Letter from the President

Seizing Opportunity: How Industry Has Helped Confident Investors and Issuers Navigate Challenging Markets

Background: Investors and Issuers Make Most of Erratic Economic Environment

Throughout last year and extending into the early months of this year, financial markets were marked by volatility and a marked rebound in financial asset prices. Share prices moved steadily higher in the last six months of 2010, with the TSX Composite Index up 19% year-over-year, and 25% through to the mid March 2011 market peak. Bond yields held fairly steady on balance for much of last year, despite swinging prices. Yields, however, broke strongly lower in the final quarter of last year, with the 10-year benchmark Canada bond yield down 150 basis points. The yield collapse reflected negative sentiment about the strength of global recovery and flight to Treasuries in the wake of financial and geo-political events.

Active market participation, in terms of trading and financing, by investors and issuers throughout this period underscored high levels of confidence in well-functioning markets, the effectiveness of the savings-investment process and overall integrity of the marketplace. The overriding challenge for market participants was to identify opportunities to improve portfolio return and raise competitively priced debt and equity capital in markets fraught with volatility, marked changes in market sentiment and pervasive uncertainties about the outlook. Indeed, persistently large budget and trade deficits among many developed countries, fundamental adjustments in business practice, structural change in markets and deepening globalization in trade and financial transactions, have made prediction more difficult.

In this unpredictable environment, Canadian investors and issuers have shown remarkable resilience and responsiveness to changes from economic and geo-political shocks to seize narrow windows of investment and financing opportunity.

Regulatory Reforms Bolster Investor Confidence

Reforms underway in Canadian retail markets, notably the regulatory framework for the investor-advisor relationship, will reinforce confidence in the investment process by supplementing existing rules and procedures. The new framework is evolving into a balanced package of practical and targeted rules focused on better disclosure

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of financial products and the investment process, tougher standards for KYC and investor suitability, as well as portfolio performance reporting. Many of these new rules and principles both formalize and supplement existing practices, but now higher standards will be imposed industry-wide, subject to full compliance and audit across the industry. Numerous IIAC committees and working groups have contributed to this rule-making process, and will develop best practices and guidelines to assist firms to comply with the new rules and principles.

Further, IIAC efforts to help investors understand the importance of basic financial knowledge and the value of an advisor will boost confidence and market participation. These efforts focus on providing easy access to the IIAC internet platform to obtain relevant financial information from the industry, and hot-links to key internet sites and materials. Finally, the single regulator project -- with the right leadership, decentralized focus and effective regulatory framework -- has the potential to leverage off existing strengths in Canadian markets to make Canada the hub for capital-raising and trading in the shares of global energy and mining companies.

Recent Industry Performance: Wide Differences Based on Company Focus

The various investment and financing patterns over the past 18 months or so, reflecting varying market conditions, have had a significant impact on industry performance. Earnings results in this period have differed across firm groupings dependent on the particular business focus of firms.

Full-service firms down

Revenues and earnings performance at the national full-service firms fell sharply in the past year. Revenues were down 10% year-over-year and operating profit down about one-third from 2009 levels.

Two factors contributed to the earnings plunge:

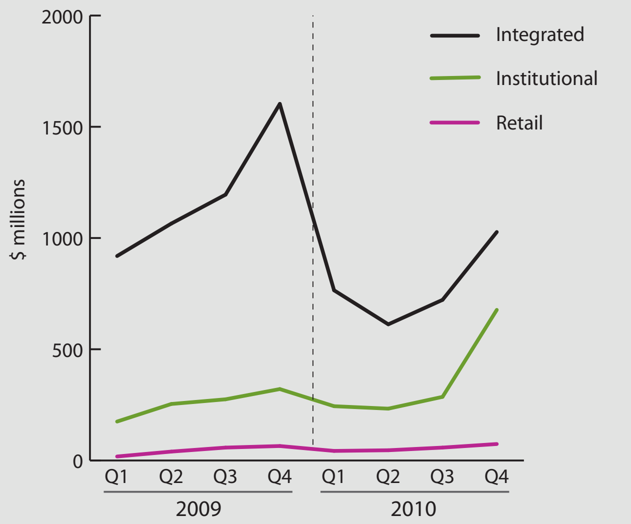
- The substantial trading gains in fixed-income debt securities in 2009, reflecting the collapse in bond yields and spreads, eroded steadily over the past year as bond yields bottomed out. While trading revenue fell in half last year, gross fixed income trading profits still contributed nearly 10% to the bottom line. Difficult trading markets persisted through the first quarter of this year.
- Investment banking revenue suffered a setback last year, but still remains close to pre-crisis bull market levels. Underwriting activity, both IPOs and secondary offerings, was sluggish in the first nine months of last year before recovering strongly in late 2010, with the fourth quarter accounting for nearly half the value of secondary offerings.

Wealth management business up

The wealth management business at the full-service dealers chalked up revenue gains of 13%. While profitable, the gains in the business, despite its revenue dominance in firm operations, were insufficient to offset the weaker performing institutional and corporate businesses. For the industry as a whole, wealth management revenue in the industry totaled $8.2 billion, up 14% in the year, $1 billion below the record level in 2007. Fee revenue rose 14% to $2.7 billion, a record level mainly reflecting upward portfolio valuation. The rising average size of book per advisor and AUM per household illustrates the segmenting of the client base to improve productivity in the wealth management business.

The flat-lining in trading and investment banking businesses at the integrated dealers, combined with a further injection of $1.5 billion in shareholders' equity, cut sharply into ROE, last year averaging 14%, well below the 20%-25% levels through most of the decade. The faltering profit performance of the nine integrated firms dragged down overall industry performance. Operating profit for the industry fell 20% last year to $4.8 billion.

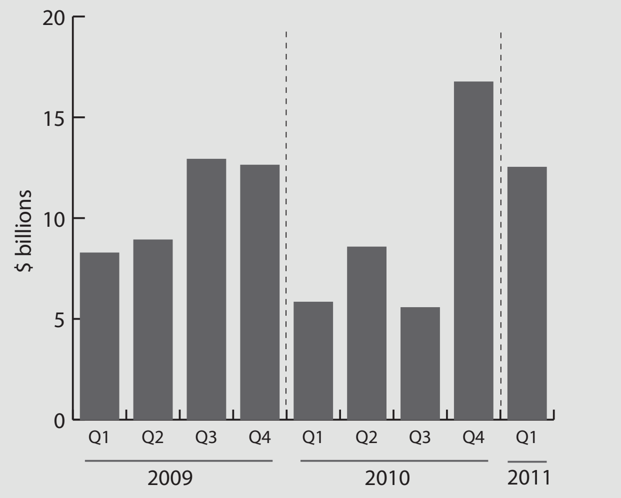
Operating Profit



Institutional firms show profit gains

The institutional firms, in contrast to the full-service firm grouping, notched up strong profit gains last year, reflecting a better performing investment banking business and minimal exposure to debt trading to drag down earnings. The upward trend in underwriting revenue over most of last year and through the first quarter of 2011 from equity offerings by small and mid-cap energy and mining companies contributed to strong earnings gains in the year. Operating profit for the group jumped nearly 40% last year to total $1.4 billion. The 18% ROE in 2010 is the largest ever recorded by the institutional group. The larger institutional firms have made efforts to build their business in Canada and the United States through strategic acquisitions.

Common Equity Issuance

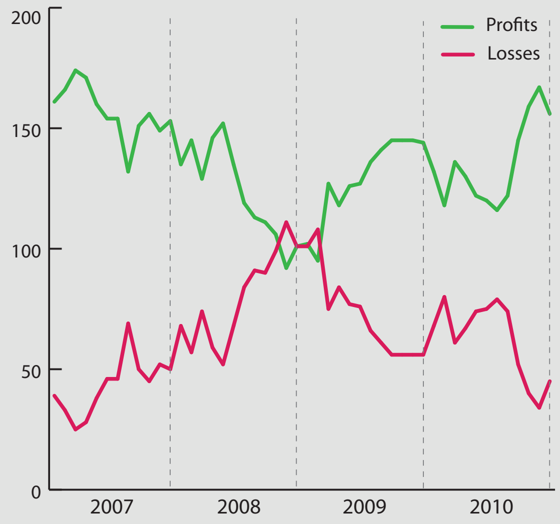


Retail firms show turnaround

The real surprise in the industry figures last year was the dramatic turnaround in performance by the 80 retail introducer firms. Earnings for this group were decimated in mid-2008 as the full impact of the financial crisis took hold, and most firms failed to rebuild profits as the market rebounded strongly in 2009. However, operating profits did make strong gains last year, particularly after mid-year, when equity markets gathered momentum and retail investors moved back into the markets. Retail revenues improved strongly on all fronts at the small firms – commissions, the fee business (mainly from higher portfolio values) and net interest earnings. As well, these firms made vigorous and successful efforts to hold down operating costs. A more competitive clearing business, stimulated by a new entrant to the marketplace, has pushed down clearing fees across the board, benefiting many introducer firms renewing contracts for clearing services (accounting for 5%-10% of operating costs). In contrast, the 35 self-clearing retail firms, measured as a group, were unable to achieve proportionate reductions in overall operating costs, contributing to a 4% fall-off in operating profit last year.

While the retail introducer firms have seen their profits double last year, and the number of Type One and Type Two introducer firms turning profitable last year up from 20 to 30 firms, profits for the group were still one-third the 2007 bull market level. Indeed, despite sterling efforts to hold down cost increases, business and competitive pressures on these firms will remain intense. Regulatory compliance costs are slated to move higher as the new client-advisor rules are phased in, tax-reporting obligations and related costs increase, and expenses for technology and skilled support staff escalate. Further, the rebound in equity markets cannot be taken for granted. Indeed, upward market momentum began to dissipate in the late spring this year.

Number of Firms with Profits and Losses



Many firms in the retail introducer group are strategically focused. They have taken careful steps to build a competitive franchise and will lever effectively off their clearing platforms. These firms will continue to benefit from improved services and innovation, and competitive platform costs. In this regard, IIAC will advocate more streamlined compliance procedures for firms using third-party service providers. Some firms in this industry grouping, however, will find amalgamations with competing firms the best option going forward. As a result, we will see continued acquisition and firm attrition among the independent self-clearers and introducer groups, and the migration of advisors across all firms in the industry.

Conclusion: Market Participation Grows Despite Structural Change, Uncertainty, and Increased Compliance Costs

Recent developments in the markets and the securities industry in the past 18 months have illustrated the underlying strength of the Canadian capital markets. Investors and issuers have not been deterred by market shocks and dislocations from economic, financial and geo-political events, or by continued market volatility. They have stayed the course to identify investment and financial opportunities, and when the right circumstances arise, have seized the openings. Investment firms across all firm groupings in the securities industry have responded to client demands for competitive returns and competitively-priced capital, and have helped firms seize the investment and financing windows.

Market participation has approached historic highs, in terms of active investors and issuers, supported by a competitive and diversified investment industry. This is a notable achievement for all market participants, given endemic structural change in capital markets, pervasive uncertainty about the economic and financial outlook, and the ratcheting up of regulatory standards and concomitant compliance costs.

Yours sincerely,

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