



Investment Industry Association of Canada Association canadienne du commerce des valeurs mobilières

RE-ENERGIZING CANADA'S PUBLIC EQUITY MARKETS

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CONTENTS

Executive Summary	3
Introduction	4
Hollowing Out of Public Equity Markets	6
i) The Evidence	6
ii) The Impacted Parties	7
iii) The Significance	10
Markets as a Public Good	11
The Importance of Regulation	12
Causes of Hollowing Out	14
i) Fixed Cost Burden in a Variable Risk Business	15
ii) The Capital Needs of a Knowledge Economy	18
iii) The Fall of the Four Pillars	19
iv) Private Capital as a Substitute for Public Equity	20
v) Crowding Out by Governments	21
Re-Energizing the Public Equity Markets – Possible Macro Remedies	22
i) Removing Fixed Regulatory Costs	22
ii) Promoting Transparency and Fairness in Private Markets	23
iii) Reducing Crowding by Government	24
iv) Encouraging FIGs to Think Big and Grow Globally	25
Conclusions – A Possible Future for Canadian Equity Markets	27



EXECUTIVE SUMMARY

The number of companies listed on the TSX has fallen from 1,486 in 2008 to 747 in 2023 – an astonishing 50% decline in 15 years¹. Canadian companies are opting to sell to foreign buyers and leave the country than go public. A flight of capital and the concentration of capital allocation decisions outside the country poses danger to the ecosystem, harming the economic position of issuers, employers/employees, investors, intermediaries and governments.

The goal of this paper is not to be a sensationalist or controversial, but to start an honest conversation to begin to effect policy changes to reverse course. Put simply, it is in everyone's economic self-interest to defend, support and build a robust Canadian investment culture.

The paper explores some of the causes of the hollowing out of equity markets – rising fixed costs for intermediaries and issuers, the shift towards a knowledge economy, the fall of the four pillars in the financial industry, private capital as a substitute for public equity, and a crowding out by governments.

The paper argues that Canada must reprioritize and focus on the system-wide incentives that will make our public equity markets more vibrant and explores ways this reprioritization may be accomplished – by removing fixed regulatory costs, promoting transparency and fairness in private markets, reducing crowding out government, and creating a conducive policy environment for financial institutions groups (FIGs) to think big and grow globally.

Thoughtful deregulation and commercial leadership can arrest the hollowing out of public equity markets so Canada can lead on the international stage.

¹ [TMX TSX | TSXV | MiG Archives](#)

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INTRODUCTION

In the 1990s, Canada heard cries from business leaders about the serious threats facing the business sector. The significant changes brought on by the Canada-U.S. Free Trade Agreement (FTA) and the North American Free Trade Agreement (NAFTA) intensified competitive pressures and prompted fears of creative destruction as the labour market churned² and the “brain drain” – the departure of skilled workers for the U.S. – picked up steam. Some business leaders spoke of the hollowing out of corporate Canada as a symptom of lost competitiveness and in response to the spate of foreign corporate takeovers which saw the loss of some Canadian icons.³ China’s rapid transformation into a global manufacturing hub and economic powerhouse brought additional

competitive pressures as well as opportunities for Canadian businesses to market their goods and services.

Since then, a plethora of research reports have pointed to several contributing factors behind Canada’s competitiveness woes including a high tax burden and regulatory burden, underperformance in research and development, high unit labour costs, and declining business investment. Often ignored are weak financial incentives, notably difficulties in raising capital and generating successful public exits. Yet, media reports⁴ on the state of Canada’s public equity markets is replete with evidence of lacking financial incentives.

² See, for example, [A Global View of Creative Destruction – BFI \(uchicago.edu\)](#)

³ See, for example, [From the Hollowing Out of Corporate Canada, to the Productivity Challenge \(irpp.org\)](#)

⁴ See, for example, [Undervalued and ignored: Why young Canadian firms are looking to foreign investors and buyers - The Globe and Mail](#) (September 2, 2024); [Canadian Exchange IPO light remains ghastly dim - newswire.ca](#) (July 2, 2024); [Toronto Stock Exchange Has Gone A Year Without An IPO - Baystreet.ca](#) (March 8, 2024); [Canadian IPO activity fell to drought levels in 2023 - Investment Executive](#) (January 3, 2024); [Take-privates in Canada outnumber IPOs, wipe billions off TSX - Financial Post](#) (November 27, 2023).



Recently, the Toronto Stock Exchange (TSX) went 18 months without a new issue.⁵ The number of public operating companies on Canada's senior TSX market declined about 50% over the 2008 to 2023 period.⁶ Even the CEO of the TMX Group stated, "I don't think we take enough risk"⁷.

Why does this matter? The public equity markets are a reflection of our private sector vibrancy (or lack of). Conversely, the challenges public markets face in breathing the lifeblood of risk capital have long-term consequences for the health of the private sector, including entrepreneurship, technological advancement, ability to scale and adapt to market changes, job creation, productivity and competitiveness, and regional economic balance.

The hollowing out of our public equity markets should be thought of as a symptom of the

broader affront to our business sector. The fundamental crowding out of 'risk capital' can be attributed to several factors, notably an over-reliance on government sector funds, agency costs, and endogenous factors increasing the cost of equity capital. Yet, when these causes are understood as a whole and as a system of disincentives, they can be reversed to stem the decline of our corporate sector.

Public equity markets are the very economic engines that will either unleash financial forces to address the major economic issues of the day or constrain the country's turnaround. Canada must reprioritize and focus on the system-wide incentives that will make public equity markets in Canada more vibrant. Addressing the challenges in public equity markets will enhance corporate Canada's competitiveness and contribute to better living standards for all Canadians.

⁵[TMX TSX | TSXV | TSX New Company Listings](#)

⁶[TMX TSX | TSXV | MiG Archives](#)

⁷['I don't think we take enough risk': TMX Group's John McKenzie on how to solve Canada's productivity problem - The Logic](#)

HOLLOWING OUT OF PUBLIC EQUITY MARKETS



i) The Evidence

At first glance, it appears the number of listed issuers on Canada’s main stock exchange has been rising – from 1,570 in 2008 to 1,809 in 2023 – but underneath the numbers the story is different. The increase in listings is the result of an increasing number of exchange traded funds (ETFs), closed-end funds, and CPC/SPACs. The number of companies listed on the TSX has *fallen* from 1,486 in 2008 to 747 in 2023 – an astonishing 50% decline in 15 years⁸:

2008

Listed Issuers = 1,570
Listed Issuers ex-ETPs = 1,486

2023

Listed Issuers = 1,809
Listed Issuers ex-ETFs = 820
Listed Issuers ex-ETFs, closed-end funds, and CPC/SPACs = 747

A report by the University of Calgary School of Public Policy⁹ concludes:

“It does not appear, however, that the decline in issuers is primarily a function of increased numbers of companies leaving the TSX. Instead, fewer companies are replacing those that leave.”

The report states:

“Rather than helping Canada’s markets become stronger, public markets have grown substantially weaker, and rather than making Canadian companies better, we now face an environment where companies would rather sell to a foreign buyer and leave the country, than go public here.”

“For the past two decades they have increasingly been opting to sell themselves than to go public”.

⁸[TMX TSX | TSXV | MiG Archives](#)

⁹[Reversing the Decline of Canadian Public Markets | Tingle-Pandes.pdf \(policyschool.ca\) April 2021](#)



ii) The Impacted Parties

A hollowing out of Canadian equity capital markets has the consequent result of harming the economic position of issuers, employers/employees, investors and intermediaries.

a) Issuers

Canadian entrepreneurs start-up companies and have wonderful ideas, but few large-scale innovative firms exist in Canada. Most are selling out too early, and mostly to a foreign buyer¹⁰, before they have a chance to grow into larger, global businesses and national champions. This means fewer corporate headquarters and their accompanying benefits (including investment and well-compensated jobs) as discussed further below.

Classical competitive advantages are harder to achieve with less vibrant capital markets where only the largest concentrated companies are properly capitalized. Over time, less financial capital leads to a reduced scale advantages for Canadian companies relative to their global competitors, resulting in reduced investments in technology and intellectual capital, stifling innovation. This further leads to reduced competitiveness not only in typically important Canadian industries such as resource extraction (oil & gas, mining, forestry and materials) and financial services, but also in the industries of the future – AI, robotics, biotech, genetics and space.



¹⁰ Ibid.

b) Employees

It is no coincidence the reduction in Canadian head offices tracks the decline in Canadian public issuers, with a 5% decline over the past 10 years (2012-2022):

Table 1: Canadian Head Offices				% of TSX listings	
	2012	2018	2022	2012	2023
Canada	2793	2737	2654	88%	95%
Ontario	1107	1088	1058	52%	71%
Quebec	577	556	557	7%	7%
Alberta	399	383	366	13%	8%
BC	319	313	309	13%	8%
Other	391	397	364	4%	2%
Per capita	1/156		1/186		

Source: Statistics Canada¹¹

The data on employment is particularly alarming. According to the Fraser Institute:

“Employment in the head office sector has also dwindled, falling by almost 8 per cent over 2018-2022 and by a little more than 6 per cent since 2012, even as Canada’s population and overall economy grew. Surprisingly, headquarters jobs edged lower from 2021 to 2022, despite the economy rebounding from the pandemic shock.”¹²

“The serial decline in head office employment is concerning because these jobs tend to be among the most desirable and well-paid in the economy. Even with Canada’s rapidly expanding population, it seems we are becoming less hospitable as a location for company growth and the high-value activities that business headquarters stimulate and sustain. That matters. Corporate head offices bring multiple economic benefits to the cities

and regions that host them including higher incomes, greater innovation and more extensive connections to external markets.”¹³

“Canada’s struggling head office sector should worry citizens and policymakers alike. The loss of Canadian headquarters and head office jobs since the mid-2010s has coincided with other negative developments, such as the downshifting of trend economic growth, a pattern of weak non-residential business investment, stagnant productivity, rising net direct investment outflows, diminishing foreign portfolio investment in Canadian equities, and a steady decline in Canada’s North American and global market shares across most internationally traded-goods industries.”¹⁴

¹¹ [The Daily — Annual Head Office Survey, 2022 \(statcan.gc.ca\)](#), March 1, 2024. Table [33-10-0110-01](#).

¹² [Canada’s struggling head office sector—a warning sign | Fraser Institute](#)

¹³ Ibid.

¹⁴ Ibid.

Table 2: Canadian Head Office Employment

	2012	2018	2022
Canada	222,339	226,631	209,029
Ontario	93,077	96,240	89,519
Quebec	51,544	52,885	49,807
Alberta	39,770	37,029	32,433
BC	16,343	18,524	17,097
Other	21,605	21,953	20,173

Source: Statistics Canada¹⁵

c) Investors

Canadian investors over time have fewer opportunities to participate in public equity markets supporting Canadian companies for outsized returns. The shift from active to passive investing, and from single stock to funds, effectively cuts the tails on broader investor alternatives.

Canadian securities, comprised primarily of indexed products, provides the investing public with reduced opportunities for outsized gains (i.e. those above a benchmark) and it forces the public to seek those gains in leveraged (ODTE), lesser (cryptocurrency), or differently (U.S.) regulated markets.

We should recognize that the rate at which Canadians seek risk elsewhere should be seen as a missed opportunity for risk capital to be invested in Canada. Over time, if these conditions continue, more capital along the risk curve will flee. In some countries (Argentina and Venezuela, for example) this capital flight

became so severe, governments themselves became unbankable.

Attracting risk capital is to the benefit of both the private and public sectors.

d) Intermediaries

Intermediaries who participate in reduced financial markets eventually have a reduced capability to maintain a critical mass to serve the needs of the nation’s capital providers and capital users. By definition, a reduced number of corporates reduces the overall industry capability to raise capital, just as fewer mouths to feed results in fewer chefs. This is evident in the reduced number of Participating Organizations, Members and Subscribers on the TSX/TSXV/TSXA that advise clients, underwrite new issues, provide corporate finance services, and assist companies interested in becoming publicly traded.¹⁶ In 2008 there were over 110; now there are 71.

¹⁵ The Daily — Annual Head Office Survey, 2022 (statcan.gc.ca), March 1, 2024. Table 33-10-0110-01.

¹⁶ TMX TSX | TSXV | Trading | Accessing our Markets | Member Firm Directory

iii) The Significance

Why should the survivors care? Markets and finance over the long term are non-rivalrous. All institutions benefit from an eco-system where a robust sector of underwriters brings issuers public through secondary trading, and money management fees flow across the entire ecosystem long after the issue is public.

A flight of capital and the concentration of capital allocation decisions outside the country poses danger to the ecosystem. Over time, as the financial side of the national corporate ledger (or the right side of the balance sheet) is managed by non-Canadian financial institutions, a mismatch between operating capital and financial capital will appear. Financial capital tends to be deployed where intermediaries perceive a better match for their own interests, including their own headquarters' regulatory exposure and business cost structures. Specifically, Canadian capital may leave Canada to be managed by non-Canadian firms, which initially invested in Canadian equities, and may instead be deployed in non-Canadian equities and economic opportunities. Put another way, capital is competed for. Home country bias, and regulatory arbitrage, among others, are real non-tariff trade barriers in capital markets.

Just as public companies have a lower cost of capital compared to private firms due to the liquidity premium¹⁷, international firms benefit from greater global liquidity and reduced systemic risk, and likewise have a lower cost of capital compared to domestic only firms.¹⁸ Foreign companies would, therefore, have greater opportunity to attract public risk capital from Canadians relative to Canadian companies. This means that Canadian investors' financial capital is being exported. This may seem insignificant in the short term, but in the long term many wealthy resource economies with a mismatch between financial capital and operating capital face significant economic challenges. While many of the free flow capital arguments revolve around free trade and the opportunity to seek out higher returns, these arguments assume a 'perfect world'. However, extra-jurisdictional expropriation, differences in taxation, and reverse capital controls may, at most inopportune moments, prevent Canada from repatriating such capital in the future when most needed.

¹⁷ Companies that have gone public have a lower risk profile and their cost of capital is lower. Investors can sell their shares at any time which gives rise to the "liquidity premium."

¹⁸ Stulz, R.M. (2022), [Globalization, Corporate Finance, and the Cost of Capital](#). *Journal of Applied Corporate Finance* - [Wiley Online Library](#), 34: 8-23.



MARKETS AS A PUBLIC GOOD

Public equity markets, broadly defined as primary, secondary or in the market for corporate control, are a public good. Public goods are non-excludable and non-rivalrous goods and services.

Non-rivalrous essentially means that the use of a good by one participant does not reduce or eliminate the availability of the good to other possible participants. Under normal circumstances, a participant in public markets, by offering to buy or sell a security and share information regarding price formation, does not reduce the ability of others to offer to buy or sell securities, or reduce the information available for someone else. In fact, participation, enhances price discovery through competitive auctions, the release of information, and the establishment of prices, which is formed by the educated guesses of multiple parties to form a collective best 'guess' at the going price of a security. As a result, this process can achieve a more accurate value than non-participation.

Participation is also non-excludable, as one participant cannot *necessarily* exclude another from participating in the market. This is important, as while the non-rivalrous nature of the service itself creates value through its expanding utility due to increasing returns to scale, the ability to 'exclude' participants,

creates the opportunity for monopoly to capture the benefits of increasing returns to scale. The well covered network effects of platform business models, such as Apple, Amazon, and eBay among others, demonstrate how these platforms exhibit characteristics of marketplaces but cannot be characterized as public goods, as they can exclude participants. Securities regulators are well aware of this phenomenon.

It is important to note that the characteristics of a public good are non-binary, but rather exist along a continuum, that is, certain goods are more or less rivalrous than others. For instance, quoting a security is less rivalrous than a tissue (if a tissue is used, it is highly unlikely but not absolutely certain, to be used again by someone else); but within securities different classes are more rivalrous than others. For example, in a dealer-market model, the bond market, primarily institutional, is certainly more excludable than the equity market which, on a relative basis, is traded more directly by end participants and beneficial owners.

THE IMPORTANCE OF REGULATION

Regulation requires some degree of necessary 'exclusion' in participation within capital markets to ensure their fair functioning. A fundamental level of education, for example, is necessary for intermediaries to deal with members of the public effectively.

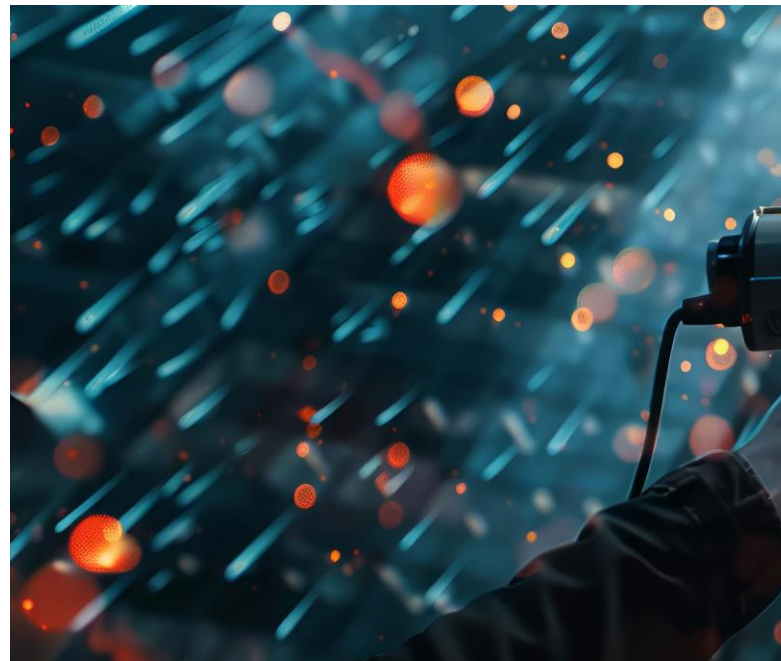
Regulation also seeks to ensure 'fair play'. Fair price formation, for example, at initial offerings, on a continuous basis or on exit from public markets through the market of corporate control (mergers, acquisitions or go private), requires that both the originators (issuers) and the intermediaries transparently disseminate relevant information and provide it on an equal basis and equal timing.

Public goods break-down when unfair actions by participants, deliberately or not, or codified systems, reduce fairness. Problems arise where information about a security is:

- guarded by 'insiders' at the issuer
- guarded by intermediaries
- selectively disclosed
- deliberately excluded (for example, market-making systems of the past), or
- non-deliberately excluded (burden/cost of behaving as an intermediary in public equity markets)

Insider trading, selective disclosure, and self-dealing are all abhorrent behaviors which damage the price discovery mechanism. If left unchecked, they lead to an accelerated decline in the trust of the public goods and their eventual disutility. Markets left to their own devices do not always self-correct for this damage, as the individual's incentive to 'cheat' may outweigh the long-term benefits of participating in the system and protecting it long-term. This is what is meant by the term negative externality as it relates to markets – a market failure.

Regulation at its most basic level seeks to address market failures by ensuring the fairness (non-rivalry, non-excludability) of the public good. This is what is meant by classical "investor protection" putting all investors on an equal footing and allowing the marketplace to form prices based on known risks.



Whether this involves disclosure regulation by issuers, regulations around research practices by intermediaries, or trading regulation which promotes order exposure, micro-structure regulation generally does an excellent job of protecting the public good. These fundamental factors are critical to ensuring markets continue to be fair. One cannot address the hollowing out of Canada's public markets (the public good) by not maintaining the core elements which allowed it to flourish in the first place and are necessary to continue behaving as such.

Where we may have lost our way is that the process of rule setting, compliance, monitoring, and enforcement activity on public goods comes with a potentially unaccountable cost. This cost needs to be borne by the public to ensure that the public good functions properly.

This cost is the agency cost, which the public bears through various mechanisms (taxes, fees – direct and indirect). The concern is that the agency cost of 'managing the rules,' as opposed to the cost of each specific rule itself, has become too expensive and that government policy at cross-purposes with the holistic need to protect the public good of the pricing of risk transference.

Put simply, any burden imposed on the public equity market through regulation, substitution, or competition by government must be assessed against the overall benefit of those regulations, laws, or economic forces in enhancing the quality of the public good – specifically, the price formation of risk transference.

These burdens and potential solutions are, therefore, detailed further in this paper.



CAUSES OF HOLLOWING OUT



A root cause analysis of the fundamental factors and economic forces which define public goods and have driven the hollowing out of public equity markets becomes the basis from which we can develop potential solutions to reverse the process. The causes of this phenomenon are broad due to:

- An increasing mix of fixed cost versus variable costs¹⁹ (as opposed to the absolute level of cost) for intermediaries and issuers which makes public markets excludable (as seen by the reduced level of both).
- The direct fixed cost of data requirements which makes public markets excludable (as required vendors to the industry).
- The cost structure itself becoming a negative externality which is damaging the public good.

Furthermore, understanding the nature of public goods helps us identify other causes contributing to hollowing out of public equity markets:

- Regulatory changes which broke the four pillars in financial services but did not break the oligopolistic nature of the strongest pillar – banking – have also contributed to excludability in markets through the substitution effects.
- Likewise, the substitution effect – the shift from public to private markets.
- Government itself has acted as a rivalrous participant in risk and, therefore, price formation through competitive effects.
- A change in the economy, as the knowledge economy appears to be ‘capital light’ in early stages of development.

These causes are explored further below.

¹⁹ We continue to reiterate that it is the relative mix of Fixed to Variable cost rather than TOTAL cost that is the burden to the industry.

i) Fixed Cost Burden in a Variable Risk Business

The underwriting of risk capital is, by its nature, better suited to a variable cost versus fixed cost business model. Aside from the fact that the bulk of fees generated from underwriting are on a variable basis, and better suited to matching with variable costs, there are a series of sequence risks which make it very challenging to cover any fixed cost burden to underwriting.

An underwriter must:

- *Search* (perhaps hundreds of companies) to evaluate the right projects/firms to be financed;
- Bear the costs of competition for *originating* economic transactions versus their peers and undertake extensive due diligence; and
- Ultimately take the risk that their timing for these endeavors matches the market's appetite for *marketing* a transaction when it is ready and ultimately *executing* on the transaction.

Each of these steps, in what we call the 'merchandising of securities', has a binary outcome, and collectively they create a low probability of any single issuer getting funded by public markets. Therefore, to manage the negative consequence of sequence risk failure at any point along the process, the underwriter of risk capital reduces their 'bet size' by, for example, compensating their staff with a lower 'fixed' compensation versus variable compensation. It is not uncommon for the leaders of these businesses to generate variable compensation of 5 to 15 times 'base salary'.

While **labor costs** were the primary cost driver in the industry, over time, **market structure forces** have driven an increase in non-labour costs such that now they are greater than fixed labour costs, creating coincident negative consequences:

- a) Less room for the variable compensation which drives the risk seeking behavior to engage in the sequence risk by competent personnel, and

- b) Increasing the risk borne by any single transaction, such that only larger and larger players can compete.

Based on experiences managing the profit/loss of the largest trading activities, as well as independent boutiques, the above have been a main economic driver of consolidation. The largest players, with the most breadth, can diversify away some element of sequence risk or subsidize the cost of maintaining platforms. In contrast, smaller firms may succeed in managing sequence risk, but any one major miscalculation or misfortune may remove those firms from the industry, consequently reducing industry capacity overall.

The **cost of regulation** and its explicit burden have increased with its scale.²⁰ The implicit costs of regulatory decisions themselves have also naturally increased fixed costs. Regulatory authorities, as their own independent economic enterprises, more naturally seek fixed revenue streams which are more predictable to build and fund their own fixed cost base. Each and every decision they make, therefore, becomes tinged with this economic incentive to shift from 'variable to fixed'. Here are a couple of examples of dozens of incremental shifts in the economics of the industry shaped by regulatory capture:

²⁰ See, for example, [The Good, the Bad and the Unnecessary: A Scorecard for Financial Regulations in Canada | C.D. Howe Institute | Canada Economy News | Canadian Government Policy \(cdhowe.org\)](#)

Example 1 - The Going Public on the Toronto Stock Exchange:

As a member-owned utility, prior to demutualization, a cost-plus revenue and industry rebate model forced this utility to manage itself as a low-cost operation as excess cash flows were returned to the membership. The trade-off for the Toronto Stock Exchange in going public was gaining control of its revenue model while opening itself up to competition. The industry's thesis was that competition in trading, along with the benefit of valuation and market forces of innovation, would more than make up for the lost ability to drive down variable costs. The flaw in this thinking by its independent dealer-members was centered around the data component, for which the TMX Group now enjoys a thorough monopoly. This monopoly was implicitly awarded at the cusp of market digitization at the end of last century, before we could imagine the vast quantities of data now available at our fingertips.

TMX Datalinx revenues were \$58.8 million in 2004²¹ and rose to \$225.8 million in 2023 (excluding Trayport).²² *Not a single cash equity trading floor in Canada which has existed over the same period has seen a commensurate increase in cash equities revenues, but rather, multiple have seen a decline.* Over the same period, trading volumes remained relatively flat, while institutional commission rates declined from sometime over 3 cents a share to fractions of a penny. As a result, at least some portion of that increase of \$165 million has been redirected from an industry profit pool and the compensation mechanism to underwrite risk capital into the pockets of TMX shareholders. In a classic short-term versus long-term tradeoff, market data products may be “biting the very hand that feeds them”. Currently it is unlikely the TMX would experience a simple organic decline in data revenues, but rather risks facing a one-time cataclysmic, or a series of step-change declines, in its Toronto Stock Exchange platform (at one point, the threat of Alpha ATS and multi-market competition). For example, a trading or data client whose fees are now highly concentrated could realize that the services it has been incrementally added into no longer have a value proposition and entirely cancels subscriptions or participation. This is singularly rational for the TMX, but not necessarily united in purpose to ensure Canada maintains a pre-eminent market eco-system for risk capital.

The Toronto Broadcast Feed (TBF, in industry parlance) is the raw data feed that comes out of the trading engine. The TMX has spent the last two decades developing a panoply of products which enhance and enrich the value of this data. It may be time for the regulators to recognize that this singular feed (along with similar raw data feeds from all other venues) should be open-sourced, and those who wish to invest and compete away some of these monopoly rents would be free to do so. Likewise, in fairness to the TMX Group, mandated connectivity to ATS competition should be completely removed. After over 15 years of competitively trading equity market venues, it is time for each party to stand on their own, and not at the expense of the commons.

²¹ [TSX 2005 Annual Report, April 26, 2006](#)

²² [TMX 2023 Annual Report](#), March 28, 2024.

Example 2 - The Canadian Investment Regulatory Organization (CIRO) Funding Model:

Another example of a mismatch in economic risks within the industry is the funding model of the self-regulator itself. CIRO, in its 2023/24 annual report²³ indicated \$72.0 million in cash and cash equivalents, and \$53.7 million in investments totaling \$125.7 million in liquid capital on the operating side of its balance sheet (as of March 31, 2024), while maintaining \$35.5 million in short-term payables. The organization's working capital, where essentially its participants are funding its ongoing needs, is funding its fixed operating budget plan one full year forward. If CIRO were a private company, most of this cash on hand (>\$90 million) would be viewed as excess. But it is not private. We note that CIRO is a quasi-public entity – a regulator reporting to the Canadian Securities Administrators (CSA), who in turn reports to provincial authorities and, therefore, a branch of government, but funded solely by industry.

Put another way, CIRO generated \$153.4 million in operating expenses (before integration costs), with almost three quarters forward expenses in cash on hand and could fully fund itself without a penny of revenue over this period. This may be commendable fiscal management, which would be an exemplary for any of Canada's municipal, provincial and federal governments, and should be applauded from that perspective.

This fortress balance sheet supports a very generous off-balance sheet pension liability that its industry members have funded over the years. CIRO employees gross accrued benefit obligations of unfunded and overfunded plan amount to over \$176 million. These obligations are backed by over \$158.0 million in aggregate plan assets as well as the excess cash mentioned above. Only an additional aggregate \$17.5 million in long-term employee future pension benefit liabilities (pre-accounting assumptive valuation allowances) are backed by the excess cash outlined above. A fixed funding model has clearly worked for CIRO and its predecessors.

This position cannot be replicated throughout CIRO's membership, particularly its smaller members, whereby their employees cannot benefit from a defined benefit plan offered by their employers' pension plans. These include employees who generate variable compensation in a variable risk business. All secondary and tertiary labour functions must be funded from the root primary labour, and if their own funding model cannot afford such fixed benefits, how could they be expected to afford carrying such downstream fixed labour?

The SRO funding argument would be that in the competition for talent, compensation packages reflect what it takes to attract the best people who serve the public good. But, if as we have argued at length above, the marketplace for pricing risk in equities is a public good with common benefits across the entire Canadian economy, perhaps a funding formula which better matches the needs of CIROs talent and its fixed funding needs versus the variable supply of risk amongst its membership, particularly its smaller members, is necessary. Perhaps it is time for CIRO's fixed funding requirements to be funded at least, in part, if not mostly, by public agencies of the provinces and federal government rather than through business user fees that mismatch how they fund and compensate their own business and people.

²³ [Annual Report 2023-2024 \(ciro.ca\)](https://www.ciro.ca/annual-report-2023-2024)

ii) The Capital Needs of a Knowledge Economy

It is not profound to state that as our economy developed from an agrarian to a resource extraction, to an industrial, and now to a more knowledge-based economy, the requirements for large capital expenditures have declined at the outset of enterprise creation and scaling. Businesses today are better equipped to hedge, outsource and share and manage operating and financial risks, which allows them to more efficiently utilize their balance sheets, and reduce their operating capital requirements. As a result, risk capital naturally evolved as described earlier, with the underwriting of risk capital better suited to a higher variable cost as opposed to fixed cost business model.

Yet, this natural economic force is short term oriented. The long-term need and opportunity require a capacity to raise large sums of capital. In later stages, even intellectual capital-based enterprises require enormous sums of capital, for example, AI development.

In the biotech space, “Canada is competing with other jurisdictions to attract investors and talent to the sector. If Canada is unable to attract investors and people, then the innovations discovered here will go to where the investment and people are. We will ultimately get the innovation back in its finished form but will have lost out on the economic benefits that are associated with commercialization.”²⁴

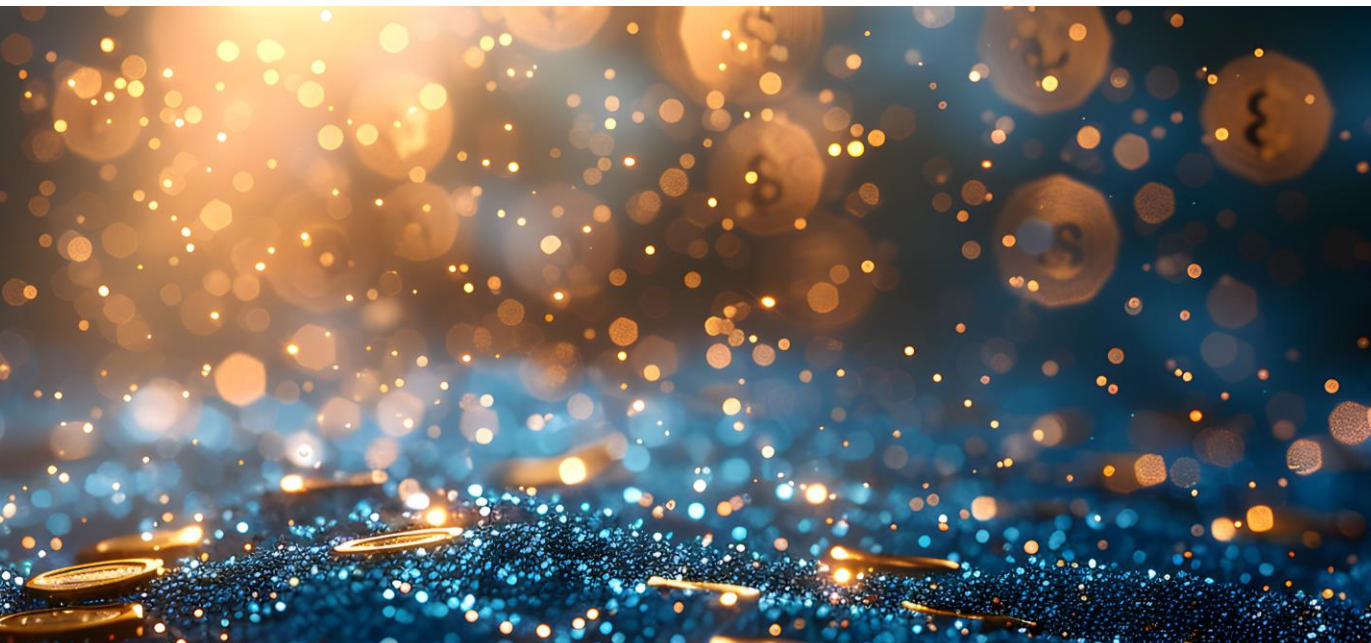
OpenAI has raised \$17.9 billion in 9 rounds.²⁵

To participate effectively in the early stages of these industries, we must be able to participate in the later stages – i.e. to participate in the depth of the book, we must see the top of the book. If we cannot, we will miss the entire opportunity.



²⁴ [Biotechnology Ecosystem - BIOTECanada](#)

²⁵ [OpenAI - Company Profile - Tracxn](#)



iii) The Fall of the Four Pillars

In the late 1980s, the ‘four pillars’ governing financial services (banks, trust and loan companies, insurance companies and securities dealers) were toppled by reforms to federal and provincial legislation that enabled financial services firms the opportunity to stray out of their traditional silos and into each other’s business segments. One of the core reasons for allowing for the fall of the pillars was the expectation that financial supermarkets would develop, with the pillars merging into each other, providing convenience to clients, synergies to shareholders and growth opportunities to the strongest of these businesses. This, in turn, would strengthen a critical sector against global competitors, particularly as other jurisdictions were moving in the same direction.

In hindsight, the banks acquired the trusts and the broker-dealers, and insurance companies acquired wealth managers and started challenger banks, developing financial institutions groups (FIGs). These groups of affiliated corporate entities have, to-date, successfully horizontally integrated at least

three of the four pillars, delivering to a large degree on the promise to create a financial supermarket. From this horizontal integration, the vast majority of corporate overheads and synergies have been wrung out over two decades and the organizations are extremely capital efficient. FIGs now need new horizons for growth beyond the domestic Canadian marketplace.

It is to Canada’s benefit for our FIGs to be globally competitive in global markets. If they play a role in underwriting global risks and the global cost of capital, and understanding the needs of global investors, they can better serve Canadian issuers, who are beginning their journeys to expand globally. Put simply, Canadian FIGs as national champions on the global stage can enable other Canadian companies to become global champions. Our governments can play a pivotal role to either encourage or discourage this strategic process. It is time, just as decades ago, for governments to appreciate and work with FIGs for the next phase of the industry’s development.

iv) Private Capital as a Substitute for Public Equity

As companies recognize that it is harder and harder to raise capital in public markets, they will still seek substitutes to fulfill their needs. One of these substitutes is capital raised for venture stage businesses in private markets via angels, crowdfunding, venture funds, and non-brokered (non-underwritten) private placements for risk and growth capital. In 2023, Canadian venture capital witnessed a cumulative investment of \$6.9 billion (pre-seed investments totaled \$135 million; seed-investments, \$834 million; early-stage, \$3.1 billion; later-stage investments; \$2.3 billion).²⁶ Canada's private equity market over the past year experienced a total investment of \$9.7 billion.²⁷

The challenge is that in remaining private for a reduced cost of transparency and fixed regulatory cost, private company issuers may bear a greater implicit cost of illiquidity as the cost of capital disadvantage differential from being private vs. public more than overwhelms the fixed transparency cost savings²⁸, making it even harder for them to survive over the long term.

Put simply, the exact same company will have a lower cost of capital if it is public. And while there is a cash savings of remaining private, they trade-off that benefit against a higher cost of capital, which presents itself implicitly in a lower discounted valuation or explicitly in a higher risk of bankruptcy by remaining so private. They also may have to compete on pricing products and compensation with their public industry peers, who may have lower costs of capital. However, if they don't have the ongoing cash requirement to be public, they have no choice but to raise funds privately and bear higher risks.

In layperson's terms, in other parts of our lives, we are starting to witness large investment pools purchasing single family homes. These large pools may receive funding from tax-free entities (pension funds) or the bond market and have a lower cost of capital than an individual seeking a personal mortgage. All else being equal, these pools with a lower cost of capital can, in effect, 'afford' to bid more for the same assets, driving up prices for everyone. The same principle holds for corporate capital. Those with a cost of capital advantage over the long run will have better opportunities.

²⁶ [Year-End 2023 - Canadian Venture Capital & Private Equity Association | CVCA](#)

²⁷ Ibid.

²⁸ Keloharju, M., Linnainmaa, J. and Nyberg, P. (2022), [Do You Really Know Your Cost of Capital? Journal of Applied Corporate Finance - Wiley Online Library](#), 34: 116-128. p. 123

v) Crowding Out By Governments

The largest contributor to a decline in risk capital funding is the growth in direct grants to businesses and other subsidies by governments. More specifically:

- Government spending (federal, provincial and local combined) on business subsidies (after adjusting for inflation) increased from \$24.5 billion in 2007 to \$38.9 billion in 2019 (pre-pandemic) and more than \$52 billion in 2022 (the latest year of available data).²⁹
- Total provincial subsidies experienced the largest increase, growing from \$13.2 billion in 2007 to \$27.0 billion in 2019 and \$35.4 billion in 2022. Federal subsidies fell from \$7.4 billion in 2007 to \$6.5 billion in 2019, and then rose to \$11.2 billion in 2022.³⁰
- Business subsidies include unrequited government transfers to businesses but exclude other forms of government support such as tax expenditures, loan guarantees and direct investments.

Many startups finance their entire first year or two of activity, beyond funding from friends and family, through government support. One tax expenditure, the Scientific Research and Experimental Development Investment Tax Credit (SR&ED ITC) alone amounted to \$3.7 billion in 2022.³¹

The rising level of government business subsidies stands in stark contrast to the declining level of financings on TSX & TSXV combined, which were \$47.6 billion and \$11.6 billion in 2007³², respectively, versus \$21.4 billion and \$5.9 billion, respectively in 2022³³.

²⁹ [The Cost of Business Subsidies in Canada: Updated Edition \(fraserinstitute.org\)](https://www.fraserinstitute.org), March 12, 2024.

³⁰ Ibid.

³¹ [Report on Federal Tax Expenditures - Concepts, Estimates and Evaluations 2024: part 7 - Canada.ca](https://www150.statcan.gc.ca/n1/pub/92-626-x/2024001/article/00001-eng.htm)

³² [2007-annual-report-en.pdf \(q4cdn.com\)](https://www150.statcan.gc.ca/n1/pub/92-626-x/2007001/article/00001-eng.htm), page 62.

³³ [TMX Group Equity Financing Statistics - December 2023](https://www150.statcan.gc.ca/n1/pub/92-626-x/2023001/article/00001-eng.htm)

³⁴ [Canada is paying 'an enormous price' for the Volkswagen battery plant. Is it worth it? | CBC News](https://www.cbc.com/news/canada-politics/volkswagen-battery-plant-1.6888888)

³⁵ [TMX Group Equity Financing Statistics - December 2023 - TMX Group Ltd.](https://www150.statcan.gc.ca/n1/pub/92-626-x/2023001/article/00001-eng.htm)

³⁶ [Final-canada-capital-markets-2023-full-year-new - LSEG.pdf \(iiac-accvm.ca\)](https://www150.statcan.gc.ca/n1/pub/92-626-x/2023001/article/00001-eng.htm)

This poses a threefold substitution issue:

- i) Indirect public subsidies, such as the SR&ED ITC tax credits, would traditionally be remitted by the private sector. But, as the supply of risk capital is increased by lower cost of capital corporate welfare programs, the share of risk capital provided to private enterprises from private capital is reduced, as their intermediaries compete less and less with government.
- ii) Large capital projects funded by government (for example, Transmountain costing \$34 billion,³⁴ a battery plant \$16 billion, among others³⁵), also reduce opportunities for large fundings by public equity markets. Governments are funded through taxation and debt markets, versus equity markets. To put it in perspective, each of these projects consumes more government funding than the TSX & TSXV do in annual equity financing respectively.³⁶
- iii) The bond market expansion bias also exacerbates the leading intermediaries' biases in underwriting lower risk debt vs. underwriting risk capital.³⁷

The result is relatively less competitively priced and disposable risk capital available directly from investors. This is compounded with the higher taxation and increased borrowing burdens to fund the government subsidy programs. Overall, the economy suffers from higher agency and transfer costs, with a greater risk of large misallocations of capital as the decision making for the allocation of such risk capital becomes more and more concentrated to those less capable of pricing enterprise specific risks. The system-wide impact of fixed costs burdens and mispriced substituted supply of capital (private markets and public sector) has to be felt somewhere. When capital exits the industry, the implicit burden is that entire segments of the risk/reward curve of risk capital are no longer served, and many good projects may go unfunded.

RE-ENERGIZING THE PUBLIC EQUITY MARKETS – POSSIBLE MACRO REMEDIES

The core challenge to-date has been that stakeholders, including governments, regulators, private issuers and financial institutions, have not been united in both purpose and process to promote Canada's risk markets, resulting in unintended consequences.

At the risk of being overly simplistic, reversing the causes of crowding out in equity markets, while considering the need to protect against negative externalities, requires a change of approach with a recognition of the pragmatic challenges of aligning differing incentive structures. Aside from some of the changes mentioned above in causes, the following is proposed:

i) Removing Fixed Regulatory Costs

Firstly, while an admirable goal, the total cost burden on intermediaries and issuers (and consequently investors) does not necessarily need to be reduced on an absolute basis to begin arresting the trends. Focusing on reducing the fixed cost burden on issuers and intermediaries will unleash the entrepreneurial spirit of new entrants:

- I) Every regulatory cost, or 2nd order effect of legislated monopolization (i.e. market data costs) ought to be analyzed in the context of their variable vs. fixed nature – and every effort should be made to shift regulatory agency revenue / funding models to a variable basis which recognizes the scale of participants.
- II) During this exercise, every regulation should be analyzed for the indirect costs it places on participants (that is, costs that do not lead to more funding of the regulator or regulation but are required expenses borne by the industry to meet compliance needs). Market data being but one example.
- III) Finally, *all* regulations (existing and future) should be reviewed and analyzed using proper cost-benefit analysis with the goal of reducing red tape.

Critics would argue that the quantity of regulation makes this analysis exceptionally burdensome and difficult to conduct. If this is truly the case, then it stands to reason, that if there is too much regulation and regulatory capture cost to analyze, then there is too much.

ii) Promoting Transparency and Fairness in Private Markets

Secondly, recognition for what is emerging as a 'middle tier' between private equity and public markets is needed.

Private equity exists because Canada's regulatory framework has long recognized that a group of individuals and businesspeople have the right to join in concert to engage in an economic enterprise for profit and organize such effort as a corporation. It is the ability to sell 'shares' or securities to the public where regulation has been introduced to deal with the 'public good' issues we mentioned above. While early-stage ventures may offer higher returns, they also have higher risks. Therefore, the public needs to be shielded from participating in these enterprises to a large extent, as they lack the sophistication or starting wealth utility to take on the risks they pose.

Where is the line drawn between public and private companies, public and private investors, and their agents or intermediaries? Publicly funded pools of capital (pension funds, investment funds), which ultimately represent retail investors, can directly participate in private corporations and have access to a risk transfer mechanism that the broader public, who funds those pools, has less accessibility to. Furthermore, wealth is a crude measure of sophistication, so high net worth individuals

also have access to many of these investment opportunities the public does not even know exist.

It hardly seems fair to the general Canadian public, or the public markets that serve them, that these selective opportunities exist. A cynic might point out that the general public is steered towards index funds expected to generate a long-term return of 8% to 12%, while not allowed to invest in opportunities which may offer higher returns.

Regulators should allow for more participation in private placements of 'non-brokered' (non-underwritten) deals and their securities and secondary trading through transparent rules-based platforms. Over-the-counter markets do exist to sell smaller non-brokered or non-underwritten primary deals through investment advisors and smaller exempt deals. However, these markets significantly underperform as they lack the most critical feature of all; liquidity – the ability to resell rapidly. This segment of opportunity needs to be expanded, simplified and deliberately promoted such that essentially, an entirely new class of 'quasi' public securities which would not have the same burdens, but not be characterized as 'safe' from a transparency or protection perspective, be created. Increased trading liquidity would be permitted with the technology tools available in public markets.

What purpose would this serve?

- Intermediaries would have a broader base of “securities” to service and would have more product to sell.
- Investors would have a broader opportunity to generate outsized returns.
- Issuers would be presented with more financing choice and new avenues to efficiently raise growth capital from more investors.
- The marketplace would be more transparent, and tradeoffs clearly codified.

The ‘quasi’ element of quasi-public is critical as these securities should not have all the benefits of truly publicly regulated securities. Some key benefits of public securities trading which could be removed from the future of secondary activity in this middle ground of quasi-public/private markets would be:

- Continuous trading or quotation. To remove promotion inequity but not to ‘liquify’ promotion, these securities would trade in daily ‘call markets’ only, or one-time daily auctions.
- Market-making.
- Broadly disseminated ‘push-based’ quotation or advertising (only last sale price to be published by qualified intermediaries)
- Index listing
- Ownership by any publicly available investment fund

Basic disclosure requirements would include:

- Corporate tax returns
- Compensation arrangements
- Full disclosure on related party transactions
- Risk Assessments
- Any public disclosures made to public government bodies privately, would be made public to the security holders

iii) Reducing Crowding by Government

Finally, and perhaps most importantly, a concerted effort by the electorate, its representatives and policymakers to reduce the crowding out of public markets by government intervention. Indeed, all of the above corrections combined are rendered moot if the government share of the economy remains at its current level of 40.5%³⁸ or above.

“Governments’ attempts to pick winners as opposed to levelling the playing field, by interfering in the free markets risk pricing mechanism ultimately distort private decisions and misallocates resources.”³⁹ This includes individual corporate subsidies that take the form of:

- Targeted job creation programs for ‘hot sectors’ which cost >\$4 million per job⁴⁰ (one might argue it is more economic to disburse the funds directly)
- Capital investment subsidies for select industries
- Direct cash subsidies for select industries (media, for example)
- Price controls through regulatory protection
- Quotas

As well as pricing away from markets, these are facilitated by government debt funding. All debt must be financed. When the government taps debt markets to meet its borrowing requirements, it competes with private businesses for the pool of available savings. This pushes up interest rates and crowds out investment (debt and equity) by the private sector. A concerted effort over time to reduce and eliminate the supply of risk capital or transference from government via corporate welfare to the individual actors who are better able to price it, will create new supply from the equity markets.

³⁸ [The Size of Government in Canada in 2022 \(fraserinstitute.org\)](https://www.fraserinstitute.org/the-size-of-government-in-canada-in-2022), March 26, 2024.

³⁹ [The Cost of Business Subsidies in Canada: Updated Edition \(fraserinstitute.org\)](https://www.fraserinstitute.org/the-cost-of-business-subsidies-in-canada), March 12, 2024.

⁴⁰ See, for example, [Honda gets \\$5 billion in tax-funded subsidies to create 1,000 jobs | True North \(tnc.news\)](https://www.tnc.news/honda-gets-5-billion-in-tax-funded-subsidies-to-create-1000-jobs) or [Canada's EV strategy has cost \\$4 million a job | Financial Post](https://www.financialpost.com/news/canada-ev-strategy-has-cost-4-million-a-job) or [Opinion: In giving billions to electric car makers, Canada is blinded by economic delusion - The Globe and Mail](https://www.theglobeandmail.com/opinion/in-giving-billions-to-electric-car-makers-canada-is-blinded-by-economic-delusion)

iv) Encouraging FIGs to Think Big and Grow Globally

To remain consistent with our comments about unnecessary corporate welfare and subsidies, we argue for indirect means of encouragement. A few ways governments can enable FIGs and their growth globally in markets include:

1. The elimination of any special taxes, charges, and fees imposed on FIGs which reduce the resources available to FIGs for global competition. These special charges speak simply to funding expediency rather than sound policy objectives and for inconsequential revenue benefits, creating counterproductive results. For example, while the Canada Recovery Dividend tax (imposed on banks and life insurance groups) applied to only two taxation years (2020 and 2021), it set a precedent by differentiating the sector and generating angst amongst FIGs shareholder investors of an increasing tax burden. All corporations are valued on an after-tax cash flow basis, and expectations of long-run rising taxation reduce embedded growth expectations. Unfortunately, these expectations for FIGs were compounded by:

- a) Differentiating how banks receive Canadian dividend income and taxing them on this, while not taxing other industries receiving the same dividend income streams.
- b) An additional 1.5 percentage point tax applied to banks and life insurance groups on taxable income over \$100 million, which increased the federal corporate income tax rate in the sector from 15% to 16.5% - a 10% increase in tax.

This is reflected in relative multiples of Canadian banks vs. their non-Canadian counterparts.

The special tax on dividends in particular harms the formation of equity capital as it explicitly discourages through taxation the carrying of equities in inventory, as extra dividend taxation raises the explicit cost of the business. Truly, a government policy working at cross-purposes of how second order effects really impact the economy. We fail to see the logic in taxing the main underwriters of a form of capital by punishing the very holding of such capital. Does our government want to actively reduce equity capital formation?

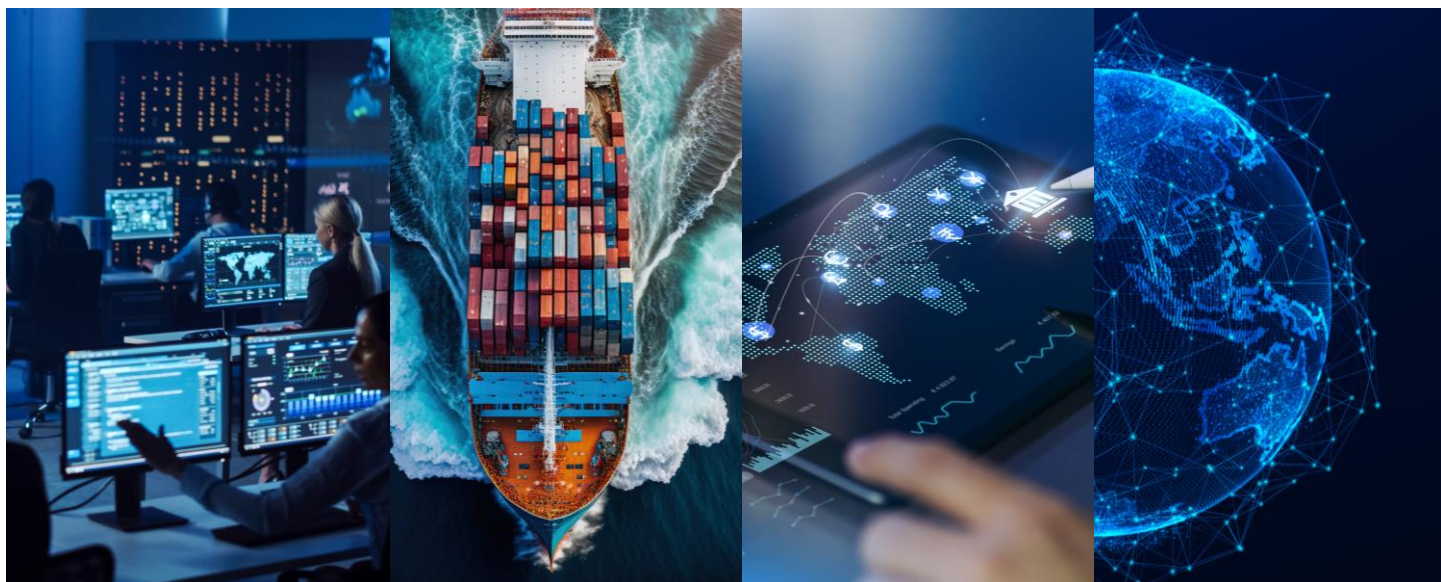


2. We argue that governments should go one step further and encourage the expansion of FIGs overseas through **tax policy**. Specifically, policies such as accelerated depreciation for capital and operating investment in overseas operations will reduce up-front risks of expansion by reducing inception risks (these accelerated depreciation tax benefits are by definition cash flow neutral to government over the cycle of capital as depreciation cannot exceed capital costs), and in the long run may create additional revenues by encouraging their growth. Likewise, reducing any barriers to the repatriation of capital from overseas operations would signal encouragement for FIGs continued global expansion. Perhaps more innovative incentives can be created where FIGs bring capital markets' business to Canada from overseas at a reduced tax rate – a net win for FIGs and governments.

3. Finally, removing any import barriers to capital would facilitate expansion in the domestic market for FIGs and encourage **two-way flows**. Canada should:

- a) Open its market to foreign capital by eliminating anachronistic ownership restrictions on industries which are no longer truly strategic in a digitized world (Media, Telco's, some Financial Institutions, etc.);
- b) Eliminate self-defeating barriers to foreign capital seeking to exploit Canada's natural advantages in resources, in particular energy, which consequently require large sums of risk capital; and
- c) Create domestic mechanisms for such international capital to be traded on Canadian venues by Canadian capital markets desks, to begin to offer international diversification discounts to Canadian issuers.

The double benefit of encouraging FIGs to think big and grow globally, is that they would be less likely to move downmarket, and the expanding pie would likely encourage new entrants in smaller niches of capital formation.



CONCLUSIONS - A POSSIBLE FUTURE FOR CANADIAN EQUITY MARKETS

We are not the first to raise the alarm of hollowing out and its impact – this dates back decades. Nor are we the first to raise the various issues that are causing harm to the ecosystem or propose possible remedies. By consolidating the work into a cohesive historical narrative, we aim to catalyze a discussion in an effort to reverse Canada's fortunes and illustrate what is possible. What may the future look like 10-20 years out, or 1 to 2 generations of management later, if implementing some of the proposals? We believe it is possible to arrest trends and reverse course, by removing the powerful incentives that hinder the development of Canadian equity markets with incentives which work for them.

Over time, with reduced crowding out, enhanced liquidity and obviated benefits of being public, the cost of equity will decline as greater volumes of risk are transferred and traded in transparent markets. More Canadian companies will choose this course of financing, and intermediaries will develop and grow new mechanisms to match users and providers of capital. Canada itself, whose population is projected to grow to well over 60 million people within the next 50 years⁴¹, will have an internal market to sustain more domestic companies.

“Migratory increase would be the key driver of population growth in Canada, continuing a trend observed since the beginning of the 1990s.”⁴² Immigrants have connectivity into growth markets elsewhere - India, Pakistan, Southeast Asia, EMEA and Latin America, nation's rich in resources but short on capital markets expertise. Canada's equity markets could play a role in their development just as 100 years ago Canada's capital markets played a role in Brazil, Mexico and the Caribbean.

Unleashing the benefits of a lower cost of equity capital across wide swaths of the economy, Canada would see faster economic growth with reduced reliance on leverage due to the equivocation of the economy, leading to a more substantially scaled business enterprises that are more productive than the government sector. While Canada's public markets have hollowed out like others, and perhaps at a greater absolute and relative pace, it is not too late. Thoughtful deregulation and commercial leadership can arrest decline and help create a future where Canada has both the scale to support consumer and producer markets, capitalize on its natural resource competitive advantages, and have the human capital coinciding with lower cost equity capital to lead on the global stage.

⁴¹ [The Daily — Population projections: Canada, provinces and territories, 2023 to 2073 \(statcan.gc.ca\)](#), June 24, 2024.

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