INVESTMENT
INDUSTRY ASSOCIATION
OF CANADA

Letter from the President

A View from the Trenches: Policies Needed to Promote Risk-Taking and Efficient Markets

An Uncertain Recovery as Governments Walk Fiscal Tightrope

The fiscal crisis may have receded to a distant memory but its consequences are still with us today, reflected in cautious investor sentiment and problems for small company financing. Although market volatility has subsided in recent months, uncertainty about the outlook, concerns about the regulatory and public policy response to struggling markets, and the wariness of event risk, pervade the marketplace. More than half the firms in the Canadian securities industry – those with business concentrated in the retail sector – continue to struggle mightily in the face of difficult business conditions, beyond the omnipresent regulatory burden and impact of prospective sales tax increases.

The strong recovery in equity and debt markets over the past year belies tepid economic conditions. The Canadian economy, measured in inflation-adjusted terms, actually contracted 2.5% last year, and may eke out 2-3% growth in 2010 as long as overstretched fiscal positions in the United States and Europe can be contained. Slowly recovering private demand will keep fiscal risks high as stimulus will only be withdrawn slowly to support growth. In Canada, business investment spending contracted 12% last year and the consensus expects modest recovery through this year. The key for recovery in the private sector and the fortunes of the securities industry is an accelerating pace of business spending and return to bullish business and investor confidence. Governments are walking a fiscal tight rope, supporting the recovery without blowing up public finances. No sign of the bond vigilantes is a good sign.

Year-End Industry Results Mask Market Challenges

First the good news. IIAC's yearly review of Canadian industry performance for 2009, to be released in early March, shows that despite the recovery's rocky beginnings, large dealers – notably the nine integrated firms – turned in solid results, with revenues up 20%. ROE averaged 24%, roughly in line with average returns over the past three years. The revenues of the roughly 50 domestic institutional firms rose 14% in a year, with an average group ROE in line with recent years. Revenue and earnings gains for these integrated and institutional firms can be traced mainly to dramatic and unexpected capital-raising in corporate Canada, shoring up balance sheets to manage operations in difficult conditions. The financial sector led the way, with the large banks and insurance companies raising common and preferred shares, as well as debentures. Large non-financial enterprise was similarly active in primary equity markets, such as the record $4 billion raised by Barrick Gold Corporation to buy back gold hedges. The recovery in commodities markets provided a window for mid-sized Canadian resource companies to tap equity markets for needed project capital. The window was restricted to those companies in a hot resource sector, such as gold and base metals, with strong project sponsorship.

But small companies outside this group found financing conditions tough. The bonanza in investment banking revenues, reflecting underwriting and advisory services, complemented strong gains in fixed income trading, a business dominated by large integrated dealers, as credit spreads collapsed and bond yields moved lower, creating profitable trading opportunities.

The presumption, based on strong recovery in investment banking and trading profits, is that the industry has left the worst of the crisis behind. Nothing could be further from the truth. First, the wealth management business remains in a parlous state as investors remain cautious in terms of trading and account activity, keeping record amounts of liquidity on the sidelines in the face of uncertain and sometimes treacherous markets. Reduced market volatility as the year went on dampened trading activity among retail and institutional clients. Caution among individual investors translated into reduced retail

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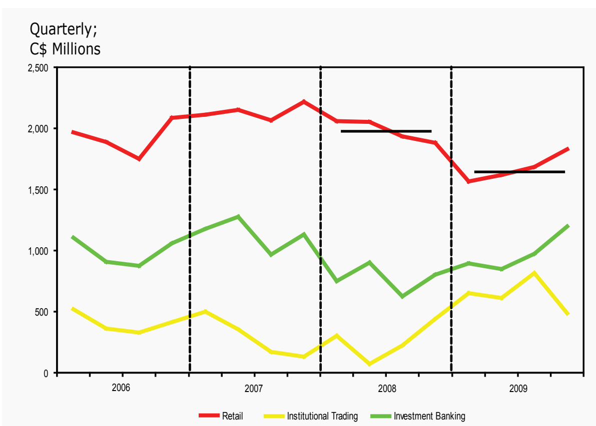
revenues. Retail revenue at the nine integrated firms, accounting for one-half of total business revenue, was down 15% year-over-year in 2009. More ominously, operating revenue for the independent retail firms has fallen steadily over the past two years, down 15% in the crisis year 2008 and another 10% last year. So much for a recovering industry. The nearly 90 introducing firms specializing in the retail business roughly broke even on an operating basis last year. These firms are barely covering their operating costs, squeezing compensation (mainly in bonus payments) and leaving little room for increased operating costs and capital expenditures, particularly if existing conditions prevail. Detailed industry statics are available at www.iiac.ca.

INDUSTRY OPERATING REVENUE
BY BUSINESS LINE



Further, strong performance of the integrated and institutional firms related to a buoyant investment banking business as companies rebuilt balance sheets as debt and equity markets became receptive to financings, and interest rates collapsed to rock bottom levels. This balance sheet restructuring of corporate Canada will probably fade, dimming prospects for the investment banking business unless a solid investment-led recovery takes hold.

IIAC Recommendations for Fiscal and Regulatory Policy To Encourage Investment

Fiscal stimulus and Bank of Canada interventions have been critical to stabilizing financial markets and providing a crucial underpinning to economic activity. While reliance on deficit financing will inevitably end as the private sector gets on its feet, fiscal and tax incentives are still necessary to buttress investor and business confidence.

Targeted and modest incentives to encourage investment spending are consistent with a fiscal strategy aimed at steady deficit reduction. First, we suggest helping middle income Canadians increase savings and investments through a retroactive TFSA account, so older Canadians can participate equitably with younger generations in this popular savings and retirement program. Second, we argue for a preferred capital gains tax rate for the listed shares of small public companies to facilitate issuance of new equity capital.

Securities regulation also has an important role to play in building competitive and efficient markets and restoring investor confidence. More liquid and active capital markets, underpinned by cost-efficient regulation, facilitates secondary trading and capital-raising activity, and attracts foreign investors to participate in domestic markets.

It has not been an easy time for securities commissions to set strategic agendas. In the aftermath of the financial crisis they must bolster investor confidence and review the adequacy of disclosure, particularly for complex derivative products, and regulatory coverage in exempt markets. Regulators must also address the pressing need for a regulatory framework for rapidly changing equity markets embracing stock exchanges and electronic trading platforms, as well as new types of trading and participants. And regulators must focus on the need for more timely and vigorous investigations and enforcement action. Of course, this regulatory agenda moves forward with the distraction of the ongoing effort to build a securities regulator for Canadian markets.

In its annual Statement of Priorities, the OSC has identified the appropriate regulatory priorities, including a deepened focus on investor protection, modernized responses to market developments, adequacy of regulatory coverage, and a strong, visible enforcement presence. But beyond identifying priority issues for investor protection and efficient markets, commissions must also put forward the regulatory approach that will achieve their strategic goals, in terms of regulatory effectiveness, responsiveness, and flexibility – at lower cost to market participants. In a response to the OSC request for comments, the IIAC has put forward its thinking on regulatory approach and methodology, including the importance of regulatory engagement with all market participants to understand market trends and developments and specific regulatory needs and optimal remedial approaches in terms of both action and timing.

Yours sincerely,

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