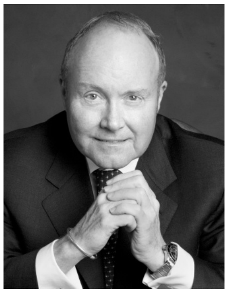
Letter from the President

INVESTMENT INDUSTRY ASSOCIATION OF CANADA



Vanishing Entrepreneurism in the Canadian Securities Industry

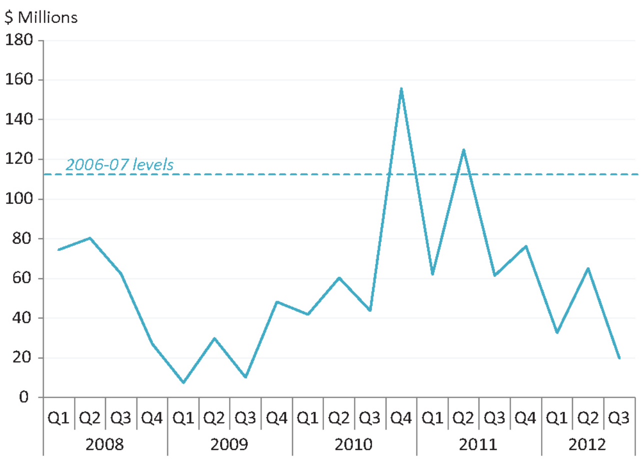
– The Role for Small Firms and Regulators

Vol. 56

Like many sectors, the securities industry has always drawn lifeblood and vigor from the entry of new firms, coming up with new ways of serving clients and forcing existing firms to work harder to compete. The good news is that in recent years five increasingly competitive carrier broker platforms have been providing needed back office and outsourcing services, as well as sophisticated investment products, that small investment dealers need, The bad news? Limited scale and specialized focus have made Canada's roughly 180 small and mid-sized dealers especially vulnerable to inevitable market downturns.

In the past, slashing spending enabled many firms to survive the challenge and improve efficiencies as business expanded when the up-cycle caught hold again. But this time, circumstances are different. The unprecedented four-year malaise in capital markets shows no sign of recovery, in terms of both investor participation and financing activity. Indeed, many investors have pulled to the sidelines and husbanded cash; many non-financial businesses have struggled in a weak economy and retrenched operations rather than expand business.

Small IPO Financings

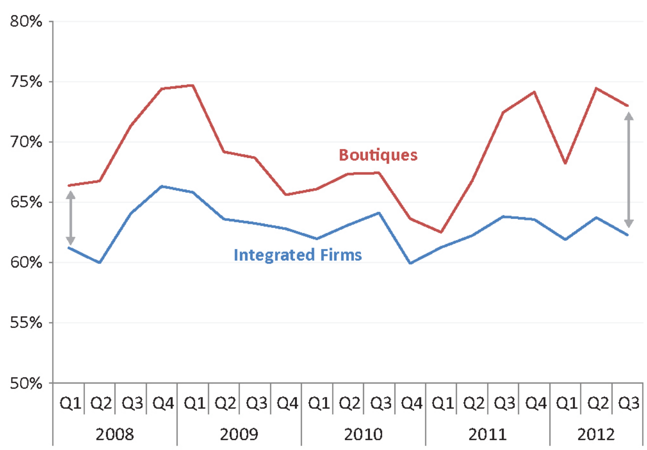


Source: IIAC

For these small and mid-sized firms in the fortunate position of needing capital to improve competitiveness or capacity have found access to capital restricted because of the inherent risk of small business shares. IPO financings for small companies have virtually ground to a halt, and secondary offerings of small business shares in public markets is now a fraction of the financing volume before the financial crash four years ago.

Meanwhile, fixed costs have escalated dramatically, both for needed technology and systems to service clients and facilitate client transactions, and to meet the demanding requirements for compliance with the rulebook.

Fixed Costs as a % of Overall Expenses



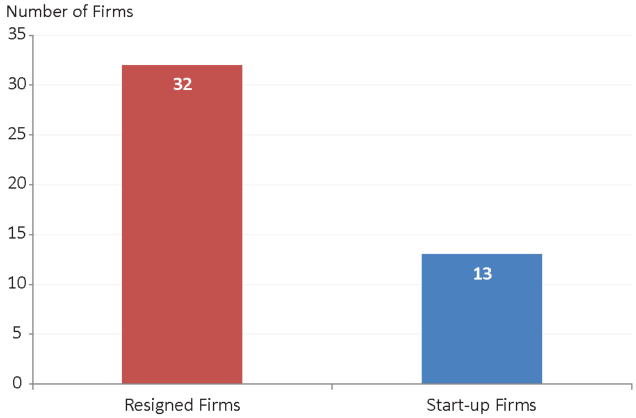
Source: IIAC

In the past several years since the crash, the Client Relationship Model has taken shape with four components: the relationship disclosure document (disclosure of the investment process), disclosure of conflicts of interest and the management of these conflicts, enhanced suitability requirements and performance reporting standards. Most of these components are being phased in over the next two years, requiring firms to put in place adequate resources and technology to comply with these new rules. Firms also must have interim procedures for the distribution of the now "Fund Facts" for mutual fund disclosure.

Small dealers face two unique problems. First, their fixed costs represent a higher proportion of overall expenses, limiting the impact of cost cutting. Increased compliance costs are a good illustration of the fixed cost burden on small firms. As small firms need to meet the same higher compliance standards for the retail business as the larger firms, they will add in significant fixed costs, in personnel and technology, more than proportionate to their relative business scale.

Second, smaller scale makes their costs per dollar of revenue about one-third higher. Weak market conditions together with rising fixed costs have devastated the boutique sector's earnings performance. Since 2007, revenues have averaged 17 percent and operating profit nearly 50 percent below pre-crash levels. In fact, half the boutique firms in the industry – some 90 firms – were losing money on a net basis in mid-2012.

Change in IIROC Membership*
Since the 2008 credit crunch



* Excludes proprietary and specialized trading firms

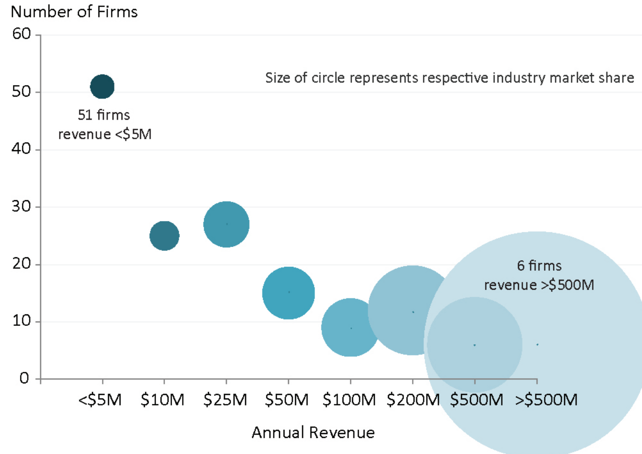
Source: IIAC

If these conditions continue much longer, we will undoubtedly see an acceleration of firm closures, amalgamations and acquisitions. In just the four years since the financial crash, we have seen the disappearance of 30 or so small and mid-sized dealers with a conventional retail and institutional business, most through acquisition. Meanwhile, higher fixed costs and the increased need for scale have posed greater barriers to entry to new firms, with only about 10 conventional dealers started up since the financial crash (excluding several proprietary and other specialized trading firms).

The amalgamation of small dealers can lead to stronger firms as a result of larger size or broader mix of business. But an accelerated pace of consolidation foreshadows negative consequences for our markets and the economy. These small boutique firms do more than just add competitive vitality to the marketplace, often making a unique contribution by offering a full array of wealth management services to investors with lower wealth thresholds, or specializing in the research, underwriting and distribution of the shares of small and mid-sized business – the demise of the small dealer will limit consumer choice for wealth management services, aggravate the already difficult financing problem for small and mid-sized companies and erode the liquidity of Venture and TSX listed shares.

Difficult conditions will improve in the near future – hopefully, this will happen before major structural change in the industry has gone too far. But whatever the course of market conditions, higher fixed costs for technology and systems, and higher regulatory costs, are here to stay. But this new reality need not mean the demise of the small dealer sector, nor the end of entrepreneurism in the industry.

Industry Vulnerability
Distribution of Firm Revenue



Source: IIAC

To ensure it does not, both the industry and the regulators have roles to play. Executives at small firms must continue to make the needed business adjustments to manage the industry's higher cost burdens. Some business models are just not compatible with these new realities, and managers must recognize the need for critical mass.

Remedial measures should include building sufficient business scale through incremental hiring or strategic acquisition, and achieving targeted cost savings. Regulators also need to take the right steps. The rule-making process must be subject to rigorous cost-benefit analysis, both to prioritize the rule agenda and avoid unintended consequences. Further, regulators need to work closely with the industry to streamline required compliance procedures and provide the needed flexibility to accommodate different business models, often with limited business scale. One size doesn't fit all. That simply means compliance procedures at individual firms should be focused first and foremost on outcomes – not compliance technique. The risk-based compliance approach is a good start but it doesn't go far enough.

We all recognize the securities business has changed irrevocably, and for the better – delivering higher quality services at a higher standard of integrity. This transformation will not necessarily result in the demise of the boutique sector or the disappearance of entrepreneurism in the industry – if industry executives and the regulators work hard to make sure of it.

Yours sincerely,

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President & CEO, IIAC
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