The Great Canadian Research Blackout

It would seem that there is a very tilted playing field in the area of access to research between different classes of investors in the Canadian equities markets. In the interests of protecting smaller investors they have actually just managed to put them on the wrong side of a Get Smart-like Cone of Silence. We have been fairly unrelenting in our critique of the Canadian trading platforms for the woes or the universe of Canadian listed mining stocks. We have also taken swipes at the industry players themselves for egregious and non-serious behaviour. Regulators have come under attack for not being tough enough.

Strange though it may seem one area where the regulators have been tough just appears to have been overkill. It now seems like an eternity ago but Canadian companies used to have pages on their websites where they could list the reports that analysts had written on them and provide links or actually downloadable copies of the reports. This was the same as in many other countries, most particularly in the closest parallel market, that of Australia. Then Canadian regulators decided to go their own way and ban Canadian companies from referring investors to reports written on them or even linking to them.

The gist of their intention was that a member company must essentially provide NI43-101 compliant ‘QP’ status for everything they assist shareholders or potential shareholders to access about their company.

The legal basis for this is set out here: http://www.iiroc.ca/Rulebook/MemberRules/Rule00029_en.pdf

And states:

29.7 (1) No Dealer Member shall issue to the public, participate in or knowingly allow its name to be used in respect of any advertisement, sales literature or correspondence, and no registered or Approved Persons shall issue or send any advertisement, sales literature or correspondence in connection with its or his or her business which: (a) contains any untrue statement or omission of a material fact or is otherwise false or misleading; (b) contains an unjustified promise of specific results; (c) uses unrepresentative statistics to suggest unwarranted or exaggerated conclusions, or fails to identify the material assumptions made in arriving at these conclusions; (d) contains any opinion or forecast of future events which is not clearly labeled as such; (e) fails to fairly present the potential risks to the client; (f) is detrimental to the interests of the public, the Corporation or its Dealer Members; or (g) does not comply with any applicable legislation or the guidelines, policies or directives of any regulatory authority having jurisdiction.

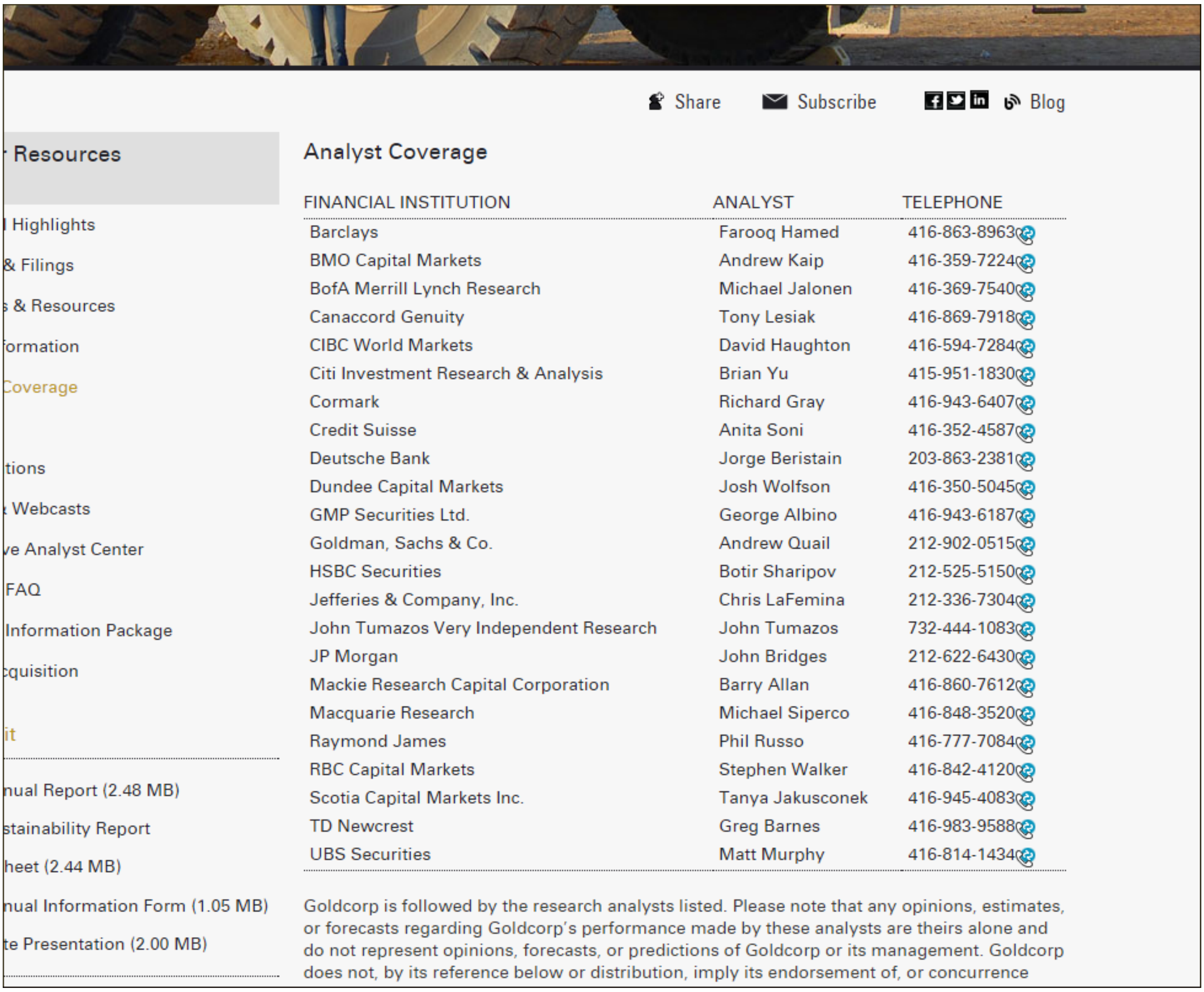
Be that as it may. It rather looks like IIROC are in denial that the “product” actually exists. Everyone knows that companies say to investors “such and such has initiated coverage on us today with a Buy” it’s just that it’s not put down on paper (or on a website). This seems a remarkable denial of reality by the powers that be who oversee the Canadian securities industry.

Self-Promotion or Maintaining an Informed Market

We have noticed one or two companies that still send out press releases referring to coverage in the hope that regulators are asleep at the wheel. In light of other (in)actions by regulators that is probably a fairly smart move by those companies. IIROC will only come after a listed company as a result of a complaint, otherwise they are not watching.

However those that stick by the rules are limited to providing an “Analysts Covering Us” list which in some cases includes analysts that haven’t written a thing on a company since 2005, some who are dead and some whose firms are dead.

While Goldcorp (below) can still boast a healthy roster of analysts covering them, other companies like Eldorado Gold have dropped the analyst coverage lists from their websites. Goldcorp is now more of the exception rather than the rule.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nual Information Form (1.05 MB)
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Analyst Coverage

FINANCIAL INSTITUTION	ANALYST	TELEPHONE
Barclays	Farooq Hamed	416-863-8963
BMO Capital Markets	Andrew Kaip	416-359-7224
BofA Merrill Lynch Research	Michael Jalonen	416-369-7540
Canaccord Genuity	Tony Lesiak	416-869-7918
CIBC World Markets	David Haughton	416-594-7284
Citi Investment Research & Analysis	Brian Yu	415-951-1830
Cormark	Richard Gray	416-943-6407
Credit Suisse	Anita Soni	416-352-4587
Deutsche Bank	Jorge Beristain	203-863-2381
Dundee Capital Markets	Josh Wolfson	416-350-5045
GMP Securities Ltd.	George Albino	416-943-6187
Goldman, Sachs & Co.	Andrew Quail	212-902-0515
HSBC Securities	Botir Sharipov	212-525-5150
Jefferies & Company, Inc.	Chris LaFemina	212-336-7304
John Tumazos Very Independent Research	John Tumazos	732-444-1083
JP Morgan	John Bridges	212-622-6430
Mackie Research Capital Corporation	Barry Allan	416-860-7612
Macquarie Research	Michael Siperco	416-848-3520
Raymond James	Phil Russo	416-777-7084
RBC Capital Markets	Stephen Walker	416-842-4120
Scotia Capital Markets Inc.	Tanya Jakusconek	416-945-4083
TD Newcrest	Greg Barnes	416-983-9588
UBS Securities	Matt Murphy	416-814-1434

Goldcorp is followed by the research analysts listed. Please note that any opinions, estimates, or forecasts regarding Goldcorp's performance made by these analysts are theirs alone and do not represent opinions, forecasts, or predictions of Goldcorp or its management. Goldcorp does not, by its reference below or distribution, imply its endorsement of, or concurrence

Alacer Gold have a similar list which comes with the wordy disclaimer "Alacer Gold Corp. is followed by the analysts listed above. Please note that any opinions, estimates or forecasts regarding Alacer Gold Corp's performance made by these analysts are theirs alone and do not represent opinions, forecasts or predictions of Alacer Gold Corp. or its management. Alacer Gold Corp. does not by its reference above or distribution imply its endorsement of or concurrence with such information, conclusions or recommendations. The list is current to the best of the Company's knowledge (as of February 18, 2016)".

We wonder then if any of these analysts have negative views on the company. Are these universal lists or a qualified list? We cannot imagine that the now departed Maudore Minerals, when I was the only analyst covering them and had a Short rating on it, would have had me on their coverage list. We will never know!

Protecting Those Who (Maybe) Don’t Want Protecting

In so many other things the regulators at the OSC and BCSC are prepared to leave things in the hands of the old adage “caveat emptor” and yet when it comes to research they are again indulging in nanny-state attitudes. Frankly it just creates a three-tier level of market intelligence. Sure if you are a client of Big Bay Street Broker that is listed as covering the stock you might be able to get the research but if you are not then you can remain in the dark. How does this help the investor without access?

Even if you are a client of BBSB then all you will get to see is that broker’s version. If you had access to the coverage of all five brokers who have written something then you can at least compares the Five Shades of Grey employed to promote the stock.

Conclusion

Speaking to a veteran IR chap of our acquaintance, he commented this week “Companies should be expected to aggregate information developed about their company for the benefit of their investors. The junior resource companies, especially, are not attracting ‘new money’ to the space they are simply competing for dollars that are already allocated, for the most part. Accessing the story from different perspectives will ultimately generate more informed investors”.

To which our response was “Hear, Hear!”

The current system merely promotes a Three-Class market. Those with access to most research (institutions and heavy hitters), the second class with access to one source of research from their own broker and the Steerage with no access to any research, who are locked below decks and going down with the ship. Times for regulators to backtrack on this one.

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.