

REPORT OF THE ADVISORY COMMITTEE

PROPOSED SPECIALIZATION OF CANADIAN EXCHANGES

SUBMITTED TO

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BACKGROUND

On March 15, 1999, the Canadian stock exchanges announced an agreement to restructure public financial markets in Canada. Under the agreement, the Montréal Exchange received national responsibility for the development and negotiation of derivative products. The Deputy Prime Minister and Minister of State for the Economy and Finance of Québec formed a Committee of experts to assess the business plan of the Montréal Exchange and advise him on the economic impact of such specialization in Québec.

The members of the Committee wish to stress that the agreement between the stock exchanges is the result of a changing situation and negotiation. Some aspects of the agreement are the culmination of a trend initiated quite some time ago. However, the Committee was not mandated to comment on what might have been. Accordingly, the Committee had a choice between two alternatives: either advise the Minister that he recommend to the Commission des valeurs mobilières du Québec that it not approve the new agreement between the stock exchanges because it goes against the interests of Québec, or advise the Minister to recommend approval of the agreement with suggestions on precautions to take and initiatives for improving it.

The Committee concluded that the status quo was not a viable option and that the agreement between the stock exchanges should be viewed as an opportunity. It is just as much in the interest of the Canadian financial industry as in that of Québec that the Montréal Exchange's project succeed. The Committee is well aware that the agreement is between entities which have roughly the same owners and which accordingly could be easily changed. However, it assumes that the parties are acting in good faith because the other exchanges, having invested \$40 million in Montréal's economy, also have an interest in the success of the project.

In this context, the Committee has decided to advise the Minister to recommend approval of the agreement, to improve it through related initiatives while being vigilant that the parties follow through on their good intentions.

SUMMARY AND RECOMMENDATIONS

SUMMARY

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The Committee wishes to stress that the agreement between the stock exchanges is the result of a changing situation and negotiation. Some aspects of the agreement are the culmination of a trend initiated quite some time ago. However, the Committee was not mandated to comment on what might have been.

Accordingly, the Committee examined financial market restructuring in the world and noted a broad trend towards the concentration of exchange volumes in one trading centre. Financial markets place great value on the liquidity of securities and the cost of trading them. This concentration is occurring everywhere through mergers and alliances. This movement is driven by technology which enables crucial cost reductions in the fierce competition between stock markets. With four competing stock exchanges in a small market, Canada was on the way to being marginalized. A reorganization of financial markets was needed and the Montréal Exchange had no choice but to take part, given that its share of stock market trading volume in Canada was less than 10%.

The Committee examined the business plan developed by the Montréal Exchange to carry out its new responsibilities. The financial forecasts and underlying assumptions were reviewed. The potential revenue from derivative products was estimated using reasonable assumptions that reflect risk factors. The modernization of technology and the formation of a high-calibre team of human resources were identified as key success factors. Expenditure and investment budgets were drawn up and the Exchange made provision for cash reserves to enable it to adjust in the event of delays or cost overruns. In short, the Committee considers that the Montréal Exchange has a credible business plan.

Recognizing that this restructuring is to some extent inevitable, the Committee tried to predict its impact on Québec's economy. At the macroeconomic level, the correlation between stock markets and economic growth is not very strong. The agreement reached by the stock exchanges is an agreement in principle and the operating details of the new environment will be decided in ancillary agreements whose content the Committee is obviously not aware of. Accordingly, the Committee had to anticipate the practical consequences of the proposed restructuring on certain segments of the economy.

Particular attention was paid to the situation of small and medium-sized enterprises (SMEs) in Québec, first regarding the migration to the other exchanges of securities of companies

already listed on the Montréal Exchange and second, regarding access to capital for SMEs considering an initial public offering. Consideration was also given to the need for Canadian securities commissions to adapt the regulatory framework to the new situation.

The Committee concluded that the Montréal Exchange has to take part in the restructuring of Canadian financial markets, that it was not within its mandate to judge whether the Montréal Exchange could have negotiated a better agreement, that the agreement reached presents the Montréal Exchange with a new and stimulating challenge, that the agreement presents the Montréal Exchange with an opportunity with considerable potential but which, like any opportunity, involves risks that have to be managed.

RECOMMENDATIONS

The Committee therefore recommends that the Minister of Finance of Québec favour the proposed restructuring and the role the Montréal Exchange will be asked to play in it, while at the same time formulating the following recommendations:

1. THE AGREEMENT OF MARCH 15, 1999 BETWEEN CANADIAN STOCK MARKETS

a) Access to capital and services for Québec SMEs

- i) The Commission des valeurs mobilières du Québec (CVMQ), before approving the ancillary agreement on the operation of service outlets, should ensure that these have decision-making authority, that they offer service in both official languages, that provision is made for an impartial appeal mechanism at the Exchange level, subject to the jurisdiction of the CVMQ. In addition, a formula should be found to ensure that these outlets are permanent. To reassure local issuers that these outlets will operate fairly, the Committee suggests that, as a transitional measure, the ancillary agreement attribute the operation of these outlets to the existing Listing Service of the Montréal Exchange.
- ii) The exchanges and securities commissions should reach agreement among themselves on the principle of recognition of the jurisdiction of incorporation of all issuers. This would allow an issuer to offer its securities wherever it wants, but if it issues securities which are listed on a stock exchange in Canada, it must apply for listing with the service outlet of the exchange located in the jurisdiction of its principal place of business and agree to become an issuer subject to the regulations of such province.
- iii) According to the agreement of March 15, 1999, the Toronto and Western exchanges are to immediately begin discussions to define original and continued listing standards, dividing the eligibility of companies between the two exchanges. Once this has been done, securities will be migrated to the appropriate exchange. The agreement stipulates the migration of securities listed exclusively on the Montréal Exchange before such determination. As a result of this, a considerable number of companies listed in Montréal would be migrated directly to the Western exchange, while competing companies with an identical profile but listed

in Toronto could stay there until the new standards are defined. The Committee views this process as inequitable and suggests that, to avoid penalizing companies listed exclusively in Montréal compared with their competitors listed in Toronto, the exchanges should agree to a transition rule allowing companies listed in Montréal to be listed in Toronto until the new standards applicable to everyone are finalized.

- iv) To study how the migration of securities listed on the Montréal Exchange is carried out and to assess the effectiveness of the proposed measures that apply to Québec SMEs, the Committee suggests that the CVMQ set up an oversight committee. This committee would report to the CVMQ, providing it with observations and recommendations concerning the access of Québec SMEs to stock market capital in the proposed new environment.

b) Corporate governance of stock exchanges

The agreement is silent on the representation of the regions on the boards of directors and various committees of the exchanges. The exchanges should make a more formal commitment ensuring solid and appropriate regional representation.

2. THE REGULATORY FRAMEWORK

Canadian securities commissions will have to adapt the regulatory framework to reflect specialized exchanges with a national mission rather than competing exchanges with a regional mission. As in any negotiation, the CVMQ will have to be flexible on some points and firm on others.

- ! Regarding the access of Québec SMEs to capital, the CVMQ should be steadfast in affirming its jurisdiction. Accordingly, the service outlets of Canadian stock exchanges operating in Québec must be subject to the review power of the CVMQ.
- ! Regarding the other regulatory responsibilities of the Montréal Exchange, if it wishes to concentrate on its primary mission, the CVMQ must be ready to take charge of these other areas of activity, delegate them to other stock exchanges or to the Québec section of the Investment Dealers Association of Canada (IDA). In this new context, the Committee considers that the CVMQ should reconsider recognition of IDA Québec as a regional self-regulatory agency and thus ease the regulatory work load of the future derivatives exchange.
- ! The Minister should also form a study group to ensure that Québec's legislation regarding derivative products is modern, up-to-date and harmonized as much as possible with the global derivatives industry.

- ! The Canadian securities commissions, in order to reduce duplication, have agreed on a system in which they rely mutually on each other. The current resources of the CVMQ are clearly insufficient. If it is to assume, along with the Montréal Exchange, a national leadership role regarding derivative products, it is clear that the Minister must give it the resources to fulfill its mandate or the authority to delegate it to an agency with such resources.

3. THE ANCILLARY ROLE OF THE MONTRÉAL EXCHANGE

The Montréal Exchange faces a major challenge. It requires the full attention of its officers and the concentration of all its resources on what is essential, i.e. derivative products. For these reasons, the Committee reiterates its recommendation concerning the recognition of IDA - Québec. Even if such recognition is not essential for IDA to play a more active role in non-regulatory activities, the agency will gain credibility if it is recognized. In short, the Committee recommends that the Minister ensure that the role of rallying point of Montréal's financial community and public educator regarding investment management be filled either by the CVMQ or another agency (for instance, the IDA or the Institut de Finance Mathématique), and submits that the new derivatives exchange is perhaps not in the best position to do so. This suggestion should not be seen as an indication that the Committee favours the creation of a new agency. On the contrary, the Minister and the financial industry should encourage the emergence of a single rallying point for the community. Finally, if there are changes, it is important that the Montréal Exchange not abdicate its responsibilities from one day to the next and that provision be made for reasonable transition measures.

4. DEVELOPMENT OF EXPERTISE AND THE BUSINESS PLAN

The private sector (Toronto Stock Exchange \$33 million and Western Exchanges \$7 million) is investing \$40 million in the project of the Montréal Exchange and has not asked for assistance from government. The Committee recognizes that there are risks associated with this project and that it is a stimulating challenge not only for the Montréal Exchange, but for the entire Montréal community. To successfully meet the challenges of a derivatives exchange, Montréal can count on excellent computer, mathematical, financial and communications resources. However, this exchange must be able to attract and retain international experts in the field, as well as retain locally trained experts. The federal and Québec governments will accordingly have to facilitate access by the Montréal Exchange to such resources and improve the project to maximize its chances of succeeding and the economic spin-offs. The following recommendations are made in this spirit:

- i) To facilitate hiring employees at competitive conditions, the Minister and his federal counterpart should find a formula to enable employees of the Montréal Exchange, investment dealers, fund managers and independent traders (locals) concentrating exclusively on derivative products to enjoy the tax benefits associated with International Financial Centre status.

- ii) The derivatives Exchange will play a national role in Canada. The Québec and Canadian governments are major stakeholders in the bond markets and, indirectly through their retirement plans, in stock markets. Even if only as users, they have a definite interest in the success of the derivatives Exchange because it will enable them to manage their risk more efficiently. Accordingly, it is legitimate and normal that they should support research and development into derivative products both to meet their particular needs and to support the emergence of a strong industry. The availability of R&D funding offered by the two levels of government would contribute substantially to encouraging the creation of a critical mass in this field in Montréal. The Exchange as well as brokers, institutions and other interested parties could avail themselves of these funds. In effect, not only must the Exchange create relevant products, but investors must know how to use them.
- iii) In the context of the development of a derivatives exchange, it is essential to develop knowledge at the cutting edge of financial technology. To contribute to the development of a critical mass for research and training in this field in Montréal, the Institut de Finance Mathématique de Montréal should play a leading role. Without having studied the matter, the Committee considers that, to have an impact, the minimum budget would be some \$5 million a year. In view of the substantial amounts involved, the various levels of government must participate along with the private sector.
- iv) Finally, the Exchange itself must undertake R&D programs. The Committee hopes that the Québec government will participate along with the Exchange in shared-cost programs. In addition, the Exchange should maintain close links with the Institut de Finance Mathématique de Montréal.

5. THE SOLIDARITY OF MONTRÉAL'S FINANCIAL COMMUNITY: A KEY SUCCESS FACTOR

The proposal that Montréal become Canada's centre for derivative products is a stimulating, motivating project, an opportunity to be seized but also a significant challenge for all stakeholders. This report underscores the importance of the involvement of the entire community (exchange, brokers, institutional investors, universities, governments and their agencies). Montréal cannot afford the luxury of dissension if it wants to recover as a financial centre. Accordingly, our final recommendation to the Minister deals with Montréal's financial community as a whole. In concert with the Exchange, we suggest that he bring all his influence to bear to convince and obtain tangible undertakings from key stakeholders to participate in this project.

I. THE COMMITTEE'S MANDATE

On March 15, 1999, Canada's four major stock exchanges announced that they had reached an agreement designed to restructure how they offer their services in Canada. The exchanges agreed to eliminate duplication of their services, with each of them specializing in a specific area. Under the terms of this agreement, the Montréal Exchange would cease its securities trading activities and concentrate exclusively on the trading of derivative products.

Faced with such a sweeping change, the Deputy Prime Minister and Minister of State for the Economy and Finance of Québec, Bernard Landry, formed a Committee of experts to assess the business plan of the Montréal Exchange and advise him on the economic impact in Québec of specialization in derivative products (Appendix I). This document summarizes the Committee's work and recommendations.

II. THE ROLE OF AN EXCHANGE

1. DEFINITION

The following definition of an exchange was put forward by Professor Pierre Laroche, Ph.D., Professor of Finance, Hautes Études Commerciales de Montréal, in an opinion on the restructuring of Canadian stock markets submitted to the Committee on April 1, 1999:

An exchange is an organized market on which real or financial assets are traded. A securities exchange offers a service to its participants in the sense that it facilitates the securities trading because it:

- \$ brings together a large number of economic agents,
- \$ facilitates the circulation of information,
- \$ lowers transaction costs (because of economies of scale).

[TRANSLATION]

It is important to point out the facilitator's role in this definition of an exchange. The exchange does not create transactions, but rather reflects the activity of investors. There are two broad categories of exchanges, namely those on which basic securities (e.g.: stocks) are traded, and those where derivative products such as option and futures contracts are traded. A particular feature of derivative products exchanges is that they enable the participants to exchange financial risks. Another feature is that they themselves must develop and create products that will be traded. These features add value for the economy.

The general public tends to see an exchange as a symbol of prestige, a powerful institution. This perception goes back to a time when communications were not what they are today. An exchange reflected the transactions of investors and brokers who were members of a community geographically fairly close to its headquarters. A city or country took pride in its financial power as measured by the size of its exchange.

The basic definition of an exchange remained unchanged for a long time, but the technological revolution in the computer and communications sectors changed the meaning of what an exchange represents. The activity of local investors became almost secondary in the success of an exchange. The old saying "securities trade where they are owned" is less and less valid. These days, an active exchange reflects its ability to attract investors from all over the world by offering them products that are relevant to their management, and ample reliable information that can be easily and inexpensively accessed. Geographical considerations hold little importance.

2. LIQUIDITY

Negotiation of the same product on two or more geographically distant exchanges was justified by the high cost of communications and delays caused by distance. That is no longer true today. As a result of the globalization of financial markets and the institutionalization of savings, buy and sell orders are larger, more frequent and come from all over the world. They are routed, executed and reported electronically almost instantaneously. An investor in Paris or Hong Kong is no longer at a disadvantage because of distance compared with an investor in an office in the same building as the exchange. A market's liquidity becomes an important consideration before deciding to invest. Lower transactions costs attract liquidity and liquidity makes it possible to cut costs. Accordingly, stock exchanges are now engaged in a merciless technological war.

III. THE RESTRUCTURING OF FINANCIAL MARKETS

1. GLOBALIZATION

In his opinion to the Committee, Professor Laroche writes:

The globalization of financial markets is now acknowledged and widely documented. The large number of mergers and other cooperation agreements between international exchanges over the last two years confirm this observation. [TRANSLATION]

At the same time, the institutionalization of savings and the consolidation of the portfolio management industry continue throughout the world. Gigantic pools of money are being created and increasingly managed at a global level. Competition among investors, managers and other market players generates substantial pressure to lower transaction costs and transmit information instantaneously and reliably. Accordingly, private electronic trading systems have developed. They are less costly and, in 1998, accounted for over 16% of trading volume in the United States., compared with 3% in 1990. It is generally admitted that this pressure is the driving force behind mergers and other forms of combination of exchanges.

Although the same basic variables encourage mergers and other agreements between exchanges, their features reflect their own markets. Some comments on this issue follow.

a) Europe vs USA

In terms of the value of stock traded, the European market amounts to about 60% of the US market. There are more exchanges in Europe, thus markets are more fragmented than in the USA and the number of mergers or alliances either completed or under discussion is much greater than in the United States. While the advent of the euro this year has certainly encouraged and facilitated this movement, the forces of restructuring were already at work in Europe. It was acknowledged that transaction costs were higher there than in the USA. European stakeholders realized that if the Americans were not to assume a dominant position on their market, it was in their interest to form combinations without delay. Whereas in the USA, the dominant markets (New York and Chicago) are being challenged by parallel systems, in Europe, the issue is still to determine who will be dominant. Europeans have to deal with political sensibilities, while in the USA, the contest is mainly one of economic forces.

Of the 23 combinations concluded and under negotiation listed by Professor Laroche in Europe and the USA since 1997 (Appendix II), 13 are within Europe, seven with the USA (including four involving private trading systems) and three affect entities involving the two large markets.

In short, the pressure to restructure is greater in Europe because their markets are smaller and more fragmented. Meanwhile, the uncontested world leader raises the bar ever higher.

b) Elsewhere in the world

The Americans and Europeans (if they act quickly) hold a dominant place on the planet and there is a strong likelihood that in the not-too-distant future, few local markets will be able to prosper without some form of alliance with either of the dominant global forces. Even the most local exchanges will become accessible to the world electronically with a developed regulatory system and a reliable transactions settlement system. Without that, they will have neither the liquidity nor the confidence needed to maintain the interest of their natural markets. We are not arguing that there will no longer be a place for exchanges outside the USA or Europe. However, smaller exchanges will have to have global links and a minimum size to ensure a certain degree of liquidity. Transaction costs will probably be higher, but, up to a point, the natural markets will be prepared to pay this price if, in return, they see higher potential returns than on major markets.

If any market has the size and underlying economic potential to compete with the Americans and Europeans, it is the Asian market. However, it must be acknowledged that from the regulatory and political standpoints, the Chinese and Japanese markets are still very closed. Last year's economic crisis did not encourage international investors to participate in these markets. They have a lot of work to do to modernize themselves before entering the global stream. Those that have made the effort are in

the global market system. For instance, Singapore is negotiating with the Chicago Mercantile Exchange and Sydney has recently announced talks with Singapore.

The other major continent, Latin America (including Mexico) has modernized its installations and regulation in recent years. Mexico, in particular, has succeeded in slowing the erosion of its market towards the USA by carrying out internal reforms (stricter stock market regulation and an entirely electronic trading platform). As for other Latin American stock markets, while they have modernized their systems, it must be recalled that an exchange is, above all, a facilitator. If there is no interest among investors, nothing happens. The economic crisis, the impact on the currencies of Brazil and Argentina, have temporarily alienated international and even local investors.

In short, the economic and financial crisis in Asia, with its effects in Latin America and even Central Europe, has sapped the interest of investors for these markets. As a result, there has been an easing of competitive pressures to continue with reforms and make the investments needed to become world-class exchanges. It is likely that as long as this situation lasts, large-capitalization companies in these regions will tend to seek listing on the major exchanges in Europe and the USA. Similarly, fund managers in these regions will tend to invest national savings on international markets. Accordingly, smaller companies will pay the price, in terms of capital formation, for local exchanges that fail to modernize.

c) Canada

Canada accounts for about 2% of world stock market capitalization. Interest among international investors for Canadian markets has fallen since the time when global investors in natural resources saw the Canadian market as relatively well organized and regulated (with the exception of Vancouver). Today, international investors have no absolute need for Canada and have a number of options to trade in natural resources (Australia, South Africa, commodities and their derivatives). For exposure to technology or major industrial issues, the US market offers liquidity, low cost and a strong currency. To add to their choice, major Canadian companies have their securities listed on US stock markets. More than 50% of Canadian market capitalization is inter-listed in the United States. So why invest in Canada?

Canadians have stubbornly resisted change. The obstacles placed in the path of Instinet (private stock trading system), of Nasdaq terminals, of private bond trading networks (Cantor, Fitzgerald) are examples of resistance to change. Fortunately, the Canadian Depository for Securities Limited (CDS) was created. It brought about the de-materialization of securities, facilitated transaction settlement and lowered transaction costs. It is only within the last few years that the country's securities commissions have harmonized their regulations to simplify public offerings in Canada. The commissions have worked strenuously to agree among themselves while maintaining their respective jurisdictions. While essential, these harmonization

measures have focussed the attention of the financial community on the domestic market while developments among our neighbours to the South were proceeding rapidly.

Markets for derivative products developed quickly in the USA in the early 1980s, and then in Europe. In Canada, the exchanges reached a truce by dividing the market for options and futures contracts. The Montréal Exchange received the market for futures contracts on debt securities while the Toronto Stock Exchange received the market for equity futures. The three markets shared options on equities. The result was a lack of focus and the issue was lost in the shuffle. In defence of the Canadian exchanges, investors in Canada and professional managers had shown no interest in these instruments until quite recently. Even in the legislation, these instruments were described as risky, making them difficult to use. According to the Montréal Exchange and McKinsey & Cie., derivative products are under-developed in Canada compared to the world average by a factor of between 7 and 14 (Appendix (III)).

However, a noteworthy exception was the development of a three-month contract on bankers=acceptances, the BAX. This contract is now among the most heavily traded futures contracts in the world. There are lessons here for the future. Launched in 1988, the BAX started slowly (four years) and the contract survived thanks to the persistence of the Exchange and of certain financial institutions which made volume quota commitments. In 1992, European banks and American brokers began to pay more attention to the product. With hindsight, this can be attributed to the fact that the liquidity of Government of Canada Treasury Bills began to be insufficient for the needs of the market. This phenomenon was magnified with the reduction in the federal government=s borrowing program. BAX contracts filled this need to the point where open contracts now represent more than four times outstanding bankers= acceptances and more than twice outstanding Treasury Bills. The underlying value of daily BAX trading amounts to \$30 billion, compared to \$5 billion for Treasury Bills. This success is due to perseverance, sound analysis of market needs and a consensus between the exchanges and the financial industry.

In short, because of geographical competition among exchanges, brokers and securities commissions, Canada=s financial market has maintained costly duplication of services and investments and has not kept pace with the rest of the world. Our equities market is gradually drifting towards the United States and our derivative products market is not as developed as it should be. This harsh but factual observation sets the scene for the restructuring proposal advanced by the exchanges.

2. AGREEMENT AMONG CANADIAN EXCHANGES

On March 15, 1999, the Canadian exchanges ratified a contract designed to improve the liquidity of each type of product and reduce transaction costs for users. The way the exchanges propose to do this is for each of them to specialize in a specific market. This will concentrate transaction volume in one place and eliminate costly duplication in terms of

human resources and computer development. Each exchange would become national in scope.

The contract is an agreement in principle lasting ten years and is subject to the approval of the securities commissions. It stipulates exchanges of assets and cash as well as the creation of service outlets through contracting-out. However, the agreement does not stipulate the operating details of these outlets. It stipulates that an ancillary agreement on this issue is to be concluded by June 1, 1999. Naturally, the agreement makes no mention of the changes that will be required to the regulatory framework since that is the responsibility of securities commissions. The agreement also states that members of one exchange will have automatic and non-discriminatory access to the other exchanges. It purports to guarantee the same thing to companies whose securities are listed on the Montréal Exchange, but the Committee will express a reservation on this matter further on.

The agreement stipulates that the Montréal Exchange transfer to the other exchanges its equities trading activities and, in return, it will become the exclusive market for the trading of derivative products, and will receive \$28 million to carry out a major development of this market along with a computer platform estimated at between \$10 and \$14 million.

Since the agreement has been publicly released, it would serve no purpose to reproduce it here in detail.

3. COMMENTS AND CONCERNS

a) Risks associated with a derivative products exchange

Outside financial circles, derivative products are still viewed as casino chips. The Committee does not share this belief, but nonetheless it did consider the risk profile of an exchange dealing exclusively in derivative products and consulted the external auditor of the Canadian Derivatives Clearing Corporation (of which the Montréal Exchange is a 50% shareholder).

It is worth mentioning here that the financial risk linked to the operation of a derivative products exchange is borne by the Clearing Corporation. The Clearing Corporation ensures settlement of all transactions between members and maintains the financial security of the market by interposing itself between every member buyer and every member seller, by calling margins, by liquidating, if need be, the positions of members in default, by overseeing and limiting positions and lastly by guaranteeing proper completion of transactions. Unlike a stock exchange where buy and sell transactions disappear once settled, in the case of derivatives, they continue on the books of the Clearing Corporation until they expire. Accordingly, there is a greater risk.

The Committee estimates that this risk is slightly greater than the risk relating to the operation of a stock exchange. The lines of defence set up to protect the Clearing

Corporation are accordingly stronger. The recent history of Barings Bank in Singapore has shown that these lines of defence work well and the Committee could come up with no recent example of a derivative products exchange that had fallen into financial difficulty. By acquiring 100% of the shares of the Canadian Derivatives Clearing Corporation, the Montréal Exchange also acquires all of the lines of defence.

b) Term of the agreement, signatory parties and permanence of outlets

These questions have emerged from the anticipation of a negative turn of events. Since bad faith or failure cannot be excluded, the Committee considered such questions. For instance, what would happen should the members of the Montréal Exchange decide to shut down and/or move the exchange elsewhere in Canada? The Committee assumes that the contract will be honoured but provision is made for possible amendments with the unanimous consent of the parties. Should the derivative products exchange prove to be a success, it is unlikely that it would close or move. Accordingly, this possibility must be considered in the event of failure. The Committee is of the view that in such circumstances, Montréal will have missed a good opportunity, but will not be in a situation much different than it is today. In his opinion to the Committee, Professor Laroche states on page 8: *in the long run, we do not believe that the disappearance of derivative financial instruments from Canadian exchanges would have irreparable economic consequences.* [TRANSLATION] American derivative products exchanges would eventually fill the gap.

Lastly, it should be borne in mind that the parties to this agreement are the exchanges. There is nothing to prevent one or more members of an exchange from starting up a private stock trading system. Entry barriers are dropping. It would be more difficult to set up such a system for derivative products because of the greater complexity of the Clearing Corporation. As a result, even if derivative products prove to be a resounding success, should there be sufficient demand to develop a local equities exchange, the agreement would not prevent non-signatory third parties or a member of an exchange from setting one up.

c) Corporate governance of exchanges

Each one will become a national exchange specializing in its field. The agreement among the exchanges expresses the concern to provide service in the regions. However, the agreement is silent as to the representation of regions on the boards of directors and the various committees of the exchanges. The Committee believes the exchanges should give a more formal commitment ensuring solid and appropriate regional representation.

d) Local brokers in Québec

The exchanges have complex and elaborate trading rules. Members dealing on the exchanges agree to submit to them and in case of dispute, mechanisms exist to reach a settlement. The Committee does not think such disputes are in the public interest. However, it would be desirable that appeals of such decisions be heard locally. This should not call into question the grounds of the restructuring. For many years, brokers have accommodated themselves to existing mechanisms and if this meant going to Vancouver, Toronto or New York, they had no choice but to go.

e) The ancillary role of an exchange

Traditionally, exchanges have assumed related responsibilities, thus reflecting their role as leader of the financial community. This was at a time when most member brokers derived the bulk of their revenue from commissions on stock. In 1998, with the exception of a few specialized boutiques, revenue from exchange commissions accounted for less than one-third of members' total revenue.

Exchanges played a role as a rallying point for the financial community (brokers, managers, investors) through social and philanthropic activities. They also played an educational role vis-à-vis the public by promoting the working of financial markets. As mentioned above, they developed expertise in regulating their members. Lastly, they promoted their services to encourage the listing of new securities.

The Committee questions whether an exchange specializing in derivative products is the best place to carry out the functions mentioned above. The Montréal Exchange lost its leadership in the financial community at the same time as it lost its importance for its members as a whole. Its specialization in derivatives helped it win back a measure of importance, and it is to be hoped that this trend will continue with a community that is less locally based. From an educational or public standpoint, what will be the source of its legitimacy for promoting the savings products now offered by brokers? As for promotion among companies to encourage them to list their stock on an exchange in Canada, this will be done on a sub-contracting basis for other exchanges or directly by these other exchanges. The same holds true for regulation of its members: why would a derivatives exchange regulate mutual funds transactions or the conduct of its members' representatives? Why would it regulate the solvency of its members since the Clearing Corporation assumes the financial risks associated with the solvency of members?

Lastly, the Exchange's new mandate is a challenge that will require the on-going attention of its staff. This raises the question: is it advisable that the Montréal Exchange continue to fulfill these related functions?

Clearly, the next question is: who then? Brokers operating in Québec could form an association, hire staff, obtain recognition from the CVMQ as a self-regulatory agency and fulfill the functions of rallying point, educator and regulator of its members. It is unlikely that the local industry would have much enthusiasm for the idea of creating

another agency. Another approach would be to recognize the Québec section of the IDA. Historically, in Québec, this agency is viewed as being controlled from Toronto. This is particularly unflattering for the many industry volunteers who devote much of their energy to it. The impression is given that they are incapable of thinking for themselves. Be that as it may, it is perhaps time to review this situation. Recognition of the Québec section of the IDA by the CVMQ would invest it with responsibility which its members would take seriously. Under the umbrella of the CVMQ, the members of IDA Québec could show that they are capable of defending Québec's interests. Small local brokers are especially fearful of the big Toronto machine. Do they think they would have more influence by forming their own separate group? The Committee believes it is time that the financial community in Québec rally round a common agency where everyone, big and small, Québec, Canadian and foreign, integrated and specialized, can interact positively.

IV. THE BUSINESS PLAN OF THE MONTRÉAL EXCHANGE

1. TWO QUESTIONS:

Before assessing this business plan, as stipulated in its mandate, the Committee raised the following two basic questions: i) should the Montréal Exchange participate in the restructuring of Canadian markets in view of the previously noted trends? and ii) did the Exchange have options other than accepting the terms of the agreement?

a) The participation of the Montréal Exchange in the restructuring

In view of the global trends noted above, of Montréal's remaining market share, of the definition of what an exchange is (i.e. facilitate transactions of a large number of participants at a competitive price through advanced technology), and the forecasts of the Exchange itself, the Committee concludes that the status quo is unsustainable and that the Exchange was right to seek to participate in a restructuring of markets.

b) Does the Montréal Exchange have other options?

The Exchange described to the Committee the four options it studied before coming to the March 15 agreement. These four options are:

- i) Attack on all fronts.
- ii) Identify and aggressively develop derivatives and equity niches.
- iii) Survive in the equities market and aggressively develop derivatives.
- iv) Take part in the restructuring of the Canadian market by specializing in derivative products.

The Committee did not identify other viable options and shares the opinion of the Exchange that the first three are either unrealistic or offer poor prospects. As to the fourth option, the Committee can only speculate on what might have been the results of negotiation with the other exchanges. For instance, it could be argued that Montréal could have retained the

market for trading in the securities of junior industrials (excluding natural resources) along with a national mandate for derivatives. This would imply the need to maintain two infrastructures for junior securities (one in the West for natural resources and one in Montréal for industrials) and that the Canadian Dealing Network in Toronto would dissolve itself in favour of the West and Montréal. The Committee assumes nothing, but believes it is unlikely that the Montréal Exchange, given what it could have offered in this negotiation, would have been able to convince the other exchanges to make such concessions. Be that as it may, any negotiation involves compromise. In the circumstances, the Committee doubts that reopening negotiations, if that were possible, would result in any improvement significant enough to warrant the risk of losing the opportunity that currently presents itself.

2. DESCRIPTION

The Committee received three presentations of the business plan developed by the Montréal Exchange to carry out the new mandate to develop derivative products in Canada. Like any business plan, it offers various scenarios along with the underlying assumptions. The Committee was given access to the required information.

Here again, the intention is not to present all the details of the business plan, but rather the broad thrust. The Exchange pinpointed six strategic imperatives:

1. Protect the gains made on interest rate derivatives and develop them.
2. Promote options and futures contracts on exchange-traded securities and indices to build a critical mass.
3. Develop and market new products at an appropriate time and on an on-going basis.
4. Attract new participants to the market.
5. Install an automated trading platform.
6. Obtain changes to the regulatory framework.

To meet these strategic imperatives, the Exchange has identified two key success factors:

- a) Successful installation of a new automated trading platform.
- b) Its ability to form a world-class team of experts.

It follows from the preceding that the Exchange expects a major transformation of its profile and this cannot happen without a major capital investment. Overall, the Exchange forecasts an investment of about \$20 million over the next five years to install its new automated trading platform and adapt it on an on-going basis to the needs of the market. In addition, annual technology maintenance expenses of \$5 million are forecast. The Exchange also plans to form a team of from 15 to 20 people whose remuneration would be \$3 million annually, supported by a development and promotion budget of about \$2 million. The corresponding figures for derivative products in 1998 were \$700,000 and \$1.5 million.

On the revenue side, the Exchange offers three scenarios whose chief variable is the speed at which the Canadian derivatives market can catch up to the development of global derivatives

markets. The expected scenario is that progress will be made linearly over ten years at a level of development equivalent to 55% of that achieved in the world. The Committee considered the five-year projections, believing ten-year projections to be too uncertain.

3. ASSESSMENT OF THE BUSINESS PLAN

The strategic stances underlying the business plan were mentioned in the preceding chapter. The impact and spin-offs on Québec's economy and the macroeconomic considerations will be discussed in the following chapter. The Committee examined the Exchange's projections, their assumptions and financial forecasts. More specifically, it examined whether the revenue projections were realistic and, in light of the key success factors identified earlier (technology and human resources), paid particular attention to forecast expenditures.

a) Revenue

Revenue projections are based on the following assumptions:

- i) The market for the underlying securities grows by 10% a year. This reflects the average growth in volume for the last 40 years for the 12 most developed countries.
- ii) The three scenarios differ in the assumed rate at which the Canadian market catches up to the average level of derivatives development in the world. For the most likely scenario, this means reaching 55% of the average world development ratio, revenue growth of 28% a year for options, index-related products and new products, and 19% a year for products related to interest rates. The BAX is already well developed, so there is no need to catch up.

There is nothing unreasonable in forecasting reaching 55% of the world level of derivatives development over a period of ten years, in fact, quite the contrary. However, the annual growth rates are high, especially as part of this growth is expected to come from products that do not currently exist. In the short term, revenue from derivatives will jump from \$10 million in 1998 to \$19 million in 2001. That may appear ambitious, but it must be borne in mind that about half this increase will stem from existing volumes migrating from Toronto. Also, for many years now, growth rates in the financial sector have been much greater than in most other industries. Accordingly, the Committee is comfortable with these projections.

b) Projected expenses

The Committee considered the budget allocated to the creation of a derivative products team. The Exchange expects to recruit a team of about twenty people headed by three or four highly paid team leaders (some from outside Québec). In view of the weak Canadian dollar, recruiting expenses and bonuses and the substantial remuneration paid by the industry for individuals with the desired profile, the Committee believes the Exchange under-estimates the cost of this team.

Expenditures on technology are notoriously unpredictable in every sphere of economic activity. Although it has not assessed the technological risk, the Committee notes that the Exchange expects to allocate significant amounts to this activity. From an investment point of view, the Exchange expects to spend \$21 million over two years, not including the estimated value of the system transferred from Toronto, estimated at \$10 million. Maintenance and operating expenses are reduced by less than \$1 million over two years, in spite of the elimination of an old system (stocks) and the installation of a modern system (derivatives).

As for other expenditures, the Exchange assumes it will retain all the ancillary functions it currently fulfills. Regulatory functions, among others, will be maintained because it is not within the Exchange's jurisdiction to decide on the future regulatory framework. According to the Exchange, while such types of activities require expenditures, they also produce offsetting revenue. In answer to the Committee's questions, the officers of the Exchange admitted they had been conservative in this regard.

Overall, the Committee concludes that the projected expenses in the most likely scenario appear reasonable while acknowledging that advanced technology and quality of human resources are key success factors.

c) Risk and potential of the business plan

The firm of McKinsey & Co., respected international consultants and advisers to the Exchange, showed the Committee a table indicating the ratio of development of Canadian derivatives markets compared to the world average (Appendix III). With the exception of the BAX, the Canadian market is under-developed. The Exchange's projections over ten years, assuming Canada achieves 55% of the average world development, indicate total revenue of \$84 million compared with \$21.8 million next year.

The financial projection method used by the Exchange stipulates the introduction of a single new product, i.e. a contract on the S&P 60 index and its orderly growth. Experience seems to indicate that in reality, the launch cycle for a new product is growing ever shorter. It took less than three years for contracts on electricity and natural gas to take hold in the United States (New York and Chicago) and once off the ground, they grew far faster than the rate used by the Exchange. Accordingly, the Exchange need succeed with only one project and the projections will be surpassed. This product could be the new S&P 60 index, but it could also be a revival of a contract on long-term interest rates which is missing in Canada. The lessons learned from the BAX and indications from the largest institutions in the country, including the Bank of Canada, point to a very promising potential. The Exchange has identified a contract on pulp and paper though it did not assign a value to it in its projections since market studies have not been carried out. With a creative team, the Committee is confident the Exchange could identify and market other winning products.

The corollary to the preceding is the risk relating to this type of potential. Many derivative products have been launched throughout the world, including some in Montréal, and many have been failures. In addition, a product's success is not guaranteed forever. The needs of markets change and competition is fierce. Chicago tried to take control of the BAX. It did not take long for Frankfurt to steal the contract on German bonds from London. At present, the Montréal Exchange is vulnerable in having only one star product.

The end of competition among exchanges, the growing awareness among Canadian institutions of derivative products and the investments the Exchange is about to make should enable it to benefit from this situation. It should be able to offer products that attract a variety of customers. A product on pulp and paper will not attract the same customers as those who deal in stock options or who are interested in contracts on long-term rates. A degree of diversification of risk should occur naturally.

Because of the above, the Committee wanted to examine the pessimistic specialization scenario. The basic assumption behind this scenario is that nothing takes off and that derivative products have the same growth as the underlying products, i.e. 10% a year. The Committee wanted to assess the Exchange's financial capacity to cope with a slow start. The projections indicate that the Exchange would have sufficient liquidity for five years under this scenario. Now, it is reasonable to believe that it would not take five years to react. In addition, the forecast expenses could be scaled back to secure additional leeway.

Nonetheless, the Committee stresses the importance for the Exchange of achieving success with its first initiatives. The success of the BAX in Montréal attracted the attention of investors throughout the world. It would be wiser to build on a series of small successes than to try to hit a home run.

d) Conclusion

Derivatives offer good potential for development for the Exchange. Even if the Committee's concerns regarding the insufficiency of funds allocated to hiring a derivatives team were justified, the Exchange would have enough financial flexibility to adjust. As for technology, the amounts budgeted appear sufficient. The choice of an established system and the availability of competent resources in Montréal reduce this risk. In short, the Committee believes the Exchange's business plan is credible.

V. IMPACT ON QUÉBEC'S ECONOMY

The new role proposed for the Montréal Exchange and the restructuring of Canadian financial markets involve substantial changes. It is normal and prudent to consider the impact of this restructuring. The Committee considered this issue from a macroeconomic approach by

seeking precedents that might offer some lessons. Professor Laroche was consulted in this regard. Some of his conclusions, which the Committee agrees with, are reproduced below:

The importance of stock markets varies appreciably from one developed country to another... These data indicate that not all developed countries have a financial system that places the same importance on stock markets...

These results, though cursory, indicate that stock markets are much smaller in Canada and Québec than in the developed countries. Consequently, it is reasonable to think that the impact of an eventual restructuring of Canadian exchanges might be smaller here than in our major trading partners.

The size of the stock market, its degree of international integration and the volatility of market prices are not strongly linked to economic growth.

Liquidity appears to be the characteristic of stock markets that contributes most to economic growth and, especially, capital formation...¹
[TRANSLATION]

Professor Laroche continues with the view that if the trend towards exchange consolidations continues, the link between a region's economic development and the operation of stock markets can be expected to weaken.

As far as derivative products exchanges are concerned, there are no studies showing a positive or negative correlation with economic development. However, according to Professor Laroche, it can be said that the presence of derivatives exchanges makes a fairly important contribution to improving the allocation of financial resources. The perception persists that derivative products are of use only to certain speculators. They provide a mechanism for exchanging risk at minimum cost for many types of players, not just financial institutions. In the longer term, the frequency and variety of such exchanges of risk should grow as new products are created and the public participates more actively.

Apart from the macroeconomic aspect of its review, the Committee considered the practical impact of the restructuring on stakeholders in Montréal (Exchange employees, private and institutional investors, large companies, SMEs, brokers, lawyers, accountants). As the members of the Committee themselves are experienced practitioners in most of these sectors, they were able to rely on their experience. In view of the special importance placed on the impact on SMEs, this subject was dealt with separately. In addition, members of the Committee were able to tap their respective networks for anecdotal evidence.

1. ECONOMIC IMPACT ON QUÉBEC SMES

¹ *Avis sur le projet de restructuration des marchés boursiers canadiens*, Professor Pierre Laroche, Ph.D., April 1, 1999, p. 6-7.

There are two important aspects to study concerning the smallest companies in Québec. First, the migration of companies currently listed on the Montréal Exchange to one of the other Canadian equities exchanges, and second, access to the capital market for companies wanting to make an initial public offering.

a) Migration of companies listed in Montréal to the other exchanges

Concerning the migration of securities currently listed on the Montréal Exchange, the agreement between the exchanges stipulates an automatic transfer to one of the other exchanges through the non-discriminatory application of existing listing rules. The Montréal Exchange provided the Committee with the following information:

- \$ of the 573 companies listed in Montréal, 378 are inter-listed on another exchange (Toronto or in the USA). Only four companies are inter-listed exclusively with one of the Western exchanges;
- \$ 195 companies are listed exclusively in Montréal, of which 118 are mining or oil and gas exploration companies;
- \$ of the 77 industrial SMEs, 43 would not automatically qualify for the senior securities market (Toronto);
- \$ of these 43 companies, it is estimated that half could qualify for the senior market by applying for an exemption, and the other half would have to list on the junior (Western) market or consider migrating to the NASDAQ in the USA.

In short, considering that the natural resources exploration companies would automatically migrate to the Western market, about twenty of the 573 companies listed on the Montréal Exchange would be forced to seek a listing on the Western market. However, an independent study, commissioned by a member of the Committee, sets this number at seven.

The Committee noted an inequity in the proposed order of things. The minimum standards for continued listing on the Toronto Exchange (like Montréal, in passing) are less stringent than the standards for initial listing. Under the terms of the agreement between the exchanges, companies listed in Montréal which do not satisfy listing requirements in Toronto will be listed on the junior securities exchange. Consequently, companies listed only in Montréal which satisfy the continued listing requirements but not the initial listing requirements would be placed in an unfavourable position compared to their competitors in an identical situation already listed in Toronto. The members of the Committee feel this is not fair. According to the agreement, the equities exchanges must immediately begin discussions to define listing standards demarcating between senior and junior securities. Following these discussions, securities will be migrated to the appropriate exchange. The Committee is of the view that companies listed in Montréal should not be migrated until the same exercise is carried out for companies listed in Toronto. Accordingly, the Committee favours the adoption of a transitional measure allowing companies listed in Montréal

to migrate to the Toronto Exchange (if they want to) until the new standards applicable to all Canadian companies are in effect.

A further comment concerning the Western exchanges is appropriate. It has often been mentioned that the transfer from Montréal to the West is a demotion because the Western exchanges have a poor reputation in the world. It must be pointed out that while this reputation is still present, it is changing. The events giving rise to this reputation date back to the 1980s. In the early 1990s, the rules began to be tightened on the Vancouver Stock Exchange and in 1995, the local securities industry, in concert with the Securities Commission and the Government of British Columbia, made changes with the result that the exchange is now much better regulated. Indeed it is ironic that the biggest scandal of the decade and perhaps in history, Bre-X, occurred on the Toronto Stock Exchange. In addition, the Vancouver Stock Exchange was the first in Canada to equip itself with a fully automated platform and has developed good expertise in systems and in the management of listings for junior companies and natural resource companies. Accordingly, the Committee does not share the view that companies transferred to the West will suffer from lower valuation multiples because of their listing. These companies generally have not reached a stage in their development where they are generating profits, so one wonders what multiples are being referred to.

Finally, Vancouver and Calgary, under the terms of the agreement among the exchanges, are to merge their operations. The location of the merged exchange has yet to be announced and the name Vancouver will likely not appear in the new corporate name. It is also likely that Toronto and Montréal will change their corporate names to better reflect their new profile. The community will simply have to get used to the existence of three exchanges with national mandates.

b) Initial public offerings (IPOs)

The second aspect of the economic impact of the restructuring on SMEs concerns IPOs, access to capital and new exchange listing services. In his opinion, Professor Laroche concludes:

In short, we do not believe that the proposed restructuring threatens the financing of Québec companies. Of course, in the short term, companies (especially small ones operating in traditional sectors) will have to adjust to the new situation, but in the longer term, all could benefit from it. [TRANSLATION]

While agreeing with this conclusion, the Committee decided to examine this issue in more detail since access to capital for Québec SMEs is an important concern.

The potential physical absence of a stock exchange in Québec prompted the Committee to examine two questions. First of all, how important is the presence of

a regional exchange for capital formation, and second, assuming the absence of an exchange, what measures would have to be taken to facilitate access by SMEs to an exchange located elsewhere in Canada.

Concerning the relative importance of a regional exchange in capital formation, the Committee was informed of the existence of studies done a few years ago by McKinsey & Cie for a number of Montréal financial institutions, including the Montréal Exchange. These studies tended to show that the presence of a stock exchange in Montréal was less important for SMEs than the presence of venture capital. Montréal has developed a significant concentration of venture capital for start-ups, but there is a lack of capital for the second and third phases. As a result, SMEs in Québec have tended to seek listing on an exchange prematurely, hence their relatively poor price and liquidity performance on the exchange. According to the Montréal Exchange, the stock price of SMEs that launch an IPO in Canada falls by an average of 40% during the first 18 months following their listing, compared to a drop of 16% in the USA. It is therefore reasonable to affirm that the presence of intermediate level venture capital is a more pressing need in Montréal than that of maintaining a stock exchange. If Québec SMEs waited to achieve a more advanced stage of development before launching an IPO, they would benefit from larger markets and better conditions when they are initially listed on an exchange. These observations agree with those of Professor Laroche regarding the relatively minor impact of the restructuring on capital formation for SMEs.

Notwithstanding the preceding, the Committee nonetheless recognizes that Québec SMEs need to have access to an exchange even if it is not necessarily local.

Articles 1.5 and 3.1 of the agreement between the exchanges clearly state that the exchanges intend to satisfy regional needs and in particular ensure access to the same range of services in the same places as is currently the case. It states that the exchanges are committed to providing issuers with a quality of service with respect to access to capital equivalent to that provided at present. The two stock exchanges in Canada have accordingly undertaken to operate offices, which we call outlets, in places where either of them currently offers services. Interim agreements are stipulated between the exchanges to ensure that these objectives are achieved. The Committee does not question the good faith of the exchanges, particularly as it is in their interest to maintain a high level of service since, even after the restructuring, the Canadian exchanges will not have a monopoly.

Nonetheless, the operating method and types of activities carried out on the exchanges will be covered by a separate agreement whose content we do not know at this time. Accordingly, the Committee is concerned by the content of this ancillary agreement. If the stock exchanges agree to set up post office boxes whose only function is to forward mail to head office, the interests of Québec issuers will be ill served. These outlets must have local decision-making authority to ensure that it is not necessary to travel to Toronto or Western Canada accompanied by legal counsel

and accountants every time a problem has to be settled. It goes without saying that the service must be available in French. An impartial appeal mechanism must be provided allowing local representatives to exercise their jurisdiction without risk of undue pressure. The Committee gave lengthy consideration to the nature of this appeals mechanism. Should it be situated directly with the Securities Commission or should it be left to the exchanges? The Committee concluded that the industry's self-regulatory system has proved itself and should be allowed to continue. Accordingly, it believes that the appeal mechanism should be left to the exchanges, provided the appeal is heard locally in the home jurisdiction of the issuer seeking market access and that the securities commission of such jurisdiction be the ultimate forum of appeal of a decision by an exchange. The Committee believes the circumstances in which a commission would have to decide such a dispute are rare, and that is how it should be. There is no reason for government to intervene in such disputes and the simple fact that the parties have access to it should provide an incentive to keep the system in balance.

In addition, to prevent shopping among outlets, an issuer should be required to deal with the outlet in the jurisdiction where its principal place of business is located. This would not prevent issuers from choosing, as they are free to do at present, the jurisdiction where they wish to file a prospectus and would provide local outlets with a sufficient volume to justify the development of decision-making expertise not only for the outlet but also in terms of the ancillary services that gravitate around a financial centre. Although no exhaustive studies have been done, this model draws on the European home jurisdiction model. European issuers can have access to whatever market they choose but, for regulatory purposes, they are answerable to the authority in their country. In formulating this opinion, the Committee has assured itself that this approach would not impede companies from freely choosing where to obtain financing.

c) Renegotiation of the agreement

The Committee debated at great length the impact of the proposed agreement on Québec SMEs, given the fundamental role of SMEs in Québec's economy. In this context, one of the alternatives discussed by the Committee was the renegotiation of the terms of the agreement to maintain in Montréal an exchange limited to trading in the shares of Québec SMEs together with the national mandate for trading in derivatives. To reduce technology costs, the exchanges could agree among themselves to create a common computer platform and each could thus manage its own listing system and apply its specific trading rules on the secondary market.

This approach would require a thorough renegotiation of the agreement between the exchanges. The greatest danger in a renegotiation is that the other exchanges may reach an agreement among themselves and leave the status quo in Montréal. The reopening of negotiations between the exchanges, should they accept to do so, involves significant risk. Such marginalization would be fatal for Montréal. The

Committee has studied the status quo scenario and the clear conclusion is that the Montréal Exchange would not have the capital to make the necessary investment in human and technological resources to compete successfully. Accordingly, the Committee cannot support the idea of running the risk of Montréal losing the opportunity to receive an investment of \$40 million to develop derivatives expertise by forcing the Montréal Exchange to maintain a listing of SME stocks which could be set up later with other capital if there is sufficient demand. To put the importance of this issue into perspective, there were three new listings exclusive to the Montréal Exchange in 1998, and five in 1997.

Lastly, the proposal that a stock exchange for SMEs be maintained in Montréal using a technology platform common to all the exchanges, assuming, it must be repeated, that the other exchanges agree to this alternative, provides SMEs with little additional reassurance compared with the outlets supported in accordance with the Committee's recommendations. However, this proposal would maintain competition between Canadian exchanges, competition which would show up in lower original and continued listing standards, variable trading rules, higher costs and multiple listings. The Committee has serious doubts as to the financial viability of such an exchange. An exchange on which 100 to 200 relatively illiquid securities of SMEs would be traded holds little promise. Apart from the issue of financial viability, the Committee has been advised that while SMEs fear being lost in the universe of a national exchange, many SMEs are just as worried by the consequences of a lack of interest by the financial community in an exchange for dealing in a limited number of small-cap securities.

After thorough analysis, the recommendations put forward to the Minister regarding access to capital and services for Québec SMEs are the best way to secure access to an efficient and dynamic public market.

2. ECONOMIC IMPACT ON OTHER MARKET PARTICIPANTS

a) The investing public

In general, the investing public has reacted negatively to the loss of stock listings on the Montréal Exchange and the general lack of knowledge of derivative products does little to reassure investors of the wisdom of the change. However, when questioned, investment counsellors who advise these investors state that private investors only rarely specify the stock exchange on which they wish their transactions executed; rather, they ask for trades to be executed at the best price. This is why, over time, trading volumes are concentrated on the most efficient exchanges. Accordingly, the effect of the restructuring on private investors will be transparent. They will continue to place orders with the same people, at the same place and in the same way as before. The important thing for private investors is their relationship with their investment counsellor, and this relationship is not affected by the restructuring.

b) Institutional investors

Even more than the individual investor, a financial institution will execute its orders on the exchange offering the best price and lowest cost. Portfolio performance is the critical factor in assessing professional fund managers. For a long time, many have shown their preference for the Montréal Exchange, but growing competitive pressures mean that this preference can no longer be applied if it involves higher execution costs. Even the Caisse de dépôt et placement du Québec, which has been one of the Montréal Exchange's most loyal supporters over the years, executes only 40% of its volume in Montréal. Institutions in Montréal have to place their orders where their counterparties place theirs, thus contributing to the concentration of volume on other exchanges. Some investors have even expressed renewed interest in derivative products on the US dollar to limit their risk when transactions are executed in the USA.

c) Large companies

Large companies that are inter-listed on many exchanges see only a very small percentage of their shares traded on the Montréal Exchange. For such companies, migrating their Montréal volume to other exchanges would only improve the liquidity of their securities, and would eliminate the costs of original and continued listing on the Montréal Exchange. For these companies, there is no negative impact.

d) Employees of the Montréal Exchange

A distinction must be made between employees of the Exchange and those of brokers working at the Exchange. Concerning its employees, the Exchange estimates that about 25 jobs would be lost because of the loss of equities trading and about 20 jobs gained because of the increased activity in derivatives. However, the Committee considers that the institution's new vocation and the modernization of its trading platform will mean on-going changes over the next few years. The Committee is in no position to estimate the number of jobs lost or created at the Exchange, but it is confident that the quality of the jobs remaining and added will rise.

As for the employees of member brokers working at the Exchange, it is estimated that about 65 of them will be affected in the near term. The Exchange believes that members will assign about 50 of them to other tasks. A cursory check with major brokerages in Montréal confirms this estimate.

As for the future, if the past is any indication, all it takes is one successful product to generate significant spin-offs. According to the Exchange, between 1994 and 1998, the number of jobs tied to independent traders (locals) rose from 30 to 150 thanks to the success of the BAX. A new star product should contribute to the creation of roughly the same number of new jobs. This does not include potential jobs as traders and analysts of all kinds with users of derivative products.

d) Investment dealers

From an operational standpoint, the restructuring will involve only minor changes to software for routing customer orders. At the economic level, the restructuring should eliminate duplication and lead to lower costs, part of which will probably be passed on to customers. Uncertainty as to the future regulatory framework also raises questions as to the impact of the restructuring on certain dealers in Québec and Western Canada. Currently, the exchanges in Montréal and the West regulate their members. As self-regulatory organizations, these exchanges have been delegated, by their securities commissions, the responsibility to carry out professional and financial inspection of dealers operating within their territory. This is not an issue in Ontario because a few years ago, the Toronto Stock Exchange transferred its member regulatory function to the IDA. But in Québec, must an exchange specializing in derivatives continue to regulate members some of whom currently trade only a very few derivatives?

The agreement between the exchanges guarantees members of one exchange access to the other exchanges. Only five of the 78 members of the Montréal Exchange are not listed with another exchange. Accordingly, this should not pose a problem. Still, local dealers may fear having to travel to Toronto to settle day-to-day operating or regulatory issues. Once again, this underscores the importance of the operation of the services outlet and the future regulatory framework.

Lastly, the Committee examined the effect of the restructuring on the presence of financial analysts in Montréal, at dealers as well as institutions. The Committee noted a trend in recent years for analysts to be located near the head offices of the market sectors they follow, particularly in the case of industries whose head offices are concentrated in one region (e.g.: oil in Calgary, paper in Montréal). In general, analysts have not needed to be geographically concentrated because of advances in communications technology. This enables dealers and institutions to hire the best person available regardless of where he or she wants to work. Be that as it may, Canada's financial centre has moved to Toronto and that alone increases the attraction of that city. The fact that the Montréal Exchange no longer deals in anything but derivatives is a secondary consideration. Lastly, if Montréal is successful with derivatives, this will generate a force of attraction for derivatives analysts.

f) Related services

An exchange is a focal point for a community of all kinds of services (lawyers, accountants, printers, translators, etc.). For many years, with the shift of Canada's financial centre to Toronto, the quantity and expertise relating to such services has also moved to Toronto. The Committee is concerned by the potential acceleration of this movement. Here again, the operation of the service outlet and the regulatory

framework will have an important impact on this issue. Still, the Committee notes that this move is already well under way and should the derivatives exchange prove successful, it would be an excellent way to concentrate the operations of the exchange in a specialized niche and provide a focal point for expertise in derivatives.

VI. THE REGULATORY FRAMEWORK

By transforming the mandate of the exchanges from regional to national, the proposed restructuring is of direct concern to the regulatory framework of the securities industry in Canada. National institutions will be regulated by provincial agencies. These agencies have made significant efforts to harmonize their regulation in recent years, especially regarding initial public offerings. The restructuring will probably revive the debate over the creation of a national securities commission. Provincial commissions will accordingly have to work together even more closely to thwart this concept.

Currently, the securities commissions approve the regulations of the exchange operating in their jurisdiction and delegate to the exchange aspects of the regulation of members such as solvency, customer complaints or registration of persons working in the industry. In some cases, authority is delegated to the IDA. The agreement between the exchanges stipulates that they will continue to act as self-regulatory organizations, based on the delegated authority they receive from provincial commissions or on agreements between them concerning the oversight and regulation of their respective market (article 10.1).

Accordingly, the restructuring raises such important questions as:

- P Will the service outlets of the two stock exchanges set up in Montréal come under the jurisdiction of the CVMQ?
- P Will the CVMQ have to approve regulations of the Toronto Stock Exchange and the Western Exchange?
- P Will decisions made by the outlets be subject to review by the CVMQ (cf. the discussion on access to capital for Québec SMEs)?
- P Will staff working at these outlets be registered with the CVMQ or the Montréal Exchange?
- P Will securities commissions in Western Canada and Ontario accept the jurisdiction of the Montréal Exchange within their territory regarding derivatives?
- P Is it appropriate for an exchange specializing in derivatives to continue playing a role as a self-regulatory organization and regulate the solvency, registration and conduct of members some of which trade only a very small volume of derivatives? In Ontario, the Toronto Stock Exchange has transferred these duties to the IDA, which raises the issue of recognition of the IDA in Québec.
- P Concerning public takeover bids and insider trading, the commissions have been able to develop mechanisms to harmonize their actions; the Committee sees no major impact on these issues arising from the restructuring.

P Ontario has passed legislation on futures contracts, while Québec has not. If Québec is to become the derivatives capital of Canada, would Ontario be willing to repeal its legislation for the sake of harmonization? Should Québec pass legislation?

What is certain is that an efficient and flexible regulatory framework has two effects:

- it inspires confidence in investors without generating costs that encourage them to turn elsewhere; and
- it supports a service industry of all kinds of experts who contribute to employment and innovation.

The coming negotiations between securities commissions and the role the CVMQ will play regarding the oversight of the exchanges following the restructuring will accordingly be of prime importance and is of concern to the Commission.

VII. ACKNOWLEDGMENTS

The members of the Committee thank the Deputy Prime Minister and Minister of State for the Economy and Finance of Québec for his confidence in them and hope their contribution to this important development in Canada's financial markets will be useful.

The members of the Committee also thank:

- P Professor Pierre Laroche, Ph.D., Professor of Finance, École des Hautes Études Commerciales
- P Mr. Bill Rupert, partner, Ernst & Young, Toronto
- P The Montréal Exchange, its staff and its consultants, McKinsey & Cie, who made themselves available to the Committee
- P Mr. Jean-Claude Cyr, Mr. Jean Campeau and Mr. Pierre Rousseau who contributed to the deliberations, and
- P Mr. André D. Godbout, secretary general of the Committee, assisted by Ms. Alice Régnier.

SIGNATURES

Chairman of the Committee: Mr. Jean Turmel
President,
Banque des marchés financiers, placements et trésorerie
National Bank of Canada

Members:

Mr. Guy Casgrain
President
Casgrain et Cie Ltée

Mr. Pierre Cléroux
Québec Vice President
Canadian Federation of Independent Business

Mr. Rodrigue Lussier Jr.
Head of Investments
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Mr. Jean-Luc Landry
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Ms. Monique Leroux
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Mr. David McAusland
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Board of Trade of Metropolitan Montréal
Vice President, Legal Affairs and
Secretary
Alcan Aluminium Limited

Mr. Henri-Paul Rousseau
President and CEO
Laurentian Bank of Canada

Secretary General: Mr. André D. Godbout

DATE: April 30, 1999

PRESS RELEASE

Office of the Deputy Prime Minister and Minister of State for the Economy and Finance:

**MR. LANDRY'S REACTION TO THE PROPOSAL
OF THE MONTRÉAL EXCHANGE**

Québec City, Monday, March 15, 1999 B The Deputy Prime Minister and Minister of State for the Economy and Finance, Bernard Landry, today reacted to the decision of the Montréal Exchange to conclude an agreement with the other Canadian exchanges with a view to specializing its activities on derivatives.

In a world of open markets and specialization, the proposal put forward by the Montréal Exchange appears interesting and deserves more detailed analysis, the Deputy Prime Minister said.

I have therefore taken two steps. First, I've asked the Commission des valeurs mobilières du Québec to provide me with an opinion on the advisability of such an agreement, from the standpoint of the operation of financial markets and the public interest.

I have also set up a task force consisting of representatives of the business community in Montréal. The task force will study the business plan of the Montréal Exchange and make recommendations to me in this regard.

The task force will be chaired by Mr. Jean Turmel, of the National Bank. He will be assisted by Mr. Jean Campeau, Mr. Guy Casgrain, of Casgrain & Associés, Mr. Jean-Claude Cyr, of the Caisse de dépôt et placement du Québec, Mr. Jean-Guy Desjardins, of Placements T.A.L., Mr. Jean-Luc Landry, of Montrusco, Ms. Monique Leroux, of the Royal Bank, Mr. David McAusland, of the Board of Trade of Metropolitan Montréal, and Mr. Henri-Paul Rousseau, of the Laurentian Bank. The task force is to report before April 30.

Appendix II

Stock market consolidation throughout the world since 1997

Mergers

Degree of advancement B> Exchanges involved	Agreement in effect	Agreement reached	Under negotiation
Amsterdam and SOM (become AEX) Brussels and BELFOX (HEX) Stockholm and OM Paris and MONEP DTB and SOFFEX (become Eurex) NYBOT and NYCCE MATIF and MEFF NASDAQ and AMEX NASDAQ and PHLX			

Pooling of Trading Systems

Degree of advancement B> Exchanges involved	Agreement in effect	Agreement reached	Under negotiation
Oslo and OM Deutsche Borse and Vienna Stockholm and Copenhagen (NORDEX) London Stock Exchange and Deutsche Borse			

Appendix II (continued)

Common Access System

Degree of advancement B> Exchanges involved	Agreement in effect	Agreement reached	Under negotiation
Frankfurt, Paris, Amsterdam and Brussels (become Euro NT [specializing in securities with strong growth potential]) CBOT and EUREX Eurex and MATIF (Euro Alliance) Benelux			

Mergers

Degree of advancement B> Exchanges involved	Agreement in effect	Agreement reached	Under negotiation
Cantor-Fitzgerald and NYBT (CFFE) CBOT and Prebon Yamane (CBB) CME and Matif (Globex 2) CME and Cantor-Fitzgerald IPE and NYME NASDAQ and Deutsche Börse CME and SIMEX (Globex Alliance)			

Acronyms: AEX: Amsterdam Exchange; BELFOX: Belgian Futures and Option Exchange; BEX: Bourses de Bruxelles; CBB: Chicago Board Brokerage; CBOT: Chicago Board of Option Trading; CFFE: Cantor Financial Futures Exchange (electronic exchange); CME: Chicago Mercantile Exchange; DTB: Danish futures and options exchange; EUREX: European electronic exchange; IPE: International Petroleum Exchange; LSE: London Stock Exchange; MATIF: Marché à terme international de France; MEFF: Spanish futures and options exchange; MONEP: Marché des Options Négociables de Paris; NASDAQ: National Association of Security Dealers Automated Quotes; NYBT: New York Board of Trade; NYCCE: New York Coffee & Cotton Exchange; NYMEX: New York Mercantile Exchange; OM: Oslo Markets; PHLX: Philadelphia Exchange; SIMEX: Singapore Mercantile Exchange; SOFFEX: Swiss Options and Futures Exchange; SOM: Stockholm Option Market

DEVELOPMENT POTENTIAL OF CANADIAN MARKETS

Equity options

Development ratio

World average 0.22 Canada 0.03

Indices

Development ratio

World average 1.22 Canada 0.15

Interest rates (long-term)

Development ratio

World average 8.46 Canada 0.60

Interest rates (short-term)

Development ratio

World average 44 Canada (BAX contract) 49

Source: Montréal Exchange / McKinsey & Cie