ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

INVESTMENT INDUSTRY ASSOCIATION OF CANADA

INVESTMENT IN CANADA'S INTEREST

A DISCUSSION PAPER

Submission to Industry Canada, November 21, 2007 (R)

The Investment Industry Association of Canada (IIAC) is a member-based, professional association that advances the growth and development of the Canadian investment industry. IIAC acts as a strong, proactive voice to represent the interests of the investment industry for all market participants. Our member firms range in size from small regional firms to large organizations that employ thousands of individuals across the country. Our members work with Canadians to help build prosperity and investment security for investors and their families.

The IIAC's aims are fourfold:

Advocacy: To be the voice of the investment dealer and brokerage industry, advocating on regulatory and public policy issues for an investment environment that is efficient for our members and that fosters savings and investment by Canadians

Industry profile: To build a better appreciation of the contribution that the securities industry makes to Canadians, to Canada's capital markets and to the Canadian economy

Member support: To offer operational support that contributes to the ongoing success of our members and to their ability to cost-effectively serve investors and issuers

Market advancement: To promote globally competitive capital markets for Canada.

PURPOSE

To discuss how Canada can benefit from foreign direct and indirect investment while promoting investment by Canadian companies in Canada and abroad and improving the ability of Canadian companies to compete globally.

> **Whether through the removal of barriers that inhibit aspiring firms, or through the refinement of policies that are the foundation of economic activity, the government has a significant role to play in establishing the conditions that will assure Canada's position as an attractive destination for investment, both by Canadians and those from abroad. Robust investment drives economic development, and underpins Canada's prosperity and quality of life.**
>
> – *Sharpening Canada's competitive edge*
> Competition Policy Review Panel, October 30, 2007

SUMMARY

- In light of its large geographic scale, vast resources and proportionally small population, Canada has been the beneficiary of inward investment throughout its history. This has contributed to Canada's high standard of living. Globalization has not put Canada at a disadvantage, however, this may change unless leaders in this country act to create as competitive a business environment as possible for Canada's home-grown companies.

- The recent acquisition by foreign firms of Canadian companies caused a number of concerns, ranging from whether the companies would be run in the interests of Canada and Canadians; to whether jobs, investment and taxes would be pulled from Canada; to worries that foreign governments would use acquisitions for political ends. These concerns are usually misplaced and often outweighed by the value that foreign investment has brought and continues to bring to Canada.

- The Investment Industry Association of Canada (IIAC) is pleased that the federal government has chosen to investigate fact and perception through the creation of the Competition Policy Review Panel (the Panel), which released its consultation paper *Sharpening Canada's Competitive Edge* in 2007. Consistent with the Panel Chair's statement that "We must ensure that our policies are modern and effective, to enable Canadian firms to maximize their productivity and competitiveness", the IIAC believes that the key to improved productivity and the competitiveness of Canadian business is increased capital formation and more efficient capital markets. Capital spending expands the scope and efficiency of business to compete more effectively in domestic and global markets. Efficient capital markets facilitate savings growth as well as venture and other capital-raising endeavours.

- This discussion paper reflects the IIAC's views on the principles that should govern investment policy decisions, the issues they aim to address and specific recommendations. In summary:
  - We must rely on market forces – not governments – to find winning companies and sectors
  - The government has a critical role to play in:
    - Identifying ways to promote investment and growth of Canadian business by improving the competitiveness of our large global companies and removing barriers to building small enterprises into a critical mass of mid-sized companies that can compete globally

- Removing obstacles to the competitiveness of our capital markets and Canadian companies to improve investment returns, liquidity and choice, including by modernizing the content and structure of securities regulation governing capital markets activity.

PRINCIPLES

1. **Cost-benefit analyses and timely consultation:** Policies, laws and regulations should be based on realistic cost-benefit analyses, with all parties able to contribute effectively to the debate.
2. **Efficient laws and regulations:** For free markets to work best, they should be as free as possible of unnecessary or duplicative laws, regulations and procedures. Laws and regulations that are required for investor protection, transparency, efficiency and ensuring a level playing field must be enforced effectively.
3. **Need for certainty and consistency:** Canadian policymakers must take into account how their actions (or inaction) will be perceived internationally and mitigate the risk of negative effects.

ISSUES

1. **Risk of headline-driven decision-making:** Policy changes may be undertaken that are based on headlines and not fact – perceptions that Canada is losing Canadian companies; that companies acquired by foreign entities (in particular foreign government-owned ones, where some are viewed as benign and others as "bad") may be antithetical to Canadian interests; that jobs will be lost; and that foreign governments may use acquisitions for political ends.[1] However, a decision to restrict investment may have unexpected outcomes – for example, the Canada Pension Plan Investment Board itself makes investments in foreign countries and thus Canadian investor interests may be impeded should other countries limit investing by Canadian sovereign entities to retaliate for any Canadian limitations implemented.

2. **Canada constrains Canadian company competitiveness:** Strategies to improve Canadian firms' ability to compete in Canada and globally are lacking, unevenly applied, inconsistent between levels of government and/or subject to political influences. These include strategies relating to taxes, legislation and regulation, and productivity improvements. In some cases, policies, regulation or the related enforcement (or lack of enforcement) tilt the playing field in favour of competitors outside of Canada.

3. **The risk of uncertainty:** The federal and provincial governments have recently made decisions or taken actions that call into question whether Canada is, indeed, open for business. Canadian governments have been perceived both within and from outside Canada to reverse course without warning, causing dislocations in the marketplace and a loss of business confidence. Consider the following examples: the sudden removal of interest

[1] Germany is facing a similar situation to Canada. *Deutsche Bank Research*, on September 27, 2007, reported that: "The degree of openness of the German economy has resulted in comparatively close trade and financial investment ties with other countries. This has stood Germany in good stead so far. Foreign investors' renewed interest in commitments in Germany … [has] created additional impetus to growth. The distinction between "good" and "bad" capital is therefore not particularly helpful – all the more so, since the view that foreign sovereign capital pursues strategic rather than yield-oriented investment aims has proved misplaced on the basis of experience so far and as a general rule."

deductibility on loans to foreign subsidiaries; the reversal in the tax treatment for income trusts; and the Alberta Royalty Review Panel report recommending royalties that were seen as massive new taxes (a daily e-letter by a credible foreign global investment analyst following the Alberta government's publication of the oil and gas royalty scheme said that the scheme, on top of the October 30, 2006 income trust change, was sufficient to push the advisor, and possibly others through him, into divesting from Canada due to the inability to obtain certainty about government policy).

RECOMMENDATIONS

1. **Rely on existing legislation such as the *Competition Act* to protect Canadian interests and:**
   - Require and/or make better disclosure of both inward and outward direct and indirect investment, as well as inward and outward cross-border mergers and acquisitions
   - Given the higher concern surrounding sovereign-owned investment, especially from countries where governance, transparency, and legal and accounting standards may vary considerably from the Canadian norm, work with international counterparts to promote minimum standards for disclosure – do not prohibit sovereign-owned investment altogether to avoid risks of retaliation against, for example, major Canadian government-run pension plans.
   - Work with Finance and Industry Canada to identify and publicize where other countries impede Canadian companies' ability to do business or enable their indigenous companies to be more competitive than Canadian businesses in third countries.

2. **Improve Canadian firms' ability to compete in Canada and globally:**
   - ***Improve the tax environment for investment in Canada by Canadians:***
     - ***Lower taxes on capital gains as promised in the 2006 Conservative Party platform and increase the maximum annual RRSP limit from 18 to 25 per cent of earned income to encourage further savings and investment:*** This will stimulate productive capital formation and make Canada more attractive to people with talent and drive who are discouraged by the personal income tax system's high marginal tax rates. These start at a relatively low level of income, encourage spending over investment and discourage people from increased work efforts or education to improve their future earnings, productivity and prosperity for Canada (refer to the IIAC's discussion paper: *Better Capital Gains Treatment = Gains In Canada's Productivity*). We also urge provincial counterparts to reduce the corporate tax burden in line with the federal government's goal of reducing the combined corporate income tax rate to 25 per cent.
     - ***Encourage research and development spending by extending the Scientific Research and Experimental Development (SR&ED) tax credit program:*** The program should be extended from small Canadian-controlled private corporations (CCPCs) to small and mid-sized companies listed on the TSX Venture Exchange, CNQ and other markets so that these firms no longer lose access to SR&ED credits as a source of financing just when they are at the critical stage of expansion implied by going public. As well, at least for CCPCs, provide refundable benefits rather than just tax credits, which may not be able to be used when most needed, that is, at the start-up phase when income is low or non-existent. The IIAC also recommends measures to promote a stronger liaison of businesses with universities by encouraging R&D-through-to-development-and-commercialization partnerships, with a view to developing more clusters of expertise in regional or national sectors.

- ***Compensate provinces for any net loss from eliminating sales tax – the tax on tax still buried in many products and services exported from Canada that makes them less competitive – to harmonize with the GST while avoiding a net increase in net provincial sales tax paid by intermediaries:*** This would create a more efficient consumption tax and relieve the sales tax burden of beleaguered manufacturing companies. The potential rate reductions from this are significant, as recently estimated by the C.D. Howe Institute.

- ***Streamline the regulatory framework:*** specific changes will vary by sector; in the case of the investment industry:

  1) ***Alleviate the regulatory burden and lack of national perspective/accountability regarding Canada's capital markets by rationalizing the activities of regulatory bodies to eliminate both gaps and duplication***, to better achieve the transparency and efficiency improvements that each individual regulator has as its mandate. While the debate rages on as to the benefits of a multi-jurisdictional "passport model" versus a common securities regulator, the one common conclusion is that the way the current system works does not help the competitiveness of Canadian firms globally or Canadian capital markets domestically. Non-Canadian firms that come to Canada do so *despite* the multi-jurisdictional morass and we will never know what opportunities Canada and Canadians do not see because of this.

     For this reason, the provincial governments and their regulators should continue efforts to reduce the significant regulatory burdens on capital markets, investors and issuers by eliminating the duplication of rules, regulations and multiple fees for securities distribution and broker registration across jurisdictions. Regulators should streamline prescriptive rulebooks, rely on fundamental principles and modernize the regulatory regime to facilitate the mobility of investors and the distribution of public offerings and private placements across Canada. The proposed Passport System is a good first step to this end, but it does not resolve all of the issues.

     As an example, while we agree that the issuance of debt or equity by small new companies needs greater review, requiring review in each jurisdiction in which securities are made available makes it prohibitively expensive for some small firms to make it to the next level. In this regard, a 2007 Canadian Bankers Association study states that: "If the… firms seek to raise capital in all 13 jurisdictions rather than just one, we estimate that regulation-related costs would double to 16% of capital in the case of a firm seeking to raise $1 million and to 4% of capital in the case of a firm seeking to raise $10 million. In practice, this limits the jurisdictions in which firms seek to raise capital." As a particular example, the Prospectors & Developers Association of Canada (PDAC) notes that junior mineral exploration companies, because they generally have no cash flow, sell shares to finance stages in exploration programs. Financings tend to be small and relatively frequent, with 64 per cent being for less than $250,000. PDAC argues that a disproportionate amount of money raised is spent on regulatory matters rather than direct investment.

     Success on this agenda should result in higher investor returns (as they will be undiminished by as many regulatory fees) and a lower cost of capital for issuers. Provincial governments would do well to work towards a national construct for securities regulation that would lead to greater regulatory efficiencies, a national perspective and accountability for capital markets, and more vigorous and effective securities enforcement.

  2) ***Adopt a principles- rather than rules-based regulatory regime*** in as many aspects of government as possible and, where not practical, consulting with the firms affected to ensure the most cost-effective ways of regulation (refer to the IIAC's discussion

paper: *A Capital Idea – Clear, Consistent, Competitive Canadian Capital Markets Legislation and Regulation*). Principles-based regulation should not be equated with *no* enforcement; in fact, effective enforcement of reasonable rules is critical to the credibility and competitiveness of capital markets. It is also important to ensuring a level playing field, for example, between domestic registered firms and unregistered foreign internet-based providers of investment services.

3) ***Expedite review and action on government-related recommendations that will reduce business costs of operation****,* without disadvantaging Canadian taxpayers or investors. In this regard, we are pleased that the federal government is reviewing its departments for efficiencies, but believe that this process should involve representatives of the businesses or individuals that most closely interact with these departments (refer to the IIAC's discussion paper: *The Taxing Truth – Canada Needs to Rationalize Tax Reporting for Intermediaries*).

4) ***Communicate the urgency of getting on with the competitive agenda*****:** Canadians need to understand that building strong, competitive businesses is the key to economic growth and prosperity, and that the interests of companies and Canadians are usually closely, if not always fully, aligned.

5) ***Get involved in a capital markets strategy to promote Canada's capital markets and Canada as a place to invest:*** The IIAC supports moves towards freer trade. The Association welcomes Canada's and the G7's decision to pursue removal of barriers to trade in global financial markets and indications that the U.S. Securities and Exchange Commission (SEC) may be prepared to dismantle regulatory barriers to access U.S. capital markets. The initial mandate of the IIAC's Free Trade in Securities Committee is to gain better access to the U.S. institutional marketplace for Canadian investment dealers by removing U.S. regulatory impediments to Canadian dealers who wish to gain access to U.S. markets. The objective is to permit Canadian registered investment dealers to directly access U.S. institutional clients, without the need to comply with U.S. registration requirements. Reducing unnecessary costs for capital markets participants will improve the ability of Canadian firms to compete better and take advantage of freer trade. As well, a greater focus on the capital markets in prominent government websites should be undertaken: For example, sectors listed on the Foreign Affairs and International Trade Canada (FAITC) and Industry Canada websites should be expanded to include capital markets/financial services.

3. Establish Canada as being clearly "open for business":

- ***Market Canada, including its advances that improve certainty for investors (modernized securities transfer, and bankruptcy and insolvency legislation), and its reductions in bureaucracy and red tape, after receiving more input from capital markets and financial services industry representatives***. Further work on a national strategy to promote Canada and Canada's capital markets as places to invest should be undertaken and U.K. Trade and Investment provides useful sectoral examples to consider in this regard.
- ***Establish/better publicize a portal for Canadian businesses to access and share information on trade and investment,*** specifically relevant information from Industry Canada, FAITC, the Canadian International Development Agency (CIDA), Export Development Corporation (EDC), Finance Canada and provincial development agencies.
- ***Ensure timely, clear and consistent decision-making*** by the federal government and timely implementation of legislation and regulation.

- ***Explain the implications of apparent inconsistencies in direction on investment in Canada*** in First Ministers' meetings and with other provincial counterparts at different levels.

BACKGROUND

Open markets matter. The healthiest economies over time accept both inflows and outflows of foreign direct investment (FDI) and the attraction can be greater if the perceived tax and regulatory burdens are lower.

Benefits of FDI Outflows	Benefits of FDI Inflows
Opportunities to expand business operations in foreign markets and exports, bringing greater market share for Canadian products and services	International competitors force Canadian firms and managers to operate more efficiently
Better access to international technology, resources, innovation and financing	Better access to international technology, resources, innovation and financing

Source: *"Canada is missing out on global capital market integration,"* C.D. Howe Institute, August 21, 2007

Is Canada losing out to foreign competitors?

At both a macro- and a micro-level, the answer is both "yes" and "no." But on average, the "no's" have it… to date.

At a macro level, yes, Canada has lost ground because globalization has created a more competitive world, where trade in goods, services and capital are no longer restricted to developed countries like Canada. The role of the BRIC countries – Brazil, Russia, India and China – are expanding and costs in these developing countries are lower, making outsourcing a concern for some in North America.

And no, Canada is not losing out to foreign competitors – while new competition from developing nations risks undermining the Canadian economy, the Canadian economy has benefited from booming commodities markets in an expanding global economy. As an example, Canada has also benefited directly and indirectly from China's growth. As a direct benefit, the value of exports from Canada to China has increased by almost eight per cent since 2001. Indirectly, China's demand for Canadian industrial raw materials, notably energy and metals, has pushed up world prices for Canadian commodities. This is just one reason for the three-per-cent per-annum growth in Canadian GDP in the past five years, the second-highest rate of growth among the G7 countries.

Yes, jobs have been lost and head offices have departed from Canada to the home country of their new owners. And no, according to The Conference Board of Canada, foreign takeovers led to a four-per-cent increase in the number of head offices in Canada between 1999 and 2005. And where some head office jobs have been lost, to the extent that these companies relate to the resource sector, as many do, most of jobs will stay here in any event as the resources are in Canada: in fact, Canada's unemployment level is down to 6.1 percent – a significant drop from the 9.5 percent rate 12 years ago.

At a micro level, yes, there recently has been a noticeable increase in mergers and acquisitions by foreign firms. And no, Canadian companies are not just being acquired; they are also acquiring. The dollar value of the Canadian companies being sold (over $111 billion last year) is slightly higher than the dollar value of the foreign companies Canadians are buying (about $84 billion in the same period). Last year, Financial Post Crosbie: Mergers & Acquisitions in Canada

reported that Canadian companies acquired almost 500 foreign companies – including 241 U.S. companies – while foreign purchasers acquired only 175 Canadian companies. The ratio of firms gained versus firms lost is almost 3:1. And according to the same database, in the first three months of 2007, Canadian firms announced the purchase of 134 foreign companies, while foreigners bought only 46 homegrown Canadian firms – still a ratio of almost 3:1. So, Canada is not the only country where companies are being acquired (for example, Silicon Valley's Lucent Technologies was acquired by the French telecom giant Alcatel for $11.6 billion). Globalization is happening … globally … in every free market country.

What would be the effect of policies limiting foreign acquisitions?

The effect of the introduction of Canadian policies limiting foreign acquisitions would likely be the erection of trade and/or investment barriers to Canada and Canadian firms. There may be a short-term gain for long-term pain. The impact of the *Foreign Investment Review Act* as a chill on investment in Canada some decades ago can be examined to confirm if this assumption is correct.

Can Canadian companies compete?

Although Canada does not offer the same economies of scale as the U.S., Canadian home-grown companies rank as global "industry leaders." The Institute for Competitiveness and Prosperity reports that, in 1985, Canada only had 33 "world-beating" companies; by 2005, that number had risen to 85 and included some of the biggest names globally: Nortel, CAE, Bombardier and RIM.

While Canada has held its own in merger activity, some larger, more visible corporations have been taken over by foreign interests. According to statistics from the Institute for Competitiveness and Prosperity, the recent spate of acquisitions left Canada with only 72 companies that rank as worldwide "industry leaders," down from 85 – a loss of 13 world leaders in two years. According to a just-released study by PricewaterhouseCoopers, the number of Canadian companies among the world's 40 largest public mining companies fell from twelve in 2003 to six in 2006.

In the past two years, not only has the Canadian dollar been soaring and the economy and employment been growing, so too have the costs of doing business. Regulation has been increasing in almost every field with little in the way of countervailing reductions. While there have been tax decreases, they have generally not been as far or as fast as in our competitor countries. We need a more enlightened regulatory and tax environment to stay competitive, especially in a world with freer trade in securities.

We have been losing in traditional areas of strength:

- While Canada has over 1,200 mining companies listed on the TSX and TSX Venture Exchange, compared with approximately only 200 on the London Stock Exchange and the Alternative Investment Market (AIM), there are signs that our role in global capital markets is weakening. For example, London is almost catching up with Canada as a mining finance centre, raising $10.8 billion compared with $12.5 billion in Canada last year.
- In global financial markets, nine years ago, the Royal Bank of Scotland and Bank of Montreal were the same size. Today, the Royal Bank of Scotland is four times the size of BMO, with a market value of more than $126 billion. What is more, Canada has only one bank, the Royal, among the top 50 worldwide, whereas in the 1980s, Canada had four times that number.

We believe that other industry sectors will have similar examples. These emerging realities are not problems created by globalization. They are created because Canada is not fully effectively identifying ways to promote the investment in and growth of Canadian businesses and has not effectively removed unhelpful barriers to competition.