing to 40 percent, from the 60 percent recommended in the JIC Report, the number of directors of a firm which must be industry participants;
- regulating on the question of the diversification of securities firms into non-securities related business -- even with SRO approval -- because the industry had just appointed another Joint Industry Committee to look into this issue; and, finally,
- invoking a sunset provision which removes all restrictions on ownership if the rules are not renewed in five years.³⁴

Accompanying Mr. Kniewasser's explanatory letter was a ballot which asked IDA members to vote on two questions:

- (A) Are you in favour of By-laws with the option of Public Ownership in the Canadian securities industry under conditions invoked by the Ontario Securities Commission?
- (B) If your answer to the above is NO, would you agree that the IDA Board of Directors review the subject and then reopen it with the Stock Exchanges and/or Securities Administrators, as considered appropriate in the circumstances?

Of the 57 votes received from a membership of 76, 12 voted YES to question (A), 45 voted NO to question (A) and of these 45, 42 voted YES to question (B).

The Executive Committee at its meeting held on November 25, 1981 reviewed the results of the voting and, in accordance with these results, unanimously agreed that the question of Public Ownership should be re-opened with the Stock Exchanges and the Securities Administrators.³⁵

³⁴ A.G. Kniewasser, President of the Investment Dealers Association of Canada, "Letter addressed personally to all CEOs of IDA Member firms," 30 October 1981, 3-4.

³⁵ E.M. Andrews, Secretary of the Investment Dealers Association of Canada, "Bulletin to all CEOs of Member firms," 26 November 1981.

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PRECISIONSM RESOLUTION TARGETS

Ottawa and the Ontario government have hammered out a restructuring plan that will allow banks and trust companies to take 100 per cent ownership of investment dealers.

Sources said today Ottawa and Ontario overcame major differences Monday at a closed meeting in Ottawa between Tom Hockin, Minister of State for Finance, and all provincial ministers responsible for financial institutions.

The main players at Monday's meeting were Hockin and Monte Kwinter, Ontario Minister of Consumer and Commercial Relations.

Sources said Ottawa is anxious to allow banks to control 100 per cent of securities firms to enable Canada's investment industry to compete with giant investment houses of the United States and Japan.

But Kwinter, who last spring announced Ontario is willing to allow financial institutions to hold 30 per cent of investment houses, has been reluctant to allow full ownership, fearing undue corporate concentration.

But the two Ministers have agreed that:

- Ottawa will amend the Bank Act to allow 100 per cent ownership of investment houses while Ontario will enact accompanying changes in its Securities Act.

- To appease Ontario, Ottawa will allow trust companies under its jurisdiction to hold 100 per cent of securities firms. Ontario will make accompanying amendments in its trust company regulations.

- Ontario has also agreed to allow foreign interests to hold up to 100 per cent of investment dealers in a year's time. Foreign interests have been restricted to 10 per cent individual ownership and 25 per cent aggregate ownership of an Ontario securities firm since 1971.

Under the Bank Act, banks cannot own investment dealers. But sources say Stanley Hartt, Deputy Minister of Finance, has told the six largest banks to go ahead and take full control of investment dealers because the Bank Act will be amended.

The following day, December 4, 1986, Monte Kwinter, the Minister of Financial Institutions made the following statements to the Ontario Legislature:

...It was the consensus of all the groups consulted that a substantial liberalization of the ownership rules, beyond the levels indicated in my June announcement, was required.

Other events in the fast-changing capital markets have also led us to a broader opening of the industry.

It has recently become clear that the role of the Canadian banks and other federal financial institutions in the securities market is in the process of being greatly expanded.

The most obvious example of this is the formation by the Bank of Nova Scotia of a subsidiary that is a full service securities dealer. Scotia Securities has been registered in Quebec and is beginning to carry on business there.

Banking is a matter that under the constitution falls to the federal government. Securities regulation is a matter of provincial jurisdiction. Accordingly, each level of government has a role to play in structuring our financial markets.

Ontario and the federal government have discussed the issues in our respective spheres of responsibility. I am pleased to report that fact, as co-operation between us is essential to the efficient working of our markets. While my understanding is that the federal position is not yet settled, I am hopeful that banks and other federally incorporated financial institutions will be allowed a major participation in the securities industry through subsidiaries.

This part of the process to liberalize the entry and ownership apparatus in Ontario (and Canada) came as an anti-climax. The federal government had to act quickly, and the provincial government, which was still attempting to sustain a majority of Canadian ownership in the investment dealer industry, was obliged to meet the new "Quebec standard" or risk losing Toronto as the pre-eminent financial center in Canada.

Conclusion

As was the case throughout the history of the process of liberalizing the securities industry, the industry itself controlled the agenda and the political and regulatory officials followed suit. The closing scene of this long episode followed the same pattern. The Ontario government could not come to a quick conclusion about the modalities of the implementation of a liberalization apparatus; the federal government had trouble coming to a "slow" resolution of its proposals for the reform of financial services industry more generally. The industry, then, filled the void.

The industry dictated the character of the policies that would be adopted by the Ontario and federal authorities -- as had been the case all along -- while Quebec authorities bent on nation building continued to run ahead of all of the other policy actors. It is ironic indeed, that Ontario officials and the Ontario based industry had all along opposed the policies that had been proposed by the Quebec authorities, but in the end it was the Quebec policies which set the standard for the liberalization of the Ontario industry.

The main difference in the conclusion of this drama with earlier events, is that the Ontario government had realized the consequences of past policies and accepted the generalities of the prescriptions offered-up to cure the problem. The Ontario government and the OSC had effectively freed themselves from the grasp of the industry -- but they had not acted quickly enough to be seen to be acting independently.

Variables such as competition among governments, the influence of ideas, a desire to preserve power and influence -- a change in the appreciative system -- the authority of policy entrepreneurs and the long process of policy learning had all reached an apex in the second half of 1986. The organization of the Canadian securities industry itself would finally reflect the competitive character which had so defined the activities of its very existence. Moreover, it would find itself "befriended" by partners with very deep pockets.

CHAPTER ELEVEN

CONCLUSIONS

Introduction

The purpose of this dissertation has been to examine the factors and processes which gave rise to the liberalization of entry into, and ownership of, the investment dealer industry in Canada in the mid-1980s. At a theoretical level the dissertation has been informed by the literature surrounding: the politics and economics of regulation, the role of interest groups in the supply of public policy, the public choice cost-benefit calculus of elected and appointed officials in these processes, and the role of federalism with respect to competition among provinces and between provinces and the federal government in the preservation of both economic leadership and jurisdictional supremacy. Because of the openness of the Canadian economy and the globalization of the financial markets over the last decade or so, this project was also influenced by the ideas surrounding state capacity and its ability to resist exogenous developments offshore.

The dependent variable in this analysis was the 1986 policy output of the Ontario, Quebec and federal governments -- liberalization -- variously characterized as deregulation and/or "reregulation."

The explanatory (or independent) variables which shaped the policy output were first, the activities of interest groups. These groups were the industry's trade associations -- essentially the self-regulatory agencies such as the IDA and the various stock exchanges around the country. The second explanatory variable was the incentives which shaped the character of the policies supplied by elected and appointed officials. Both of these groups of policy actors were at various times acting (supplying public policy) in their own self-

interest -- probably to the detriment of the "public interest." There was a significant inter-provincial and federal-provincial dynamic which paced the liberalization process and this dynamic is the third explanatory variable. The idea of competitive federalism was at work here. And finally, the policy developments in the OECD area generally, but especially in the United States and the United Kingdom provide a powerful context for the configuration of the new regulatory apparatus and the processes that were required to achieve it.

Given these explanatory variables, the important contributions of this project are (i) the fashioning of an analytical framework to explain the political and economic dynamics which ultimately gave rise to the liberalization of entry and ownership in the Canadian securities industry; and (ii) the identification of the asymmetric information base which provided the mechanism through which the industry was for so long able to capture the provincial regulator in Ontario.

This is the first such thorough analysis of this subject matter in Canada using the political science/public administration paradigms and thus fills an important void in Canadian scholarly research surrounding the financial services industry. Economists have had a lot to say on these matters in the past, to the exclusion of most others. Moreover, our knowledge base of policy supply has been expanded and perhaps more importantly the stage has been set to test the validity of the asymmetric information phenomena as a more general explanatory variable in respect of the supply of other regulatory policy in Canada.

The Thesis and the Dependent and Independent Variables

This analysis contained in the dissertation shows that the key regulator of the investment dealer industry in Canada, the Ontario Securities Commission, during the early years of the period analyzed, was regulating the industry and effectively restricting competition in the interests of the industry itself. Subsequently, the OSC altered the regulatory regime in the face of "political" forces which were more compelling than these interests alone. Moreover, the liberalization of entry and ownership rules was in the interests of the elected officials. And over time politicians did detach themselves from the influence of the securities industry elites -- particularly following the election of a Liberal

government in Ontario in 1985 following many years of provincial Conservative rule -- in order that the Toronto market should remain a vibrant venue for the Canadian financial services industry. Similarly, the forces which pushed Quebec to liberalize earlier, and in more dramatic fashion than Ontario, reflected not only Quebec's political aspirations arising out of the social upheavals beginning in the early 1960s, but also the desire to sustain Montreal's position as a financial center in Canada.

The ability of the industry to obtain its desired regulatory policies for much of the period examined, and thus to capture the provincial regulator in Ontario, was related to the fact that it had a monopoly on the qualitative and quantitative information about the industry. There was inadequate capacity within the appropriate ministry or regulatory agency to counter this monopoly and thus Ontario officials, for a long time, had no analysis that would justify taking a judgement that was qualitatively different from that of the industry. It was only when the phenomenon of globalization began to impinge on the potential vitality of Toronto as a financial center and its significance realized by policy entrepreneurs in each of the regulatory bureaucracies and at the elected officials level did the influence of the industry over the supply of regulatory policy diminish. This of course was contrary to the received theory on regulatory capture.

The engine driving the economists' rationale for regulation and deregulation in this sector were typically values such as economic efficiency, systemic stability, investor protection and avoidance of concentration. This dissertation added a powerful analytical framework using political economy and political rationality as important values helping to explain the supply of financial regulation in Canada. It was intended that the results of this research would build on the existing body of knowledge and not substitute for it.

Discussion of the Independent Variables: The Alternative Explanation

The activities of interest groups representing the key private sector actors had a dramatic influence on the demand side of the policy equation. For much of the period examined, the demand for regulatory policy was influenced by the competitive position of the indigenous industry relative to other financial intermediaries both domestically and offshore, by the fear of being absorbed by the chartered banks, and by the power of the

industry's leaders who wanted to sustain both their power and influence. In fact, it was not obvious that the demand for regulatory policy reflected the character of financial services demanded by consumers and firms nor the pace of technological advancement as it affected the overall global competitive position of the industry. Indeed, the industry's objective through virtually all of the period 1969-1986 was to protect its insular position from the vagaries of market competition.

The power of the industry leaders was manifest in their influence over key political and bureaucratic decision-makers. With respect to politicians, the industry's power was evidenced by the fear of politicians to upset those upon whom they relied for political support, while in the case of the bureaucrats, the monopoly over information by the industry elites, allowed them to "filter" information to serve their rent seeking interests.

This tension between the public and private sector actors influenced the character of liberalization policy. Indeed, there was an evolution in the liberalization rhetoric of the key governments as they moved towards a policy equilibrium. For example, it was shown that the incremental changes to announced (but not implemented) policy intentions had potential political repercussions on elected officials and as well could have affected the survival of the regulatory bureaus. Thus even proposals for policy changes, even those for which the probability of implementation was rather remote, were only codified in incremental terms. This incrementalism, in either abstract or concrete terms, reflected the consternation, of all officials, about the power and influence of the industry.

Furthermore, there is evidence of a pattern to this incrementalism. In almost every instance where a substantive issue was to be considered by the regulatory officials in Ontario (as well as in the US and UK), officials would first publish an issues paper, request the industry to comment on the issues paper, convene hearings, and finally issue a report which at best called for small changes and which for the most part was ignored by political officials. At the end of the day the industry obtained what it wanted -- the status quo which supported its rent seeking activities.

There was also a pattern to the industry's actions during the various episodes of this story. The industry would convene a joint committee among all the members of the

established SROs in Canada. This tactic ensured that all of the domestically owned firms, which dominated the membership of the SROs would speak with one unified voice. The foreign owned firms were typically impotent in these forums. Small groups of industry elites would form working committees to consider the issues and draft a report for consideration by the regulatory agency. The reports were typically drafted by senior partners from the largest laws firms in Toronto with the lead counsel frequently a former chairman or soon to be chairman of the Ontario Securities Commission. The generic position of the industry on most issues was that any change from the status quo would result in the demise of the Canadian securities industry and/or impinge negatively on the efficiency of Canada's financial markets. Indeed, the character of the industry's argumentation did not change substantively over the entire 1969-86 period.

With respect to federalism and inter-provincial competition in Canada, it was shown that Ontario and Quebec used the constitutional provisions regarding financial services for their own purposes (e.g., growth, power and self-preservation) when considering the liberalization of the securities industry. Indeed, it was the competition between Quebec, or better still, the Quebec threat to Ontario's supremacy in financial services, which resulted in the historic decisions of mid-1986. This phenomenon cut across the politics and rhetoric of both the elected and appointed officials at the provincial level. The federal authorities did not enter the controversy until its own policy making autonomy had been impinged upon or even usurped by the forward looking policy prescriptions of Quebec and Ontario's attempt to catch up to them.

The overarching phenomenon which underlined the need for regulatory policy liberalization were developments outside Canada and competitive pressures among government's within Canada; the former were shown to be exogenous to indigenous Canadian processes while the latter were seen as exogenous to the individual government's concerned. Moreover, it was in this area that we saw the state evolve from an entity that was captured by the industry to an independent and autonomous actor in supplying public policy output. This was evident particularly in the context of the conjuncture of the final events leading up to the ultimate liberalization decisions at both the federal and Ontario and Quebec government levels. More generally, the regulatory agency, the OSC, which had been captured by the industry early in the period, had begun

to distance itself later in the period and became independent at the point it became clear that the industry's survival and Toronto's supremacy in financial services required a profound liberalization of the entry and ownership apparatus.

In respect of the globalization phenomena the ideas surrounding liberalization of the entry and ownership restrictions was extraordinarily important. The international transmission of ideas -- through international institutions (mainly the OECD) was important in contributing to the liberalization process globally and therefore in Canada. Indeed, we saw the effects of the rise of fashion across countries and within countries -- among those who influence or take the decisions in the financial regulation field. Thus deregulation/reregulation of the investment dealer industry was part of this broader "adjustment" process.

The international transmission of influence on the domestic supply of financial deregulation -- essentially the Americanization of the world's financial services -- can be seen from the perspective of a recursive model. That is to say, the time dimension of the analysis across countries did not coincide, but the policy formulation process was interdependent across countries and over time. Thus, there were discrete lags in the model which can be described in the following fashion: the germ of financial deregulation was planted in the United States where deregulation of broker commissions occurred in the mid-1970s. Important spill-over effects were observed in the United Kingdom -- the "Big Bang" in the City of London in the mid-1980s -- and then the revolution touched Canadian institutions and practices. However, from a comparative perspective, we saw that the removal of restrictions on competition in the securities industry -- the decisions to supply public policy that was not in the short-term interests of those being regulated -- were taken for reasons that seemed best explained by political economy than by economics alone. It was shown that Ontario and Quebec, while responding to the same exogenous stimulus, had to take account of the internal political dynamics when the decisions were made to alter their regulatory regimes.

A Summary of the Evolution of the Liberalization Process in Canada

The analysis of entry into and ownership of the Canadian securities industry, in the first instance, revolved around the Ontario Securities Act. The Act relied on ownership

rules and registration requirements as the primary instrument for regulating the industry. Registration was not generally required for those transactions which were less than \$97,000 (i.e, investors with substantial resources were presumed not to require the protection of the Securities Act).

The issue of entry into and ownership of the industry became a public policy issue in the late 1960s when Merrill Lynch, Pearce Fenner & Smith (a United States based company) acquired Royal Securities (an old and well established Canadian firm). Up until 1969, foreign owned firms had operated successfully and in a relatively unencumbered way. Indeed, the public policy issue of foreign ownership in the securities industry arose in the face of the nationalistic sentiments generally during this period which ultimately gave rise to the Canadian Foreign Investment Review legislation in 1971.

In any event, the Merrill - Royal Securities transaction served to focus the attention of the major players in the securities industry on the potential problem of how senior partners of the industry (the elites) could turnover their shares to the more junior partners and underscored the industry's vulnerability to the acquisition and competitive threats of the huge United States based firms. This problem in turn gave rise to questions about the capital adequacy of the industry and ultimately to the Moore Committee which was designated to study the questions of capital adequacy and non-resident ownership. The study was undertaken at the behest of the IDA and the members of the Toronto Stock Exchange.

Much of the Committee's attention was focused on the foreign ownership question and it concluded, with little solid substantiation, that if unfettered entry of non-resident firms was permitted, the eventual domination of the industry by the foreigners would result in increased difficulty for domestic borrowers to raise funds in Canadian capital markets. It would raise the price of capital to the securities industry such that turnovers from senior members of the industry to the junior members would be virtually impossible. Ultimately, the Moore Committee concluded that there ought to be restrictions on the ownership of securities firms. Thus the principal objective of the Moore Committee's work, which was eventually accepted by the OSC and the Ontario Government, was that the securities industry not become dominated by non-resident firms. In this instance, the

bottom line of the public policy output was that determined and sanctioned by those being regulated. At the time of the Moore Committee there was apparently little input from what would now be considered the attentive publics/sub-governments.

The Quebec government's response to the Moore Committee's recommendations was both swift and negative. Quebec's position on the key issues was to seek means of easier access to capital by the Quebec based industry and to welcome foreign securities firms to set up shop in Montreal. The province wanted to preserve an important place for Montreal in the activities of Canada's financial industry.

However, influence of the Moore Committee's recommendations persisted until 1983 when the Daly-Gordon Securities Company proposed a joint venture with the Belgium based Lambert-Brussels Corporation to deal in the unregulated sector of the securities market under the name of Gordon Capital. The regulated portion of the business would continue to operate under the earlier noted corporate identity. This proposal raised the same questions that the Moore Committee had explored more than a decade earlier. The industry's main concern was that foreign-owned competitors would enter Canada through the "back-door".

The OSC, before permitting the transaction to be completed, initiated a policy review to explore the ownership issue again. The OSC's call for a study coincided with the federal government's examination of the regulatory framework surrounding financial institutions under its jurisdiction and with the Ontario government's announced intention to appoint a Task Force to examine the needs of the province's financial system and its users. It is interesting, however, that the OSC, in announcing the ownership study indicated that public policy in Ontario was committed to preserving Canadian control of the securities industry.

The securities industry was, not surprisingly, opposed to non-industry participation. The industry's position was widely criticized by the policy community and a number of influential industry members broke ranks with the Joint Industry Committee and made the argumentation to the OSC that a certain degree of liberalization of the

industry was essential. The federal Director of Combines Investigation Act also reacted negatively to the position of a majority of the JIC membership.

In February 1985 the OSC released its Report on entry and ownership in the securities industry and the essence of its deliberations was to reduce the extent of the then existing restrictions on foreign and institutional participation in the domestic industry. At the same time, however, it preserved both a substantially Canadian owned industry and the traditional four pillars of the financial sector even though the federal government's Green Paper on the regulation of financial institutions (yet to be released) would recognize some need to blur the distinction. While the OSC felt obliged to be seen addressing the criticism of the policy community, at the same time it continued to propose public policy outputs that served the interests of the group being regulated -- although there was some evidence of accommodation of the other voices in the debate because of the fear of upsetting the elites.

In November 1986, the Bank of Nova Scotia, using the temporary investment provisions of the Bank Act, established a wholly owned full service investment dealer subsidiary in Quebec. The federal government had provided some encouragement to the banks to use the temporary investment provisions of the Bank Act, in response to significant lobbying by them for an expansion of the scope of their business in the face of shrinking and deteriorating balance sheets. In any event, this fight for turf, if that is what it was, had the effect of putting Toronto at a competitive disadvantage relative to Montreal in respect of non-industry investment in the industry and the Ontario government moved quickly to adjust its earlier policy decision. Thus, in December 1986, the Ontario government announced plans to allow banks, trust companies, non-financial companies and non-residents permission to take over 100 percent of securities firms over a two year period beginning in June of 1987. This took place with the concurrence of the federal Ministry of Finance.

This is the story of the liberalization of the ownership restrictions in respect of the securities industry in Canada. Developments following the decisions to liberalize have been very profound. The industry experienced a series of mergers as firms attempted enhance their capital positions and/or enrich the senior partners of the firms. There were

affiliations with foreign dealers and banks and ultimately the majority of the major dealers were taken over by the major chartered banks in Canada. These parent banks had the "deep pockets" which the securities industry required.

In the period since entry and ownership was liberalized, the Canadian financial markets have continued to flourish and moreover continue to be among the most sophisticated in the world. The doom and gloom scenarios of the 1970s and 1980s never materialized -- except for the fact that Canada's largest banks now own the major firms in the securities industry. But the industry continues to be owned and controlled by Canadians.

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A second component of the empirical methodology used in this dissertation was many wide ranging interviews with current and former securities regulators and officers of self regulatory organizations, with federal and provincial cabinet ministers, with senior investment industry and other financial services industry participants, and with senior public servants in the relevant government ministries and agencies. These interviews were extensive and granted to the author on the condition that they would not be for attribution. In the absence of anonymity I would have not received the needed cooperation to reconstruct the relevant events nor the required information to add necessary subtlety to the dynamic of events.

Interviews were conducted with the following:

- Four Federal and Provincial Cabinet Ministers
- Five Chairmen of the Ontario and Quebec Securities Commissions
- Two Deputy Ministers of Finance
- Five officers of self regulatory organizations
- Two federal government officials
- Five senior industry participants

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FIN

The following day, December 4, 1986, Monte Kwinter, the Minister of Financial Institutions made the following statements to the Ontario Legislature:

...It was the consensus of all the groups consulted that a substantial liberalization of the ownership rules, beyond the levels indicated in my June announcement, was required.

Other events in the fast-changing capital markets have also led us to a broader opening of the industry.

It has recently become clear that the role of the Canadian banks and other federal financial institutions in the securities market is in the process of being greatly expanded.

The most obvious example of this is the formation by the Bank of Nova Scotia of a subsidiary that is a full service securities dealer. Scotia Securities has been registered in Quebec and is beginning to carry on business there.

Banking is a matter that under the constitution falls to the federal government. Securities regulation is a matter of provincial jurisdiction. Accordingly, each level of government has a role to play in structuring our financial markets.

Ontario and the federal government have discussed the issues in our respective spheres of responsibility. I am pleased to report that fact, as co-operation between us is essential to the efficient working of our markets. While my understanding is that the federal position is not yet settled, I am hopeful that banks and other federally incorporated financial institutions will be allowed a major participation in the securities industry through subsidiaries.

This part of the process to liberalize the entry and ownership apparatus in Ontario (and Canada) came as an anti-climax. The federal government had to act quickly, and the provincial government, which was still attempting to sustain a majority of Canadian ownership in the investment dealer industry, was obliged to meet the new "Quebec standard" or risk losing Toronto as the pre-eminent financial center in Canada.