

Proposed Restructuring of the Canadian Stock Exchanges

Report by three members of the Advisory Committee

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Montréal, May 5, 1999

BACKGROUND

On March 15, 1999, executives of the Montréal, Toronto, Alberta and Vancouver stock exchanges signed a memorandum of agreement concerning the restructuring of Canada's capital markets. Under the agreement, the Montréal Exchange would become a national derivatives exchange in return for transferring its equities trading to the stock exchanges in Toronto and the West.

The Advisory Committee, set up by Bernard Landry, Québec's Deputy Premier and Minister of State for the Economy and Finance, agrees unanimously that derivatives trading should be centralized at the Montréal Exchange and large-cap equities trading transferred to the Toronto Stock Exchange, but is divided about the consequences of the restructuring as it concerns small and mid-cap equities.

The Montréal Exchange is not only a securities market but also an economic-development tool. The signatories to this report believe that Québec's economy would be better served if the Montréal Exchange continued to serve small and mid-sized businesses independently rather than simply becoming a service portal for the exchanges in the West.

The contribution by SMBs to Québec's economy is so significant that they are of special concern to the undersigned, who would like to suggest a different arrangement from the one proposed by the other Committee members.

Context of Québec's small and mid-sized businesses

Québec is well established in the North American economy but is also aware of its cultural and linguistic distinctiveness, and has always adapted its policies to this dual reality. Québec has a diversified economy whose growth depends on the development of its SMBs, especially those in the new knowledge-based economy.

These businesses occupy specialized niches and develop through their ability to innovate and to respond quickly to the specific needs of their markets. They have a strong entrepreneurial culture, but to sustain their growth and to expand internationally they need customized financial services and a regulatory framework that reflects their reality. Québec continues to develop this “intelligent capital,” which takes into account talent, technological ability and managerial skills as well as corporate financial statements. Almost one-half of Canada's venture capital is found in Québec.

Aerospace, information and multimedia technologies, biotechnology and pharmaceuticals are the leading-edge sectors of this thriving economy. Many small Québec businesses have benefited from this venture capital and intend to finance their growth in the near future through initial public offerings on the Montréal Exchange.

The Montréal Exchange

The Montréal Exchange is a tool for its member-users but it is also public property. It is not only an organization that brings investors together but also a centre for exchanges of information and regulation which, according to the efficient market theory, promotes securities transactions at prices that are the best reflection of reality.

It is also an active player in the financial community through its role in providing capital for businesses. These businesses rely on rules that are adapted to their needs so as to facilitate access to capital. The Exchange must also invest in research and development to provide new tools that will facilitate financing and reduce risks for these businesses and their investors.

MEMORANDUM OF AGREEMENT BETWEEN THE CANADIAN STOCK EXCHANGES

The undersigned recognize that the objectives of the memorandum of agreement between the exchanges are entirely commendable. We recognize that measures must be taken to improve securities liquidity and to optimize the efficiency and competitiveness of the exchanges, given the competition from the United States. Like the other members of the Advisory Committee, we endorse the concentration of derivatives trading at the Montréal Exchange and large-cap equities trading at the Toronto Stock Exchange.

Concentration of trading in large-cap equities on the North American markets seems inevitable to ensure a market that is more liquid and less costly. Québec's large companies will find no fault with such an arrangement, insofar as they hope to gain access to larger markets. Concentration of derivatives trading in Montréal makes sense to the extent that the Exchange is successful in this area and the international financial markets respond accordingly. This area is underdeveloped in Canada in relation to the other industrialized countries and offers substantial growth potential.

Centralization of small-cap equities on a single national stock exchange, however, is not acceptable for the following reasons:

1. Regional stock exchanges are clearly more efficient when they operate in proximity to the companies listed on them and to their investors. The environmental context is very important to the financial analysis of a small or mid-sized business. Those who assess the potential of such businesses must be familiar with this environment. Similarly, the proximity of a stock exchange and its decision makers is a key factor if these businesses are to be served properly. Many executives at technology and other companies have expressed concern about not being able to receive the appropriate service from a stock exchange whose managers have rarely been sensitive to the Québec realities because of their distance from Québec.

2. The location of the management of a small and mid-cap exchange is important for its success. The managers must be able to adjust the rules governing listing, procedures and continued listing to the needs of the companies traded on it.
3. Merger of the three exchanges into a national exchange is not essential for economies of scale. Such economies can be achieved if the costs of developing computer systems are shared and certain operations are pooled through outsourcing arrangements that have already proved useful in other sectors.
4. Maintaining an independent stock exchange in Montreal would not preclude strategic alliances. On the contrary, the Montréal Exchange and its counterparts in the West could initiate a network of regional stock exchanges whose membership might include U.S. or European partners, such as exchanges in Boston, Philadelphia, San Francisco or the New Europe.
5. The large proportion of venture capital in Québec suggests that the demand for financing on the public markets will be very significant in the near future.

The common owners of the Montreal and Toronto exchanges will undoubtedly understand that it is unthinkable to relinquish a useful, well-established institution that is essential for Québec's economic growth. Certainly, the public interest is well served by such an exchange.

OUR RECOMMENDATIONS

- Maintain small- and mid-cap equities trading on an independent Montréal Exchange governed by the Commission des valeurs mobilières du Québec (CVMQ).
- Encourage sharing of the costs of developing common computer and operating systems with the other Canadian stock exchanges, U.S. exchanges or other partners. In such a context, we encourage strategic alliances between the independent stock exchanges in Montreal, Calgary and Vancouver.
- Open the ownership of these exchanges to new shareholders to ensure they have the additional resources and means to achieve their objectives. Since it is desirable that a stock exchange also belong to those who invest on it and use it, this additional capital could come from institutional investors, issuers and the general public.
- Approve the transfer of all derivatives trading to Montréal in return for the transfer of all large-cap equities trading to Toronto. This initiative has been strongly endorsed by the Canadian financial community and all members of the Advisory Committee, but it requires support from the various market participants likely to contribute to the success of the two specialized stock exchanges.
- Sustain and take an active part in the development of derivatives expertise in Montréal. To ensure its growth and success, the Montréal Exchange will need human, financial and technological resources specifically for its new national role. Such resources are vital if the derivatives exchange is to achieve international recognition, which will be a key factor in its success. To that end, both levels of government will have to take up new challenges.

CONCLUSION

This counterproposal is entirely in keeping with the spirit of the restructuring of the Canadian stock exchanges. It does not affect the positioning of the Toronto Stock Exchange. It would enable the various regions to maintain independent stock markets and companies in all regions to continue to have a local stock exchange.

Moreover, it justifies maintenance of local securities commissions sensitive to the needs of the businesses in their environment and to investor protection, while engaged in efforts to achieve cooperation and harmonization.

Opening the ownership of the Montréal Exchange to other market participants would enable the Exchange to restructure itself to reflect its new role, its new status and the new players for which it would be acting as a national derivatives exchange, in addition to serving Québec's small and medium caps. In this way, small and mid-sized businesses will be protected whether they are already listed or are planning an initial public offering.

Finally, although the proposed restructuring of the Canadian stock exchanges was presented to us as a comprehensive agreement, we believe that the interests of Québec's economy leave us no choice but to recommend that management of the Montréal Exchange review the proposal to ensure it is better adapted to the realities of Québec in line with the parameters we have discussed.

ACKNOWLEDGMENTS

The signatories to this report would like to thank Bernard Landry, Deputy Premier and Minister of State for the Economy and Finance of Québec, for his confidence in them and in witness whereof would in turn like to express their confidence in the development and vitality of Québec's economy.

SIGNATURES

April 30, 1999.

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