The TMX’s Role in the Shrinking of Bay Street

After a punishing 2015, it’s getting hard to be an optimist for 2016, with nine consecutive day of losses for the TSX, copper under $2 a pound, market volume down and oil skidding around $31 a barrel. Looking at Canadian inflation at around 1% and the global economy devolving, it’s not going to be easy for small companies to grow in 2016. We’ll see below the regulators agree.

Down cycles like this are normal parts of every economy. As we’ve observed before, what goes down will likely eventually come back up. (See Dot-com, Pot-com, We’ve Seen this Movie Before). Money flows out of sectors and countries, money flows back in. Capital has no conscience and will flow to where it can earn the best return for the least amount of risk, even in the out-of-favour sectors.

“Flowing” is the underlying concept in “currency”, a word used for both electricity and capital. “Currency” has its root in the Latin word “*currens*”, the present participle of “to run”. Both money and electricity need to run to have an impact.

What’s going to be different in the next market recovery phase is that there will be fewer power lines for that currency to flow through.

Brokerage firms are the power lines through which that capital flows, from the investors to the companies that require the capital to grow. Brokers and investment bankers will find the deals that make them money while taking minimal risk with client capital. Without the conduits, the capital can’t flow.

Who have we lost?

- Pope & Co., founded in 1962, was absorbed by

EuroPacific.

- Three independents disappeared into Industrial Alliance: MGI Securities, Fin X-O, and Burgeonvest Bick.
- Octagon Capital was declared bankrupt in early December.
- Also in December, Jacob Securities announced it was getting out of its IIROC business, and that it intended, "…to focus solely on its core strengths in investment banking advisory services while divesting of its interests in retail and trading platforms". The suspension of its IIROC licence was a mere formality.
- Jones Gable, an independent dealer founded in 1965, merged with Leede Financial to form Leede Jones Gable.
- Edgecrest Capital: IIROC membership terminated in 2015.

Jobs and intelligence have been lost, negatively impacting the economy overall. More pointedly for the markets, this shrinkage will have a profound influence over how the market for small and medium cap companies can recover.

It historically has been the smaller dealers that take on the smaller companies as clients. The risk of loss of capital is greater, but the potential returns are also much greater. Overall, a smaller dealer is better positioned than a bank-owned dealer to execute a $1,000,000 financing.

Compounding the problem is that the bank-owned firms have created their own patriarchal compliance manuals designed in part to thwart any capital leaving the firm. As a result, proper transactions like non-brokered private placements and RRSP asset swaps are made to be extremely difficult, even though such transactions are legal and can be part of a long-term investment strategy.

When the market turns (and turn it will, whether in days or months or years), it will need energy to move it forward. Without the smaller independent dealers, there will be fewer power lines to feed that energy into the system, which will in turn limit the growth. Good projects will go unfunded and

Canada will risk no longer being one of the financing capitals of the world. This does not bode well for the economy, our education system or our diversified tax base.

How did we get here? The easy answer is to point to the commodity bear market following the latest superbull, including the plummeting oil market. With a dearth of financings and lower market volume, dealers could not generate the revenue needed to keep their operations afloat.

But that’s the short-term answer. In my view one of the key causes of this shrinkage was the demutualization of the Toronto Stock Exchange. In that April, 2000 transaction, the TSE went from being a members-only not-for-profit to a for-profit corporation.

That shifted the Exchange’s goal from doing what would be in the long-term interest of all its members to hunting shorter-term profit for the shareholders. That hunt led to the TSE needing to drive growth for its shareholders, resulting in its acquisition of the Alberta Stock Exchange and the Vancouver Stock Exchange (by way of CDNX). The small cap equities group from Montreal followed in 2007.

Winnipeg today maintains a specialized agricultural derivatives market, but its equity and debt trading also went to Toronto.

Without regional support and with the banks dominating the newly-branded TMX, the smaller dealers simply could not compete. The overhead consumed in running an IIROC firm was simply too great to overcome except in the greatest of bull markets. The recent wave of consolidation was the only option for any of the brokerage firm owners to defend any of their equity.

The industry itself expects this consolidation to continue this year. The December, 2015 survey from the Investment Industry Association of Canada found that roughly 51% of investment dealer CEO's expect their technology expenses to rise in 2016, mainly as a result of higher compliance costs and the cost of the tech itself. Weaker economic conditions and those higher costs will, according to the survey, drive further brokerage consolidation in 2016.

Those themes were echoed in the speech given in early January this year by Mr. Ian Russell, the IIAC's President and CEO. Mr. Russell noted that over 50 boutique firms, or roughly 25% of the industry, had exited the industry over the prior three years. That's an astonishing rate. But it is expected that the shrinkage will continue, with fewer independent firms expected to be around when the market turns.

Without those independent dealers, there will be less "flow" for the currency, meaning less energy in the financial system. Canada's economic growth will be constrained.

The onus falls on the securities regulators (including the stock exchanges) to remove roadblocks that are currently preventing informed investors from investing, to reduce the dollar cost of compliance while preserving its integrity, and to support Canada's reputation as a fair efficient transparent marketplace.

The TSXV, suffering from revenue loss, has started to address this, starting with its December, 2015 white paper aiming at Revitalizing the Markets. In that white paper, the Exchange says its goals are to reduce the cost of compliance, to expand the base of informed investors, and to diversify the stock listings away from a resource core. These are necessary goals.

The TSXV is hosting a series of town hall meetings across Canada seeking feedback from us, the stakeholders, the entrepreneurs, the officers and directors, the investors, the industry participants. The next one is Wed, Jan 20 in Toronto. Make your voice heard. We can't reverse the demutualization of the Exchange but we can pull together with the TSXV to make that transaction work for the rest of us. This is a symbiotic relationship and each of us has a contribution to make.