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February 2, 2009

Congressional Research Service

Report RL31459

*The Canadian Financial System*

The Lyndon B. Johnson School of Public Affairs; Barbara L. Miles, Contract/Project Officer

Updated June 10, 2002

**Abstract.** This report provides a description of the scope, operations, function, and regulatory framework of the Canadian financial system. The first section focuses on the Bank of Canada and its role and functions including monetary policy operations. The second section focuses on the private banking system, the third on securities dealers and stock exchanges, and the fourth on other financial intermediaries. The final section provides an historical and institutional overview of financial regulation in Canada, including a summary of recent legislation.

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# Report for Congress

Received through the CRS Web

## The Canadian Financial System

**June 10, 2002**

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Prepared by The Lyndon B. Johnson School of Public Affairs  
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<http://wikileaks.org/wiki/CRS-RL31459>

# The Canadian Financial System

## Summary

In light of the major changes in financial regulation introduced by the Gramm-Leach-Bliley Act of 1999 (GLBA, P.L. 106-102), the significant security and operational concerns connected with the events of September 11, and the failure of Enron Corp., the scope, structure, operations, and functions of the U.S. financial system are receiving a heightened level of attention. However, the United States is not unique in facing fundamental questions about markets and regulation. A number of other nations have instituted basic changes and overhauls in their financial systems. This report provides a descriptive overview of the Canadian financial system. While the Canadian and American systems are generally similar in structure and function, there are significant differences in market and regulatory practices, and comparison may yield useful insights for oversight of the U.S. financial system.

The Bank of Canada, like the U.S. Federal Reserve, plays a pivotal role in maintaining the macroeconomic stability of the Canadian economy. The Canadian central bank implements monetary policy primarily through regulation of the interest rate on overnight loans between banks. Unlike the Federal Reserve, the Bank of Canada has few regulatory powers and does not provide check clearing services.

Regulation of commercial banking is in most respects similar to the U.S. model. The industry, perhaps because of the smaller market, is dominated by six large banks, which account for 92% of total industry assets. Canadian banking is a world leader in the provision of electronic services to both retail and institutional customers.

Canada's securities industry, although it is regulated at the provincial rather than the national level, displays a striking degree of harmonization among regulators and markets. Half a dozen provincial exchanges have been transformed into one market for blue-chip stocks, one for stock derivatives, and one for start-up companies and penny stocks. A notable difference from U.S. market structure is that six of the seven largest securities firms are owned by banks. (The seventh is Merrill Lynch Canada.)

Other financial intermediaries – insurers, trust and loan companies, and mutual funds – function much as their U.S. counterparts do, although the regulatory roles of federal and provincial governments do not always correspond to U.S. practice.

Canada has confronted the same mismatches between marketplace developments in financial services and traditional industry and regulatory boundaries that made enactment of GLBA so difficult in the United States. Recent legislation has imposed similar regulatory and governance requirements on financial institutions in different industries, based (for example) on their size, rather than on the particular products and services they sell. The regulatory jurisdictions of federal, provincial, and self-regulatory organizations have been modified to protect consumers while allowing innovation in services and technology to continue.

This report describes Canada's financial system; comparisons to U.S. and other systems are for the most part left to the reader. It will not be updated.

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# The Canadian Financial System

In light of the major changes in financial regulation introduced by the Gramm-Leach-Bliley Act of 1999 (P.L. 106-102), the significant security and operational concerns connected with the events of September 11, and the failure of Enron Corp., the scope, structure, operations, and functions of the U.S. financial system are receiving a heightened level of attention. A large number of financial issues ranging from reform of deposit insurance to the possibility of federal chartering and regulation of insurance companies are all currently on the legislative agenda of Congress. However, the United States is not unique in facing fundamental questions about financial markets and regulation. A number of other nations have instituted basic changes and overhauls in their financial systems. This report provides a descriptive overview of the Canadian financial system. While the Canadian and American systems are generally similar in structure and function, there are significant differences in market and regulatory practices, and comparison may yield useful insights for oversight of the U.S. financial system.

The following report provides a description of the scope, operations, functions and regulatory framework of the Canadian financial system. The first section focuses on the Bank of Canada and its role and functions including monetary policy operations. The second section focuses on the private banking system, the third on securities dealers and stock exchanges, and the fourth on other financial intermediaries. The final section provides a historical and institutional overview of financial regulation in Canada, including a summary of recent legislation.

Unless otherwise noted, all money amounts in this report are given in Canadian dollars.

## The Bank of Canada

The Bank of Canada is the country's central bank. The *Bank of Canada Act* of 1934 defines the role of the bank: "to promote economic and financial well-being of Canada."<sup>1</sup> Founded in 1934 as a private corporation, it became a Crown Corporation<sup>2</sup> in 1938, belonging to the federal government. The Bank has considerable autonomy to carry out its responsibilities: monetary policy, central banking services, issuing bank notes, and administering public debt. The management structure of the Bank of Canada is as follows:

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<sup>1</sup> Bank of Canada Act. [<http://laws.justice.gc.ca/B-2/3990.html>]

<sup>2</sup> A Crown Corporation is a public enterprise that functions much like a private corporation. It is wholly owned by the government and is accountable to Parliament through a minister. In general, a Crown Corporation is created through a special act of Parliament that sets out in broad terms the mandate, powers and objectives of the corporation.

- ! The Board of Directors is responsible for managing the Bank and includes the Governor, the Senior Deputy Governor, 12 outside directors and the Deputy Minister of Finance.
- ! The Governor of the Bank of Canada is the Bank's chief executive officer and has full authority over the Bank's businesses. The Governor and the Senior Deputy Governor are appointed by the outside directors with the approval of the Governor in Council (Federal Cabinet) for a term of seven years. Since the Bank of Canada was founded there have been seven Governors. The current one, David A. Dodge, was appointed Governor in February 2001.<sup>3</sup>
- ! Subject to the approval of the Governor in Council, Directors are appointed by the Minister of Finance to fill vacant seats on the Board for three-year terms. Directors are mainly responsible for three aspects in the Bank:
  - i.) keeping the Bank informed about relevant economic conditions in their respective regions;
  - ii.) ensuring the Bank is managed competently according to the general policies and corporate objectives; and
  - iii.) appointing the Governor and Senior Deputy Governor.

## Bank of Canada - Monetary Policy

While the enabling legislation of the Bank of Canada gave it jurisdiction over national monetary policy, it was unclear before 1967 whose policy would prevail should there ever be a major disagreement between the Minister of Finance and the Governor of the Bank. In 1967, an amendment to the *Bank of Canada Act* specified the means through which the Government would have the right to override the Bank's monetary policy decisions. To do so, the Minister of Finance would have to publish the reasons for his dissatisfaction, indicating both the new measures that the Bank should undertake as well as the period during which the actions should be applied. The intent of the amendment has been understood to be applicable only when there is a fundamental disagreement between the Minister of Finance and the Governor, and that should it ever be used, the Governor would resign. Additionally, the amendment was intended to balance the rights of the democratically elected government to determine policy while maintaining the operational independence required by the Bank. To date, this action has never been taken by the Minister of Finance.<sup>4</sup>

In practice, monetary policy at the Bank is developed by the Bank's Governing Council (consisting of the Governor, the Senior Deputy Governor, and the four

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<sup>3</sup> Bank of Canada. "Management Structure." [http://www.bankofcanada.ca/en/manage.htm]

<sup>4</sup> Thiessen, Gordon, "Can a bank change? The evolution of monetary policy at the Bank of Canada (1935-2000), lecture Oct. 17, 2000, p. 7.

Deputy Governors appointed by the Bank's Board of Directors). The Council's monetary policy is developed by consensus, and it uses a calendar of eight predetermined dates on which it announces any new monetary policy actions, followed by the publication of its formal monetary policy report to the government. There are no recorded votes, and no transcripts or minutes are taken of any monetary policy meetings. Assisting the Governing Council is the Monetary Policy Review Committee which consists of the Governing Council, the Bank's General Counsel, the Special Adviser to the Governor, other Advisers to the Governor, the chiefs of the four economic departments, the Financial Markets Department Directors in Toronto and Montreal, and two senior Communications Department officers.<sup>5</sup>

Like all central banks, monetary policy at the Bank of Canada has gone through several evolutions. Since February 1991 the focus of Canadian monetary policy has been primarily on inflation-reduction targets.<sup>6</sup> The policy was introduced through a joint statement with the Minister of Finance, making Canada only the second country in the post-World War II period (New Zealand was first) to introduce inflation targets.<sup>7</sup> Although the Bank had been considering becoming more explicit about its inflation objective, the timing of the policy change was in part influenced by the introduction of a new federal goods and services tax (GST). The use of inflation targets was seen as a way to mitigate the effect on inflation expectations that would follow as a result of the one-time jump in prices generated by the GST. In addition, the government had also expressed an interest in having an inflation targeting agreement.<sup>8</sup>

In May 2001, the government of Canada and the Bank of Canada agreed to continue for another five-year period the inflation-control target policy: "The best contribution monetary policy can make...is to preserve confidence in the value of money by providing individuals and businesses with the certainty of a stable, low-inflation environment for their economic decisions."<sup>9</sup>

Under the inflation-control target system, the government and the Bank jointly announce a target range for inflation. Since December 1995, this has been 1 to 3%. The Bank aims to hit the 2% target midpoint over an 18-24 month horizon.<sup>10</sup> The key monetary policy variables monitored by the Bank fall into three general categories: monetary conditions, monetary aggregates, and inflation indicators. Table 1 below summarizes these key variables.

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<sup>5</sup> From interview with officials of the Bank of Canada, Nov. 7, 2001.

<sup>6</sup> Thiessen, Gordon, "Can a bank change? The evolution of monetary policy at the Bank of Canada 1935-2000," lecture Oct. 17, 2000, p. 11.

<sup>7</sup> Ibid, p. 12.

<sup>8</sup> Information provided by the Bank of Canada via e-mail correspondence dated March 19, 2002.

<sup>9</sup> Bank of Canada News Release, "Joint Statement of the Government of Canada and the Bank of Canada on the Renewal of the Inflation-Control Target", Ottawa, May 17, 2001.

<sup>10</sup> Information provided by the Bank of Canada via e-mail correspondence dated March 19, 2002.



**Table 1: Key Monetary Policy Variables<sup>11</sup>**

<b>Policy variable category</b>	<b>Policy variable</b>	<b>Description</b>
<b>Monetary conditions</b>	Monetary conditions index	A weighted sum of the changes in the short-term interest rate (the 90-day commercial paper rate) and the exchange rate (as measured by the C-6 Index) from a given base period. Note: The C-6 Index is an index of the trade-weighted exchange value of the Canadian dollar against the U.S. dollar, the euro, the yen, the U.K. pound, the Swedish krona, and the Swiss franc. The weights are calculated using the trade flows between Canada and the countries in the index.
	90-day commercial paper rate	The rate the Bank of Canada estimates for the operative market trading levels of major borrowers.
	C-6 trade-weighted exchange rate	The C-6 exchange rate is an index of the weighted- average foreign exchange value of the Canadian dollar against major foreign currencies. Weights for each country are derived from Canadian merchandise trade flows with other countries over the three years from 1994 through 1996. The C-6 index broadens the coverage of the old G-10 index to include all the countries in the EMU.
<b>Monetary aggregates</b>	Gross M1	Currency outside banks plus personal chequing accounts plus current accounts plus certain adjustments.
	M1++	M1+ plus non-chequable notice deposits held at chartered banks, trust and mortgage loan companies, and credit unions and caisses populaires less interbank non- chequable notice deposits plus continuity adjustments.

<sup>11</sup> Bank of Canada Summary of Key Monetary Policy Variables, available online: [http://www.bankofcanada.ca/en/graphs/a1-table.htm], last accessed: March 6, 2002.

Policy variable category	Policy variable	Description
	M2++	M2+ plus Canada Savings Bonds plus cumulative net contributions to mutual funds other than Canadian dollar money market mutual funds (which are already included in M2+).
<b>Inflation indicators</b>	CPI	A measure of price movements, produced by Statistics Canada and obtained by comparing the retail prices of a representative “shopping basket” of goods and services at two different points in time.
	Core CPI	A variant of the CPI that excludes the eight components with the most volatile prices—which account for 16 per cent of the CPI basket—(fruit, vegetables, gasoline, fuel oil, natural gas, mortgage interest, intercity transportation, and tobacco products) as well as the effect of changes in indirect taxes on the remaining components.
	Yield spread between conventional and Real Return Bonds	Are based on actual mid-market closing yields of the selected long-term bond issue. At times, some of the change in the yield that occurs over a reporting period may reflect switching to a more current issue. Yields for Real Return Bonds are mid-market closing yields for the last Wednesday of the month
	CPIX	Excludes the eight most volatile components from the CPI as well as the effect of indirect taxes on the remaining components.
	CPIW	Adjusts each of the CPI basket weights by a factor that is inversely proportional to the component’s variability.
	Unit Labor Costs	Are defined as aggregate labour income per unit of output (real GDP at factor cost).
	IPPI (finished products)	Industrial Product Price Index for finished products comprises the prices of finished goods that are most commonly used for immediate consumption or for capital investment.
	Average hourly earnings of permanent workers	Data for average hourly earnings of permanent workers are from Statistics Canada’s Labour Force Information

## **Implementation of Monetary Policy.**

Monetary policy implementation in Canada is distinctly different from the current practice used by the U.S. Federal Reserve. The Canadian banking system operates without reserve requirements. As a result, the Bank of Canada focuses on tools that allow it to influence the market for the use of bank surplus transaction balances. The Bank of Canada exercises a more direct influence on interest rates, in comparison to the U.S. Federal Reserve's system of manipulating the size of the money supply.

### ***General Framework of Monetary Policy Implementation.***

The overnight interest rate serves as the mechanism whereby the Bank's monetary policy actions are transmitted through the economy, ultimately affecting total spending and inflation. The overnight interest rate is defined as "the rate at which major participants in the money market borrow and lend one-day funds to each other."<sup>12</sup> In practice, financial institutions are engaged on a daily basis in the clearing and settlement of payments. At the end of the day some institutions will have surplus settlements balances while others will have deficit balances. The overnight interest rate is the rate that is paid on the surplus balances lent to the institutions that need funds to cover their deficit balances.

The Bank has created a framework designed around this daily system of payment clearing and settling which allows it to influence the overnight interest rate. In initiating a monetary policy action, the Bank first announces a target for the overnight rate after which the Bank creates an operating band. This sets an upper limit interest rate above the target rate and a lower limit below the target rate. At the end of the payment settlement day, institutions with deficit balances are allowed to borrow from the Bank at the upper limit of the operating band (defined as the Bank Rate). Institutions with surplus balances are eligible to receive interest from the Bank at a rate equal to the lower limit of the operating band.

Since institutions with surplus balances know they can receive an interest rate equal to the lower limit of the operating band, they have no incentive to lend their balances at a rate below the operating band. Conversely, since institutions with deficit balances know they can borrow at a rate equal to the Bank Rate (the upper limit of the operating band), they have no incentive to pay at a rate above the operating band. As a consequence, the Bank's framework encourages all market participants to clear the overnight money market at an interest rate that is within the Bank's operating band without direct market participation by the Bank.

### ***The Mechanics of Monetary Policy Implementation.***

The two primary systems through which payments are cleared and settled in Canada are the Large Value Transfer System (LVTS), introduced in February 1999,

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<sup>12</sup> Bank of Canada Online Glossary, available online: [<http://www.bankofcanada.ca/en/glossary/glossovernight.htm>], last accessed: March 6, 2002.

and the Automated Clearing Settlement System (ACSS). The LVTS handles large-value electronic payments while the ACSS handles paper-based payment items such as checks. While the target rate for both markets is the same, the Bank utilizes different operating bands for the two systems, the range for the LVTS being narrower than the ACSS. Given the dollar volume difference in the two systems, \$26.0 trillion<sup>13</sup> LVTS and \$5.3 trillion ACSS in calendar year 2000,<sup>14</sup> the LVTS is where the Bank focuses its primary attention when conducting monetary policy operations.<sup>15</sup> In describing the mechanics of monetary policy implementation the remainder of the report will focus primarily on the LVTS, with noticeable ACSS differences highlighted when applicable.

The primary action components for the implementation of the Banks' monetary policy are:

- ! announcements of the target rate;
- ! open market transactions taken to maintain the target rate;
- ! neutralization of government and Bank of Canada flows;
- ! pre-settlement trading by market participants.

### ***Target Rate Announcements.***

The implementation process begins with the announcement by the Bank of a change in the operating band. The decision to change or not change the target rate is made by the Governing Council. The announcements are made at 9:00 a.m. (Eastern Time) on the effective date of the change. In December 2000, the Bank of Canada switched to a system of eight pre-specified dates for announcing any changes to the operating band and thus the bank rate<sup>16</sup>

### ***Open Market Transactions.***

For both the LVTS and the ACSS, the Policy Target Rate for overnight funds is defined as the midpoint of the operating band. The operating band for the LVTS is 50 basis points (0.50%). Thus, if the upper limit of the LVTS was 3.50%, the lower limit would be 3.00% and the Policy Target Rate would be 3.25%. The operating band for the ACSS is 150 basis points (1.50%). In order to maintain the overnight rate near the specified Policy Target Rate, the Bank is prepared to enter into open market operations. These open market operations involve either the purchase of Special Purchase and Resale Agreements (SPRAs) or the sale of Sale and Repurchase Agreements (SRAs).

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<sup>13</sup> All dollar amounts are Canadian unless otherwise noted.

<sup>14</sup> Canadian Payments Association Statistics, available online: [<http://www.cdnpay.ca/eng/pub/pub-e.htm#Statistics>], last accessed: March 6, 2002.

<sup>15</sup> Bank of Canada, "The Framework for the Implementation of Monetary Policy in the Large Value Transfer System Environment" (Jan. 1999). p. 13.

<sup>16</sup> Bank of Canada Information/Consultation Paper, available online: [<http://www.bankofcanada.ca/fixd-dates/>], last accessed: March 6, 2002.

“At 11:45, if overnight funds are generally trading above the indicated target level, the Bank will enter into SPRA transactions. That is, the Bank will offer to transact SPRAs in amounts up to individual predetermined limits. Conversely, if overnight funds are generally trading below the indicated target level, the Bank will enter into SRA transactions in amounts up to predetermined limits. If the overnight rate is trading around the target level, the Bank will not intervene.”<sup>17</sup> In practice, the Bank’s open market transactions are minimal.

### ***Neutralizing Government and Bank of Canada Flows.***

The Bank’s operating band framework provides strong cost incentives for market participants to adjust their settlement positions in the market, rather than rely on the Bank’s facilities.<sup>18</sup> Thus, if the Bank’s facilities are not used, the market participants should be holding roughly zero balances at the end of the settlement day. In order to allow the market participants to achieve close to zero settlement balances, the Bank must take actions to neutralize the impact of public sector monetary flows.

Since the Bank acts as the government’s banker, any net disbursement or receipt by the government on a given day will result in an increase or decrease in the settlement balances of the market participants.<sup>19</sup> To offset the net public sector flow, the Bank engages in transactions that adjust the amount of government deposits held by market participants.

Deposits of government funds are maintained among market participants in the form of financial instruments called Receiver General Deposits. Receiver General Deposits mature and are auctioned on a daily basis by the Bank of Canada. In practice, the Bank knows by 3:00 p.m. (Eastern Time) what the net flow of public sector funds will be on a given day. As a result, the net flow is offset through the difference between the total amount of Receiver General Deposits maturing and the amount that is auctioned off back into the market. That is, if there is a net increase in settlement balances as a result of a net disbursement by the government, the amount of Receiver General Deposits auctioned by the Bank will be less than the amount of Receiver General Deposits maturing. The difference will be equal to the net disbursement. The reverse will occur in the case of a net receipt of funds by the government.<sup>20</sup>

### ***Pre-Settlement Trading Period.***

In order to assist market participants in achieving roughly zero settlement balances, the Bank has established a half hour Pre-Settlement Trading Period that begins after the close of client transactions conducted through the LVTS. The purpose of the Pre-Settlement Trading Period is to allow market participants with

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<sup>17</sup> Bank of Canada, “The framework for the implementation of monetary policy in the Large Value Transfer System environment” (Jan. 1999). p. 8.

<sup>18</sup> Ibid, p. 8.

<sup>19</sup> Ibid, p. 9.

<sup>20</sup> Ibid, p. 9.

deficit balances to cover their deficits with loans from participants with surplus balances, thus achieving close to zero settlement balances. On normal days, the market clears any large surplus and deficit balances without calling upon the Bank's overnight facilities in any significant fashion. In practice, the Bank supplies a small positive amount of settlement balances as banks do not find it cost effective to trade small amounts of overnight cash late in the trading day.<sup>21</sup>

## Commercial Banking System

The private banking system that developed in Canada is quite different from that in the United States. A different philosophy in the U.S. encouraged the development of independent local banks, while in Canada a system with a preference for limited numbers of banks with multiple branches prevailed.

Canadian banking institutions play a pivotal role in the delivery of financial services and act as the driving force behind Canada's financial system. While relatively few banks operate in Canada, the existing institutions offer a wide array of services and provide customers with access through both traditional and technological means. An examination of banking institutions, services provided, geographic distribution of banking resources and the integration of technology in the banking industry reveals a thriving and independent banking industry in Canada.

### General Overview

As of May 2000, there were 49 banks operating in Canada, 11 of which were domestically chartered, while the remaining 38 were foreign bank subsidiaries.<sup>22</sup> These 49 banks serve an estimated 20 million retail customers nationwide through an extensive network of over 8,300 bank branches.<sup>23</sup> Domestically, these banks employ roughly 236,000 people,<sup>24</sup> or about 1.5% of the Canadian workforce.<sup>25</sup> Despite a relatively small market, Canadian banks manage well over \$1.5 trillion in assets and currently hold over \$1 trillion in deposits.<sup>26</sup>

### Banking Services.

Like banks worldwide, Canadian banks provide personal and commercial banking, wealth management, and corporate and investment banking services.

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<sup>21</sup> Information provided by the Bank of Canada via e-mail correspondence dated March 19, 2002.

<sup>22</sup> Canadian Bankers Association, *Canadian Bank Facts: The Annual Guide to Canada's Banking Industry*, May 2000, p. 3.

<sup>23</sup> *Ibid.*, p. 6.

<sup>24</sup> Canadian Bankers Association, "Employment Figures by Province as of July 31, 2000," p. 1.

<sup>25</sup> *Ibid.*, p. 4.

<sup>26</sup> Busseri, Heather, Media Relations Officer, Canadian Bankers Association.

Personal and commercial banking services include checking and savings accounts, loans, mortgages, letters of credit, insurance, cash management and a full line of services to small and medium sized businesses. Wealth management includes individual estate planning, mutual funds, trust services, managed asset programs, financial planning and a full line of discount brokerage services. Finally, corporate and investment banking services encompass corporate finance, derivatives, global trading, mergers and acquisition services, merchant banking and asset securitization.<sup>27</sup>

### Predominance of Six Large Banks.

While there are 49 banks operating in Canada, six large Canadian banks hold the vast majority of the nation's assets and deposits. These banks are the Royal Bank of Canada, Canadian Imperial Bank of Commerce (CIBC), Toronto Dominion Bank (TD), Bank of Nova Scotia, Bank of Montreal, and National Bank of Canada. Table 2 outlines the relative size of each bank in terms of its assets, deposits and number of bank branches.

**Table 2: Distribution of Assets, Deposits and Branches in the Canadian Banking Industry**

Bank name	Assets (\$CDN billions)	Deposits (\$CDN billions)	Number of branches
Royal Bank of Canada	\$360	\$233	1,800
TD Bank	\$288	\$194	1,237
CIBC	\$287	\$194	1,274
Bank of Nova Scotia	\$284	\$186	1,380
Bank of Montreal	\$239	\$154	1,144
National Bank of Canada	\$76	\$51	824
<b>Six Bank Totals:</b>	\$1,534	\$1,012	7,659
<b>Nationwide Totals:</b>	\$1,665	n/a	8,329

**Note:** Dollar figures as of 10/31/01; number of branches as of 12/31/00.

**Source:** Canadian Bankers Association.

In relation to the overall size of the Canadian banking industry, it is obvious that the six large banks dominate the industry. As of October 31, 2001 all Canadian banks managed roughly \$1.7 trillion in assets, 92% of which is managed by the top six. Their dominance is further highlighted when examining their market share of deposits, loans and assets in relation to other domestically chartered banks, as shown in Table 3.

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<sup>27</sup> Canadian Bankers Association, *Canadian Bank Facts: The Annual Guide to Canada's Banking Industry*, May 2000, p. 6.

**Table 3: Market Shares of the Six Largest Domestically Chartered Banks, as of Oct. 31, 2001**

Bank name	Assets	Loans	Deposits
Royal Bank of Canada	23.1%	23.5%	22.6%
TD Bank	18.5%	17.8%	18.8%
CIBC	15.4%	15.7%	15.0%
Bank of Nova Scotia	18.3%	20.0%	18.1%
Bank of Montreal	18.5%	16.0%	18.8%
National Bank of Canada	4.9%	5.1%	5.0%
<b>Total:</b>	<b>98.7%</b>	<b>98.1%</b>	<b>98.3%</b>

Source: Canadian Bankers Association.

### Geographic Distribution of Banks.

Representative of its population, Canadian banking resources are scattered throughout the country with concentrations in Ontario, Quebec, and British Columbia. Accordingly, these areas have a substantially larger numbers of both bank branches and employees. Table 4 presents data on the distribution of both bank branches and employees by region.

**Table 4: Geographic Distribution of Bank Branches: 2000**

Province	Bank branches	# of Employees
Newfoundland	148	1,920
Prince Edward Island	34	560
Nova Scotia	269	6,395
New Brunswick	208	3,480
Quebec	1,777	39,690
Ontario	3,599	126,510
Manitoba	315	6,395
Saskatchewan	296	4,975
Alberta	715	18,475
British Columbia	930	26,835
Yukon/N.W.T./ Nunavut	38	365
<b>Total Canada</b>	<b>8,329</b>	<b>235,600</b>

Source: Canadian Bankers Association.

### Technological Integration.

Canadian banks pride themselves on the integration of technology into the banking industry. Over 57% of all payment transactions and 85% of all banking



transactions are completed electronically.<sup>28</sup> Moreover, Canadians lead the world in automatic banking machine (ABM) usage, with an average of 53 ABM transactions per person annually, followed by the United States and Sweden.<sup>29</sup> Canadians are also number one in debit card purchases, just ahead of the Netherlands and France, with an average of 45 debit transactions per person annually.<sup>30</sup> Finally, Canada leads the world with debit card terminals as well. There are nearly 13,000 terminals per one million people. A distant second is the United Kingdom with roughly 10,000 terminals per one million people.<sup>31</sup>

### **Trends in Direct Lending Income and Direct Fee Income.**

Direct fee income has become an increasingly larger share of Canadian banks' overall revenues. Over the last five years, direct fee income has increased over 80%, while direct lending income has remained virtually stagnant, increasing only 7%. In fact, from 1996 to 1999, direct lending income experienced no growth. Clearly, providing services has become an important part of an investment banks' operations. Direct service income accounted for 21% of banking revenue in 2000, up from 14% in 1995.<sup>32</sup>

### **Payments System**

The Canadian Payments Association was created by an act of Parliament in 1980, and was charged with setting up a national payments system. Its membership is composed of all the deposit taking institutions in Canada, of which 40% are banks. The remaining 60% consists mainly of trust companies and credit unions. These members all belong to statutory deposit insurance plans, which insure each account for up to \$60,000. The exceptions to this rule are credit unions, which have their own special regulations.<sup>33</sup>

In 1996, Canada decided to set up a Payments System Advisory Committee to review the payments system and the *CPA Act* of 1980. In particular, the committee wanted to review the Large Value Transfer System (LVTS) that was set to come on line in 1999 to handle large value electronic transfers. The committee produced a series of reports that described the status of the payment system and made recommendations for the future. The committee reports were positive overall, seeing the Canadian payment system as one of the finest in the world. As a main

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<sup>28</sup> Canadian Bankers Association, *Canadian Bank Facts: The Annual Guide to Canada's Banking Industry*, May 2000, p. 12.

<sup>29</sup> Ibid.

<sup>30</sup> Ibid.

<sup>31</sup> Ibid.

<sup>32</sup> Canadian Statistics. [www.statcan.ca].

<sup>33</sup> Canadian Payments Association. [www.cdnpay.ca].

recommendation, the committee wanted to continue encouraging more payments to take place electronically.<sup>34</sup>

### **Automated Clearing Settlement System.**

The payment system consists of two parts, the Automated Clearing Settlement System (ACSS) and the Large Value Transfer System (LVTS). The ACSS settles paper check and automated banking machine transactions, and was the only system in place until 1999. Checks are processed electronically at regional centers, and private companies are in charge of transporting the checks. It takes no more than two days for a check to clear anywhere in Canada. In fact, the payment system is so efficient that banks credit accounts at the time of deposit. Canadians have the option of paying bills and procuring other services, such as buying groceries, electronically. Employers can also pay their employees electronically. The ACSS accounts for almost 90% of the volume of electronic payments.<sup>35</sup>

### **Large Value Transfer System.**

The LVTS deals with inter-bank transfers and transfers between banks and other financial institutions. To be part of the LVTS a bank has to meet the technical requirements of the system and keep a reserve amount with the Bank of Canada. Currently, 14 banks are set up on the LVTS infrastructure. Other banks can offer LVTS services if they have an agreement with one of the 14 banks to process their transactions.<sup>36</sup> The LVTS offers transactions that are in real time and runs credit checks on institutions making transfers. Once a transaction has been made, it cannot be reversed. Having irreversible transactions that take place in real time is essential to the smooth operation of the system. The built-in credit reviews help to ensure that the institutions involved in the LVTS are sound. Accounts are settled at the end of the day, which saves the Bank of Canada administrative costs since it does not have to settle balances after each transaction.<sup>37</sup> As noted above, the Bank of Canada also uses the LVTS in the conduct of monetary policy.

## **Bank Regulation**

Unlike other central banks, the Bank of Canada does not play a direct role in the regulation of the national financial system except with respect to the payments system. Bank regulation is a responsibility of the Office of the Superintendent of Financial Institutions (OSFI) and of the Canadian Department of Finance. The Department of Finance is directly responsible for the process of policy formulation: preparation and evaluation of the legislation. OSFI also plays a role in the

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<sup>34</sup> "Payment System Review Discussion Paper," July 31, 1998. [www.fin.gc.ca].

<sup>35</sup> "An Overview of the Types of Payments Flowing Through the Automated Clearing Settlement System," Nov. 1998. [www.cdnpay.ca].

<sup>36</sup> "LVTS Overview," April, 2000. [www.cdnpay.ca].

<sup>37</sup> "LVTS: Real-Time Irrevocable Payments via Canada's Wire Transfer System" April 2000. [www.cdnpay.ca ].

development of regulations and legislation, but the Department of Finance is ultimately responsible for the implementation.

The Office of the Superintendent of Financial Institutions (OSFI) is a government agency, established in July 1987 by an act of Parliament that merged the Department of Insurance and the Office of the Inspector General of Banks. It regulates and supervises all federally chartered, licensed, or registered banks; insurance, trust, loans, and investment companies; cooperative credit associations; fraternal benefit societies; and pension plans.<sup>38</sup>

The Superintendent is appointed by the Governor in Council per section 5(1) of the *OSFI Act*. The appointment is not subject to parliamentary approval.<sup>39</sup> The Superintendent is accountable to the Minister of Finance and has a seven-year term. He or she works closely with the Advisory Board of OSFI, which makes recommendations on the agency's responsibilities and internal operations. The board may have between five and seven members. All serve for a period of three years, with the possibility of a second term. In the beginning of the mandate, the superintendent becomes the chairman of the board, but over time one of the other members takes that role.<sup>40</sup>

OSFI is responsible for administering five important acts: *Trust and Loan Companies Act*, *Insurance Companies Act*, *Bank Act*, *Cooperative Credit Associations Act* and *Pension Benefits Standards Act*.<sup>41</sup> The agency has several major responsibilities, the most important of which are:

- ! to strengthen public confidence in the system by evaluating the financial risks taken by institutions, and
- ! to supervise the institutions' activity in order to avoid stakeholders' (depositors, members of pension plans, and insurance policyholders) losses.<sup>42</sup>

To achieve these goals, OSFI has the right to inspect the solvency and liquidity of financial institutions. It also oversees compliance with laws and regulations. The cost of supervision is assessed to the financial institutions being supervised.<sup>43</sup>

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<sup>38</sup> Binhammer, H; Sephton, P. "Money, Banking and the Canadian Financial System," Thompson Learning, 2001.

<sup>39</sup> Interview with Tony Maxwell, Director of Foreign Relations, OSFI, Nov. 16, 2001.

<sup>40</sup> Office of the Superintendent of the Financial Institutions. "About OSFI." Online. Available: [<http://www.osfi-bsif.gc.ca/eng/about/advbrd.asp>]. Accessed: Oct. 4, 2001.

<sup>41</sup> OSFI. Annual Report 2000-2001, p. 9. Online. Available: [<http://www.osfi-bsif.gc.ca/eng/publications/osfireports/pdf/osfi01eng.pdf>]. Accessed: Oct. 4, 2001.

<sup>42</sup> Office of the Superintendent of Financial Institutions. "How We Regulate." Online. Available: [<http://www.osfi-bsif.gc.ca/eng/how/index.asp>]. Accessed: Oct. 4, 2001.

<sup>43</sup> Binhammer, H; Sephton, P. "Money, Banking and the Canadian Financial System." Thompson Learning, 2001.

OSFI recognizes that the senior management of a particular institution is responsible for avoiding financial failure of the company. OSFI's main goal is, by early intervention, to avoid failures and to minimize losses to depositors and policyholders. The three most common reaction strategies include: change of management; selling the entity or parts of it to a third party liquidator; or shutting the organization down while there is still some positive net worth.<sup>44</sup> However, in case of shutdown, the Minister of Finance has the authority to override a decision made by OSFI on grounds of "public good." If the Minister believes that the closure will have a negative impact on the public, he can "assume responsibility" for the organization and keep it open.<sup>45</sup> The Minister of Finance has authority to create a new financial institution, and may issue a letter of patent approving the creation. From there, OSFI establishes the operating procedures and the corporation is then responsible to OSFI.<sup>46</sup>

In 1999 OSFI developed a framework to evaluate the material risks of a particular institution and assess its management's risk control practices. The framework rests on several rules targeting well-recognized risks and areas of concern, and it is carried out by OSFI supervisors. Intervention is proportionate to the risk profile of the institution, and all important management functions (e.g. internal audits) are subject to supervision.<sup>47</sup>

In March 2001, OSFI supervised approximately 500 financial institutions and 1200 pension plans. Forty were under direct supervision.<sup>48</sup> In 1995 OSFI, in cooperation with the Canada Deposit Insurance Corporation (CDIC), introduced a Guide to Intervention for Federal Financial Institutions, which sets guidelines for efficient and timely response to signs of potential financial failure in supervised institutions. The guide describes the actions that should be taken according to the seriousness of the situation.<sup>49</sup> The guide recognizes five different stages of financial stability, and defines the corresponding actions of OSFI and CDIC.

### **Canadian Deposit Insurance Corporation (CDIC).**

In an attempt to further stabilize the Canadian financial system, Parliament established the Canadian Deposit Insurance Corporation (CDIC) under the *Financial Administration Act* of 1967. Accountable to Parliament through the Minister of Finance, the CDIC is charged with insuring deposits in banks, trust companies, and loan companies against loss.<sup>50</sup> Independent from governmental subsidies, the CDIC

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<sup>44</sup> Ibid.

<sup>45</sup> Interview with Tony Maxwell, Director of Foreign Relations, OSFI, Nov. 16, 2001

<sup>46</sup> Ibid.

<sup>47</sup> Office of the Superintendent of Financial Institutions. "How we Regulate." Online. Available: [<http://www.osfi-bsif.gc.ca/eng/how/index.asp>]. Accessed: Oct. 4, 2001.

<sup>48</sup> Ibid.

<sup>49</sup> Ibid. (See Appendix A on p. 43).

<sup>50</sup> Canadian Deposit Insurance Corporation, "About Us" accessed at: (continued...)

draws its operating budget from insurance premiums and funds collected from failed institutions. However, it is important to note that citizens are ultimately liable when a member institution fails. The CDIC operates under the *Canadian Deposit Insurance Corporation Act*, which delineates its responsibilities and powers.<sup>51</sup>

A nine member Board of Directors composed of the Chairman, the Governor of the Bank of Canada, the Deputy Minister of Finance, the Superintendent and Deputy Superintendent of Financial Institutions, and four private sector representatives governs the CDIC.<sup>52</sup> The *Canadian Deposit Insurance Corporation Act* requires the Board of Directors “to administer the affairs of the Corporation in all things.” The Chairman of the Board is an appointed position with a five-year term. Ex-officio members, those representing other governmental agencies, change only with personnel changes in the respective agencies. Private sector directorships are rotational in nature, but with no specified term limit.<sup>53</sup>

Only eligible institutions and accounts are covered by deposit insurance. Preliminary eligibility requirements include: (1) the monies must be held in Canadian currency and payable in Canada; (2) repayable no later than five years from the date of deposit; and (3) monies must be held at a CDIC member institution.<sup>54</sup> Moreover, the CDIC only insures specific types of accounts. Insurance eligible accounts include: savings and checking accounts; term deposits and debentures issued by loan companies; and money orders, drafts, and certified checks.<sup>55</sup> All eligible accounts at one member institution are covered for a maximum of \$60,000. Joint accounts, deposits held in trust, and retirement accounts each qualify for an additional \$60,000 in deposit insurance.<sup>56</sup>

The CDIC serves as a regulatory body for deposit taking institutions and defers to the Office of the Superintendent of Financial Institutions for bank examining purposes. The CDIC’s five primary responsibilities are<sup>57</sup> to establish conditions and standards governing the terms on which insurance is provided, decide and control entry as to which applicants obtain insurance, actively monitor and assess the ongoing performance of insured institutions and their risk to the insurance fund (including the ability to undertake annual and special examinations and to access all

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(...continued)

[<http://www.cdic.ca/?id=4>]. Last accessed on 4/21/02.

<sup>51</sup> Ibid.

<sup>52</sup> Canadian Deposit Insurance Corporation, “Organization and Structure” accessed at: [<http://www.cdic.ca/?id=57>]. Last accessed on 4/21/02.

<sup>53</sup> Ibid.

<sup>54</sup> Canadian Deposit Insurance Corporation, “How Deposit Insurance Works” accessed at: [<http://www.cdic.ca/?id=1>]. Last accessed on 4/21/02.

<sup>55</sup> Ibid.

<sup>56</sup> Ibid.

<sup>57</sup> Canadian Deposit Insurance Corporation, “General Responsibilities of a Deposit Insurer” accessed at: [<http://www.cdic.ca/?id=96>]. Last accessed on 4/21/02.

the information it needs about member institutions), set insurance premiums, and take appropriate action and impose penalties, where necessary, against institutions that are operating outside the established risk and business conduct parameters (including the cancellation of insurance).

### **Ownership Rules for Banks.**

Different ownership restrictions apply to three classes of banks and their bank holding companies (BHCs), based on their equity: large banks and BHCs with equity of \$5 billion or more, mid-sized banks and BHCs with equity of \$1 billion to \$5 billion, and small banks and BHCs with equity of less than \$1 billion.

#### ***Large Banks.***

Large banks continue to be widely held, but the meaning of “widely held” has changed. A widely held institution should not have a major shareholder holding more than 20% of any class of the institution’s voting shares or more than 30% of any class of its non-voting shares. A major shareholder is subject to a fit and proper test and the approval of the Minister of Finance. A large bank, therefore, must have at least five unrelated shareholders. This more flexible approach is designed to encourage strategic alliances and joint ventures with these large entities.

The National Bank of Canada, the Laurentian Bank of Canada, and the Canadian Western Bank, all banks with equity of less than \$5 billion, are deemed to be large banks and, therefore, cannot be acquired. The Minister, however, has the power to re-categorize these banks as mid-sized. As discussed below, if re-categorized, these banks may be acquired. Under Bill C-8, the government can review merger proposals for large banks. The government plans to implement a public merger review process.

#### ***Mid-sized and Small Banks.***

A major shareholder, including domestic or foreign financial institutions and commercial enterprises, is allowed to hold up to 65% of the voting shares of a mid-sized bank. The remaining 35% must be publicly traded on a Canadian stock exchange and may not be owned by a major shareholder. This is a significant change from the previous rules, permitting commercial enterprises to establish a significant presence in the Canadian banking sector.

There are few ownership restrictions on shareholders of small banks. Commercial enterprises, other than ones that engage in automobile leasing activities, are permitted to wholly own a small bank. Commercial owners of mid-sized and small banks are subject to a pre-approval review of their financial resources, business experience, reputation and the transparency of their corporate structures, among other things.

### **Bank Holding Companies.**

For the first time, banks may be held by regulated, widely held, non-operating BHCs incorporated under the *Bank Act*. Holding company structures permit banks the choice of moving activities that they currently conduct either in-house or in a subsidiary to an affiliate of the bank. Depending on the activity, an affiliate of the bank owned by a BHC may be subject to lighter regulation. The holding company option permits banks greater structural flexibility to compete with regulated and specialized firms, and to enter into strategic alliances. Generally, the ownership restrictions applicable to BHCs are very similar to those for banks, based on their equity.

## **Foreign Bank Branches and Activities**

### **Canadian Banks' Foreign Operations.**

Canadian banks have a long history of involvement in international finance. On average, foreign business accounts for about 40% of their earnings and in some cases it is considerably higher. The majority of this business is with the United States. However, for more than a century, Canadian banks have also had an important presence in the Caribbean. Today, they are among the most important financial institutions in some Caribbean commonwealth countries. Recently, Canadian banks have also expanded their activities in Latin America and Asia.

According to the Canadian Bankers Association, 49% of the earnings of the six largest banks are now made outside Canada, 23% of the taxes paid by the industry are coming from foreign countries, and 10% of bank employees are located outside Canada.<sup>58</sup>

### **American and Other Foreign Banks' Operations in Canada.**

There are now 42 foreign bank subsidiaries and six foreign bank branches in Canada. The six authorized foreign bank branches are: The Chase Manhattan, MBNA Canada, National City, Mellon Bank (N.A. Canada Branch), Morgan Guarantee Trust Company of New York, and U.S. Bank National Association. The largest foreign bank subsidiaries operating in Canada are shown in Table 5 below.

**Table 5: Largest Foreign Bank Subsidiaries, by Assets**

(In Millions of Dollars)

<b>Institution</b>	<b>Assets</b>
HSBC Bank of Canada	\$24,721.7
CITIBANK of Canada	\$10,456.9
Bank of America – Canada	\$8,990.7
Deutsche Bank of Canada	\$8,821.8
Societe Generale of Canada	\$5,271.1

**Source:** Canadian Bankers Association.

<sup>58</sup> The Canadian Bankers Association's Response to Bill-C-8, p. 4  
[[http://www.cba.ca/eng/cba\\_on\\_the\\_issues/reports/billc8.cfm](http://www.cba.ca/eng/cba_on_the_issues/reports/billc8.cfm)], last visit 12/21/01.

## Foreign Banks' Activities in Canada.

The major activities of foreign banks in Canada are: retail banking, small-business lending, investment banking, discount brokerage and branch banking. Traditionally, foreign banks have entered Canada for corporate lending to the subsidiaries of their multinational clients. In recent years, however, several foreign banks have established, or expanded, a presence in markets such as credit cards, investment banking, and discount brokerage. In the era of globalization, they are competing with Canadian banks on their home turf.

HSBC is a wholly owned subsidiary of London-based HSBC Holdings PLC. It is, by far, Canada's largest foreign bank subsidiary, and has approximately 140 offices and branches throughout Canada. Its total assets are about \$25 billion.<sup>59</sup>

BCI, a member of the Intesa Group with headquarters in Milan, has established 13 branches, which ranks second by number of branches. ING Direct relies entirely on electronic banking and ABMs, and is based in Amsterdam. It now has over 300,000 Canadian customers and \$3.2 billion in assets. Amex Bank of Canada is a major foreign issuer of credit cards in Canada.

## Legislation Affecting Foreign Banks' Operation in Canada.

### **Background.**

Since reaching a peak of 59 in 1987, the number of foreign bank subsidiaries in Canada declined to 45 in 1998. Their share of total banking sector assets, which stood at about 12% in 1990, fell to less than 10% by the end of 1998. Foreign banks have indicated that existing regulatory requirements make it difficult for them to compete. In order to help sustain a viable foreign bank presence in Canada, the options available to foreign banks may need to be broadened.<sup>60</sup>

During the past two decades, Canada has encouraged the liberalization of the regulatory framework governing international financial institutions, including the right to establish new entrants. Consistent with this, Canadian regulatory barriers to entry by foreign financial institutions have been largely eliminated. Foreign banks have been permitted to establish subsidiaries in Canada since 1980, and they are now eligible to open branches. In addition, other important restrictions on financial services were eliminated under the Canada-U.S. Free Trade Agreement, the North American Free Trade Agreement, and the World Trade Organization Agreement.

Consistent with the freedom being offered to domestic financial institutions through allowing financial holding companies, changes to foreign bank entry rules provide foreign banks with greater choice. Foreign entities are allowed to hold more than one banking entity in Canada (e.g., a lending branch, a full service branch, and bank subsidiaries may be held concurrently). Bill C-8 also provides foreign banks

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<sup>59</sup> The Canadian Financial System – Canada's Chartered Banks [<http://www.fin.gc.ca/toce/1995/fctshtsum95-e.html>], last visit 02/03/02.

<sup>60</sup> Background on Foreign Bank Entry Bill [[http://www.fin.gc.ca/news99/data/99-016\\_1e.html](http://www.fin.gc.ca/news99/data/99-016_1e.html)], last visit 01/25/02.



that have no deposit taking entities in Canada with virtually unrestricted investment powers. As such, the foreign bank entry provisions have the potential for increasing competition.

### ***Branching Regime.***

In addition to the existing option of establishing a foreign bank subsidiary in Canada, Bill C-8 offers foreign banks the option of establishing either a full-service branch or a lending branch. Both types of branches have essentially the same business powers as foreign bank subsidiaries and domestic banks, except with respect to deposit taking. A full-service branch is not permitted to take retail deposits, but can take deposits above \$150,000. A lending branch, on the other hand, is not permitted to take deposits, large or small, or borrow from the Canadian public. Lending branches are primarily in the business of making loans in Canada.

The main advantage of including two types of branches in the foreign bank entry regime is that regulatory requirements can be tailored more closely to the activities of a foreign bank's operations in Canada. For example, in light of the nature of their liabilities in Canada, lending branches are required to deposit only \$100,000 in approved assets with an unaffiliated Canadian financial institution. Lending branches are also subject to less frequent examination by Office of the Superintendent of Financial Institutions (OSFI) than full-service branches.

The ability to reduce Canadian regulatory requirements for foreign bank branches relative to subsidiaries stems from the fact that no Canadian retail depositors' funds are at risk. In addition, satisfactory regulation by the home country regulator is one of the conditions for allowing individual foreign banks to set up branches in Canada. While foreign bank branches are exempted from many regulations, it should be emphasized that they are regulated financial institutions in Canada. They are, for example, subject to federal regulations respecting such things as the cost of borrowing and the disclosure of interest and other charges. In addition, certain guidelines issued by OSFI apply to foreign bank branches, covering such things as accounting practices and deterring and detecting money laundering. Federal regulation and oversight of foreign bank branches are essential to safeguarding the interests of consumers and enhancing the stability of the Canadian financial sector.

The branching regime is designed to give foreign banks the same opportunities to compete in the Canadian financial services market as Canadian financial institutions. Canadian banks are subject to full regulation and are not permitted to establish lightly-regulated financial institutions to serve particular market niches. Similarly, foreign banks that choose to operate a lightly regulated lending branch are not permitted to also operate a fully regulated bank subsidiary or full-service branch. Foreign banks are permitted to operate both a bank subsidiary and a full-service branch.

### **Requirements for Foreign Banks to Establish Full-service or Lending Branches.**

A foreign bank must obtain approvals from the Minister of Finance and the Superintendent of Financial Institutions in order to establish a branch in Canada.

Provisions in the *Bank Act* provide guidance with respect to these approvals by setting out certain minimum requirements, as well as factors to be considered. Among other things, a foreign bank is required to show that:

- ! it is capable of making a contribution to the Canadian financial system;
- ! it is a bank in its home country and is regulated in a manner acceptable to the Superintendent; and
- ! its principal activity is the provision of services that would be permitted by the *Bank Act* if they were provided by a Canadian bank.

## Securities Dealers and Markets

### History of the Canadian Securities Industry

Canada's securities industry dates back to 1832, when the shares of Canada's first railroad were traded in a Montréal coffee house. Canada's first stock exchange, the Montreal Stock Exchange, was incorporated in 1874. The first Canadian securities underwriters were the chartered banks, but by the turn of the century the industry was dominated by independent securities firms, such as Wood Gundy and Company, and Dominion Securities.

Until the late 1980s, most Canadian securities firms were owned by their senior partners. Increasing demands on capital, an environment of intensified global competition, increasing market volatility, and cyclical earnings performance made this partnership structure difficult to maintain. A major ownership realignment of the securities industry took place after the removal of provincial foreign ownership restrictions and the elimination of federal restrictions on the ability of federal financial institutions to own securities dealers in 1987. The purchase of securities firms was particularly attractive to Canada's banks, which wanted to offer customers a one-stop financial services provider. Currently, all but one of Canada's large, full-service securities firms (Merrill Lynch Canada) are bank-owned (see Table 6).

**Table 6: Bank Ownership of Full-service Securities Firms**

Firm	Majority owner
BMO Nesbitt Burns	Bank of Montreal
CIBC World Markets	Canadian Imperial Bank of Commerce
National Bank Financial	National Bank of Canada
RBC Dominion Securities	Royal Bank of Canada
Scotia Capital	The Bank of Nova Scotia
TD Securities	The Toronto-Dominion Bank

## Structure of the Canadian Securities Industry

At the end of 1999, there were 188 securities firms operating in Canada. Of these, seven can be considered large integrated full-service firms, offering a wide range of services. Of the remainder, 53 firms primarily service the institutional market, and 128 are concentrated in retail brokerage. The total number of firms increased by 26% between 1993 and 1997 and has remained fairly constant since.

In 1999, securities firms assisted corporations in raising \$39 billion in debt and \$21 billion in equity. Table 7 gives an indication of the major participants in the corporate underwriting market. Securities firms also assisted provincial governments in raising \$25 billion in debt, and participated in the syndication and auction of \$50 billion in Government of Canada marketable bonds.

**Table 7: Market Share of Canadian Corporate Financing**

<b>Securities firm</b>	<b>Market share</b>
RBC Dominion Securities	15.5 %
BMO Nesbitt Burns	13.8 %
CIBC World Markets	12.7 %
Scotia Capital	10.2 %
TD Securities	9.7 %
Merrill Lynch	6.8 %

In 1999, gross revenues of the industry were about \$8.8 billion. Of this amount, \$6.2 billion (70%) was accounted for by the large full-service firms, \$1.1 billion (13%) went to firms geared to the institutional market, while \$1.5 billion (17%) was earned by retail brokerage firms. The retail brokerage group has exhibited the greatest revenue growth in percentage terms since 1993. Employment in the securities industry increased steadily for most of the 1990s.

### **Profitability and Capital.**

Net income for the industry increased 47% to \$582 million in 1999, from \$395 million in 1998. However, this result is still well below the record net income of \$850 million set in 1996. The return on equity (ROE) of the securities industry as a whole has been superior to that of deposit-taking institutions and insurers. Within the industry, there has been a considerable gap between the performance of bank-owned and independent securities dealers. In 1998, bank-owned dealers achieved an ROE of 17.7% compared to an ROE of 10.6% for the independent dealers. At the end of 1999, the regulatory capital of the securities industry in Canada totaled \$8.7 billion. Close to 70% of this was accounted for by the large, full-service firms.

### **Canadian Capital Markets**

In recent years, the established Canadian stock exchanges underwent a major realignment in order to allow them to better compete with exchanges abroad and the new electronic entrants to the Canadian market. The Toronto Stock Exchange (TSE) is now the sole senior equity market in Canada. The Montreal Exchange (ME) has

assumed responsibility for all derivatives trading.<sup>61</sup> The Canadian Venture Exchange (CDNX), created through a merger of the Alberta Stock Exchange and the Vancouver Stock Exchange, is now Canada's major junior equity market. Securities exchanges in Canada, such as the TSE, are self-regulating organizations (SROs). The principal function of a stock exchange is to bring together buyers and sellers. Traditionally, trading on most of the major exchanges has been by auction through open outcry, whereby traders confront each other directly to bargain over price. Recently, the traditional open-outcry floor-trading system of the exchange has been supplemented, and in many cases replaced, by a computer system, the electronic order books. Notably, there is no longer a trading floor at TSE. Stock trading is also conducted by brokerage firms and investment dealers over-the-counter (OTC).<sup>62</sup> Many of these stocks traded in OTC markets are stocks of companies that because of their small size do not qualify for listing on the exchanges. Some companies prefer to have their stocks traded in OTC markets to avoid the exchanges' listing fees. The Canadian Dealing Network, formerly the Canadian Over-the-Counter Trading System, was formed in 1986 as an electronic quotation- and trade-reporting system for OTC stocks. In late 1999, it joined the Canadian Venture Exchange (CDNX) along with the Winnipeg Stock Exchange.

A circuit-breaker policy was implemented in Canada on January 2, 2002. Adopted by all Canadian and American exchanges, this measure allows an exchange to temporarily suspend trading should the Dow Jones index drop more than 10% in a single day.

### **Toronto Stock Exchange.**

TSE is the premier stock exchange in Canada, capturing 98% of trading on Canadian exchanges. In 2000, it had a market capitalization of \$1.4 trillion, with 1,421 listed companies from all sectors of the Canadian economy. All transactions utilize electronic trading technology. The TSE, with a domestic market capitalization of US \$789 billion, was the world's seventh largest stock exchange in 1999 and had total trading of just over US \$332 billion. In 2000, more than 40 billion shares traded, worth more than Canadian \$944 billion, which is an 86% increase over 1999, about Canadian \$3.8 billion a day in share transactions. The TSE 300 Composite Index performed among best in the world with an annual compound return of 7.41%. In 2000, it facilitated 58 initial public offerings (IPOs), a 65% increase over 1999.

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<sup>61</sup> A small number of Quebec-based junior equities remain listed on the ME.

<sup>62</sup> OTC is a market where trades are mainly conducted over the phone.

**Table 8: Ten Largest Stock Exchanges by Market Capitalization of Domestic Companies: 2000**

Exchange	Market capitalization ( \$US billions)
New York Stock Exchange	\$11,432
NASDAQ Stock Market	\$5,205
Tokyo Stock Exchange	\$4,455
London Stock Exchange	\$2,855
ParisBourse	\$1,503
Deutsche Borse	\$1,432
Toronto Stock Exchange	\$789
Italian Stock Exchange	\$728
Amsterdam Exchange	\$695
SWX Swiss Exchange	\$693

**Source:** International Federation of Stock Exchanges

The most commonly-used Canadian stock indexes are based on stocks listed on the TSE. A new index, S&P/TSE 60™, was launched on December 31, 1998. This index is comprised of 60 blue-chip companies in leading industries from the TSE 300 Composite Index<sup>®</sup>. The new index will eventually replace the Toronto 35, TSE 100 and TSE 200 indices. Because a number of equity products (e.g., options, futures, participation units) and other index-linked financial products (e.g., index-linked guaranteed investment certificates) currently trade off the Toronto 35 and TSE 100, the phase-out period for these indices has not yet been set and is expected to be extended.

On April 3, 2000, the TSE became the first stock exchange in North America to demutualize, or to convert its business structure from a membership association to a stock corporation. It became a for-profit company known as the Toronto Stock Exchange Inc. In conjunction with the change, the market regulation function was separated from the for-profit business operations. A new independent division, TSE Regulation Services, was created to avoid conflict of interest. Regulation Services operates on a cost-recovery basis. In 2000, the overall revenue of TSE was \$235.5 million, which was up 47% over 1999. Operating expenses – \$107.4 million – were below 1999 levels, resulting in net income of \$80.5 million. On August 1, 2001, the Toronto Stock Exchange completed its acquisition of the Canadian Venture Exchange Inc. (CDNX). The two markets now operate as one corporate entity, containing separate junior and senior exchanges. These markets will continue to work on a complementary and co-ordinated basis. According to a study in 2000 by the Conference Board of Canada on the costs of going public in Canada and in the United States, it costs less to complete an IPO on the TSE than it does on any other major North American exchange.

The Investigations and Enforcement Division of TSE has many duties, including investigating manipulative and insider trading. In addition, they enforce rules that apply to brokers, for example, brokers must ensure that the best possible market price

is obtained for clients, and brokers may not trade ahead of client orders in an attempt to take advantage of non-public information concerning imminent trades. Lastly, they monitor pre-marketing activities by securities issuers and their representatives and underwriters.

### **Canadian Venture Exchange.**

The CDNX, which is the national junior equity market and successor to the former Vancouver, Alberta, and Winnipeg Stock Exchanges and the Canadian Dealing Network, began trading on November 29, 1999. With offices in Toronto, Calgary, Vancouver, Winnipeg and Montreal, CDNX offers services across the country. Trading is conducted through its TradeCDNX™ system. As of December 31, 2000, CDNX had 2,696 listed securities representing 2,598 listed companies. Starting in November 1999 with an index set at 2000, the CDNX index broke 4,000 in early 2000, reaching a peak of 4471.84 in March. Relative to 1999, its revenues and expenses (excluding merger and restructuring costs) for the year 2000 increased by 33% to \$46.0 million and by 17% to \$ 38.9 million, respectively, for an increase of \$7 million in operating earnings.

CDNX is Canada's public venture capital marketplace, providing emerging companies with access to capital while offering investors a regulated market in which to make venture investments. CDNX-listed companies are active in the mining, oil and gas, manufacturing, technology, financial services and other sectors. CDNX takes a special interest in the technology and industrial sectors. As a niche market for early-stage companies, it seeks to provide a middle step between start-up status and listing on senior markets such as the TSE, NASDAQ and AMEX. In the year 2000, 45 companies "graduated" from CDNX to the TSE, representing 38% of the TSE's new listings. Total market capital at graduation was \$8.37 billion and the market capital growth for the year prior to graduation was 302%. Graduating firms included eSoft, Genetronics, Forbes Medi-Tech, Burntsand and Cell-Loc.

There are three ways to list companies on CDNX: initial public offering (IPO), reverse takeover (RTO) and, for proven entrepreneurs with a public market track record, a capital pool company (CPC). Companies listed on CDNX are classified in three tiers. Tiers 1 and 2 each have initial listing requirements based on a company's financial performance, stage of development, and financial resources at the time of listing. Tier 1 is CDNX senior tier and Tier 2 represents innovative, early stage companies. Most CDNX listed companies trade on Tier 2. Each tier has its own minimum listing requirements for net tangible assets, property or reserves; prior expenditure; recommended work program; working capital and financial resources; earnings or revenues; distribution; market capitalization and float; reports requirements; and other criteria. Tier 3 is reserved for those companies that were previously quoted on the Canadian Dealing Network. Industry segments within each tier also have specific minimum listing requirements.

Companies are classified into five segments: mining; oil and gas; technology or industrial; research and development; real estate or investment. Companies must also have directors, officers, and a corporate governance structure in compliance with Exchange requirements; be sponsored by a CDNX member firm; and submit all necessary agreements and documentation. In addition to the listing requirements,

CDNX has also requirements and rules for tier maintenance and inter-tier movement, trading halts, suspensions and delisting. Penny shares (shares traded for under one dollar) are primarily traded on CDNX and the OTC market.

The Market Surveillance Department of CDNX performs post-trade monitoring on market activities, and assumes the responsibility of monitoring and reviewing listed company activities, and detects breaches of listing policies or the listing agreement. The Market Regulation Department conducts investigations into alleged violations of securities trading. The CDNX Conduct Review Committee determines whether a cause for discipline exists.

### **Montreal Exchange.**

Now known as the Canadian Derivatives Exchange, the Montreal Exchange (ME) was established in 1874, as Canada's first stock exchange. In 1975, it was the first Canadian exchange to list options and, soon after, to establish a major futures market. As the result of the market realignment, the ME ceased trading junior listing equity securities on October 1, 2001 and became the market for financial derivatives trading in Canada. The ME offers a wide range of derivative products on stocks, stock indexes, bonds, banker's acceptances, and other financial assets. Its main derivative products include: single stock futures (FNT, which were introduced in January 2000), S&P Canada 60 Index futures (SXF), three-month Canadian banker's acceptance futures (BAX), five-year Government of Canada bond futures (CGF), 10-year Government of Canada bonds futures (CGB), options on the ten-year Government of Canada bonds futures (OGB), and options on three-month Canadian bankers' acceptance futures (OBX). In 2000, options on iUnits S&P/TSE 60 Index Participation Fund (XIU) and S&P Canada 60 Index Options and Long Term Option (SXO) were launched. It also offers clearing services through its corporation, the Canadian Derivatives Clearing Corporation. (CDCC).

4,861,030 contracts of equity options with a value of \$2.56 billion were traded in 2000, which was an increase of 227% over the previous year. However, the ME had revenues of only \$31.7 million in 2000, a decrease of 14% from 1999. This is due mainly to the revenue loss resulting from the restructuring of the Canadian exchanges in 1999, especially the transfer of the large capitalization market to the TSE. Equity options trading continued to set new records in 2001 with a total annual volume of 5,203,143. Long-term equity options traded increased by 7% from the previous year. Daily and monthly volume records were also set in 2001. The equity products based on the S&P/TSE 60 Index showed a 10% decrease in volume of trading, whereas the CGB achieved an impressive 22% volume increase over the previous year. The interest rate contracts had a mixed year, as the BAX experienced a 15% decline.

Following the demutualization of the TSE, the ME was demutualized on September 25, 2000. The ME completed its transition to a fully electronic trading platform, the SAM (Montreal Automated System) in December 2001. This makes ME the first traditional derivatives exchange in North America to become fully automated.

As in other countries, technological change has spurred the emergence of new players in Canada's securities exchange environment. Firms such as Instant and VERSUS Technologies Inc., which operate in the U.S. as alternative trading systems (ATS), have entered Canada. Canadian securities regulators are presently re-examining ATS regulation as part of a larger review of equity market regulation. NASDAQ is another new player entering the Canadian market. On November 12, 2000, NASDAQ Canada commenced operations, with 10 securities dealers initially participating in the trading of all NASDAQ-listed securities directly from Montreal.

## Foreign Securities Activities

Canadian corporate and government issuers have been tapping foreign capital markets since the late 1800s. This is one factor which has led Canadian securities firms to establish offices in the United States, Europe and, to a more limited extent, Asia. In 1999, net new bond financing abroad by Canadian corporate issuers totaled \$8 billion, compared to \$12 billion within Canada. Government issuers, which in the past have made extensive use of foreign debt markets, reduced their foreign exposure in 1999. That year, net new government bond financing in Canada totaled \$9 billion, compared to net redemptions of \$9 billion abroad. Thus, net new bond financing for public and private issuers combined totaled \$21 billion in Canada, as opposed to net redemptions of about \$1 billion outside Canada.

Canadian equity issuers rely on foreign markets much less than Canadian debt issuers. Between 1993 and 1999, more than 95% of Canadian equity issues took place in domestic markets. Several Canadian securities firms, particularly those owned by banks, have been exploring niche opportunities, such as discount brokerage and wealth management, in the U.S. and other select markets. As Canadian banks continue to expand overseas, their securities arms will be integral in supporting banking operations and exploiting new business opportunities.

A number of foreign-owned securities firms, particularly U.S. based firms, have a long history of operating in Canada. Although several foreign firms have pursued an increased share of the retail brokerage business, only Merrill Lynch has been successful in obtaining a substantial market share. Foreign firms are increasingly active in arranging issues for corporate clients, trading in fixed-income securities, and advising on mergers and acquisitions.

The Canadian securities industry, like many of its counterparts in other countries, has been faced with the challenges of globalization, rapid technological change, and consolidation. Proximity to the U.S., the relatively low barriers to entry for foreign securities firms, free movement of capital, and an increasingly North American focus for many large Canadian corporations have made the Canadian securities business more competitive. As a response, larger Canadian securities firms have been improving their ability to service clients on a North American basis.

Canadian exchanges have also been faced with an increasingly competitive environment. Issuers of capital are increasingly able to access global markets, bypassing local markets and intermediaries. A growing number of Canadian firms are choosing to list their stock on U.S. exchanges.



## Securities Regulation

Instead of a national agency like the Securities and Exchange Commission (SEC) in the United States, Canada's provincial and territorial securities regulators are responsible for the regulation of the industry. All Canadian securities dealers are registered by the provincial and territorial securities regulators.<sup>63</sup> At the national level, the Canadian Securities Administrators serve as the forum where provincial securities regulators meet quarterly to further the goals of regulatory harmonization and mutual recognition of standards.

In Canada, each of the 10 provinces and three territories has its own Securities Commission or similar regulatory authority. The provincial securities regulators delegate some authority to the self-regulatory organizations (SRO) which have a long history of regulating and supervising market intermediation in Canada. The well-recognized SROs are the TSE, ME, CDNX, and the Investment Dealers Association of Canada. IDA membership includes the majority of firms actively engaged in securities trading in Canada. Another association, the Mutual Fund Dealers Association of Canada, has recently been recognized as an SRO. When it is fully operational, it will be responsible for regulating all sales of mutual funds in Canada, except in Quebec. It will not, however, assume responsibility for regulating the funds themselves. Firms that do not belong to an SRO are regulated directly by their respective provincial securities regulators.

### Securities Regulatory Authorities.

In some jurisdictions, Securities Regulatory Authorities (SRA) are self-funding agencies or crown corporations. In others, they operate as agencies of the provincial government under statute. Individual SRAs do some or all of the following: formulate policy; make rules; sit as an administrative tribunal in hearings on securities-related matters; and hear appeals from decisions made by the Executive Director and staff. The mandate of the SRAs is to ensure well-regulated markets which protect investors from unfair, improper or fraudulent practices, while fostering fair, efficient capital markets within each of their jurisdictions. Enforcement of provincial securities laws and day-to-day regulation of the securities industry within a particular province is delegated by law to SRAs. Specifically, all the SRAs:

- ! register directly, or indirectly through self regulatory organizations, individuals and companies who give advice about or trade in securities or exchange contracts;
- ! review prospectuses;<sup>64</sup>
- ! monitor continuous disclosure documents;
- ! conduct compliance reviews of registrants;

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<sup>63</sup> Certain security activities may be carried on by a bank in-house (not through a securities subsidiary). These activities are supervised by the Office of the Superintendent of Financial Institutions, the federal regulator.

<sup>64</sup> A document which must be delivered to recipients of offers to sell securities and to purchasers of securities in a public offering and which contains a detailed description of the issuer's business. It is included as part of the registration statement filed with the SRAs.

- ! grant discretionary exemptions from registration and prospectus requirements;
- ! investigate possible violations of provincial securities laws; and
- ! commence proceedings before the Commission or applicable Provincial Courts of Justice.

Among the SRAs, the Ontario Securities Commission regulates the largest capital market and stock exchange in Canada, the Toronto Stock Exchange.

### **Canadian Securities Administrators.**

The SRAs combine to form the Canadian Securities Administrators (CSA). It is primarily responsible for developing a harmonized approach to securities regulation across the country. Along with quarterly meetings of Commission Chairs, there are ad hoc interactions between Executive Directors. CSA Working Committees are established by the Chairs and report to them on issues of shared concern, matters of import, or other initiatives that the Chairs have decided to pursue jointly. Funding and support resources are drawn from within a Commission's operating budget on a voluntary basis.

Over the last several years, CSA has established, and continues to develop and administer, the Canadian Securities Regulatory System (CSRS). By collaborating on rules, regulations, and other programs, the CSA helps avoid duplication of work and streamlines the regulatory process for companies seeking to raise investment capital and others working in the investment industry. In recent years, the CSA has developed a system of mutual reliance that designates one securities regulator as the lead agency when it comes to reviewing applications or disclosure documents from companies that report to more than one jurisdiction. The purpose of this system is to increase market efficiency by streamlining the process and reducing the number of regulatory agencies a given company must deal with. The strategic goals of CSA are to:

- ! protect investors from fraudulent, abusive, and unfair practices in Canada's securities markets;
- ! foster the development of fair, efficient, dynamic and competitive securities markets that will provide investment opportunities and access to capital for the benefit of Canadians in all regions and sectors;
- ! maintain an efficient, effective, responsive and enforceable regulatory framework that serves and protects market participants in all jurisdictions of Canada and balances national harmonization with regional flexibility; and
- ! ensure that Canada participates actively and effectively in international regulatory arrangements and organizations.

CSA has adopted a National Policy Statement system to harmonize securities law regulation across the country on a continuing basis. National Policy Statements deal with procedures for filing and clearing prospectuses, mutual funds, timely disclosure of material information, shareholder communications, and the System for

Electronic Document Analysis and Retrieval (SEDAR).<sup>65</sup> SEDAR, which is the Canadian counterpart of the U.S. EDGAR (Electronic Data Gathering, Analysis, and Retrieval System), requires most reporting issuers to file documents electronically. British Columbia, Alberta, and Ontario are currently replacing National Policy Statements with binding National Instruments. This is part of a comprehensive reformulation process to change their non-binding National and Local Policy Statements and other instruments to binding rules. This is being done in consultation with the securities regulators in the other provinces.

While the SRAs have, to a considerable extent, standardized their codes and procedures, there can be important distinctions. The position of the CSA is that a trade or distribution can occur in more than one jurisdiction and that one must comply with the laws of each jurisdiction in which the trade or distribution occurs. As self-regulatory organizations (SROs), Canadian stock exchanges participate in the regulation of equity finances and are principal regulators of private placements<sup>66</sup> of securities pursuant to authority delegated to them by the CSA. Finally, securities law requirements (for instance, those relating to take-over bids and solicitation of proxies) may be supplemented by the applicable federal or provincial corporate statutes under which an issuer is organized.

### **Self-Regulatory Organizations.**

A self-regulatory organization is an organization that has been given the authority and the responsibility to regulate its members. In Canada, regulation of the securities industry is carried out by provincial securities commissions and self-regulatory organizations. These include the Investment Dealers Association of Canada (IDA), the Canadian stock exchanges, such as TSE, ME, CDNX, and other agencies. The Canadian SROs have been delegated responsibility by provincial governments to ensure that SRO members meet agreed-upon standards that are written into the provincial laws governing securities. The SROs regulate markets and trading as well as member firms, their employees, and their business practices by (1) setting standards that participants must meet prior to employment; (2) creating rules governing how markets must operate; (3) monitoring and examining investment dealers on a regular basis; (4) setting capital requirements to ensure firms are solvent and following all the rules; (5) extensively investigating suspected infractions; and (6) employing investigators and compliance officers to ensure that dealers are meeting these standards.

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<sup>65</sup> Available at [www.sedar.com], SEDAR is a central database containing public records of all companies publicly traded on the Canadian markets. Anyone with an Internet connection can go to SEDAR and view a company's recent news releases or financial statements.

<sup>66</sup> The offer and sale of securities not involving a 'public offering.' The definition of 'public offering' varies from country to country. A private placement typically implies that the stock will be placed only with a limited number of private institutional investors and that restrictions will be placed on the resale of the shares issued. In the United States, private placements are exempt from the registration and prospectus delivery requirements of the Securities Act of 1933.

SROs occupy a unique position because they have been delegated responsibility by provincial governments to set standards and to police their members to ensure compliance with those standards. By-laws and rules created by the SROs (as well as complaints lodged with SROs) are carefully reviewed by the securities administrators.

### ***Investment Dealers' Association.***

The Investment Dealers' Association is an SRO that also functions as a trade association for investment dealers across the country. The IDA is the only national SRO; it monitors members in terms of both their capital adequacy and how they conduct their business. If a member does not meet the minimum capital requirements established by the IDA, for example, the IDA has the power to require the member to take corrective action or it may suspend the member's trading privileges. The IDA also investigates complaints received against members, and has the authority to prosecute individuals suspected of wrongdoing and to levy fines. The IDA's regulatory actions are reviewed by provincial securities commissions. Members of the IDA must also register with the applicable provincial authority in order to sell securities in a particular province.

In addition to its policing function, the IDA is active in raising policy issues with provincial governments and the CSA on matters impacting the investing public and relating to the efficiency of the markets. The IDA also pursues harmonization of securities regulation internationally. As the industry's national trade association, the IDA represents a critically important Canadian industry. The member firms, employing more than 39,000 people in all provinces and abroad, play a key role in the national and provincial economies and account for over 97% of the industry's revenue and capital.

### **Investor Protection.**

While the principal function of a stock exchange is to bring together buyers and sellers (creating a market), the exchanges play a significant role in investor protection. Exchanges have rules governing the behavior and conduct of exchange members in many areas, including trading activities. Exchanges have specific listing and reporting requirements for companies wishing to have their securities traded on them. One important way an exchange protects the general public is by ensuring that material information about companies traded on the exchange gets widely disseminated so that all investors are trading on a level playing field. Furthermore, the Canadian Investor Protection Fund protects investors from the loss resulted from a member firm's insolvency.

As SROs, exchanges may interrupt the trading of a listed company's securities or delist the securities if the exchange feels it is appropriate. There are a number of reasons trading in a security may be halted by an exchange, for example, to allow significant news to be widely disseminated to the public. A security may be delisted if the company's financial condition no longer meets the exchange's requirements for continued trading. With respect to regulation of members, exchanges have stringent requirements on their trading activities. Furthermore, all employees of members of

a stock exchange who deal with the investing public must register with the stock exchange or the IDA, in addition to the applicable provincial administrator.

### **The Canadian Investor Protection Fund.**

The CIPF is a fund established in 1969 to protect customers in the event of the insolvency of any member of an SRO that contributes to the Fund. Sponsoring SROs (the Canadian exchanges and the IDA) contribute assets to the fund through regular annual and periodic special assessments. As soon as an investor becomes a customer of a member of any of the sponsoring SROs, the customer's accounts are covered by the fund. In the event that a member firm of a sponsoring SRO becomes insolvent, customers' losses of securities and cash balances are covered up to certain limits. The CIPF covers separate customer accounts, within certain guidelines, up to \$1 million. If a member of an SRO becomes insolvent, customers of that firm should act within 180 days of the insolvency to file a claim. The fund has rarely been called on to settle claims. The CIPF does not cover customers' losses resulting from changes in market values, only losses due to insolvency of a member of a sponsoring SRO.

## **Other Financial Intermediaries**

Other financial intermediaries that play a vital role in the Canadian financial system include insurance, mutual funds, and trust and loan companies. While the financial function these companies serve has become more integrated, each sector is regulated according to its primary financial instrument. The oversight legislation governing these other financial intermediaries was amended by the *Financial Consumer Agency Act* of 2001 to address the needs of the modern Canadian economy. The financial safety net for consumers of these services is provided through self-funded and self-regulated associations.

### **Life Insurance Companies**

Life insurance companies constitute the third largest segment of Canada's financial services sector, with 117 firms and \$258 billion in assets. The five largest companies control 54% of the market, and Canadian owned companies account for 72% of the market. In four of the last five years, the return on equity in this sector has exceeded 10%.<sup>67</sup> There are two types of life insurance companies, mutual and stock. Both provide protection from the financial hardships of death or considerable old age and offer methods for wealth management. Mutual insurance companies are owned by policyholders, who are represented by the board of directors. Stock insurance companies are owned by stockholders, and the board of directors represents both stock and policy holders. In 1999, the *Insurance Companies Act* was amended to allow insurance companies to demutualize. Demutualized companies were required to undergo a two-year transition period that ended on December 31, 2001, during which time mergers and acquisitions were prohibited.

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<sup>67</sup> Department of Finance. *Canada's Life and Health Insurers*. [http://www.fin.gc.ca/toce/2001/health\_e.html].

Insurance companies offer term and whole life policies, and have recently explored other types of policies that revise premiums, or vary the amount or timing of benefits. Traditionally, they also sell deferred and immediate payment annuities. More recently, retirement fund management has become a lucrative service for insurance companies. Firms sell individual variable insurance contracts (IVICs) to customers and pool the contracts into a segregated fund. Segregated funds were first offered in 1961, and are used mostly for pension investments. These funds are invested in securities normally prohibited for insurance portfolios, and operate like mutual funds. Segregated funds are considered to be less risky than mutual funds since 75% of the investment is guaranteed by the Canadian Life and Health Insurance Compensation Corporation (CompCorp). Through their efforts to match the maturities of their assets and liabilities, Canadian insurance companies have been able to respond to the growing demands of the baby boomer generation.

### **Regulation.**

Life insurance companies may be federally or provincially regulated. Federally they are governed by the *Canadian and British Insurance Companies Act*, or the *Foreign Insurance Companies Act*. Canadian regulations require a firm to have at least seven directors, and a minimum of one-third of those cannot be affiliated with the company. The directors must meet four times a year. The Chief Agent and Actuary must both be Canadian residents. The Superintendent of Financial Institutions is responsible for the supervision of this sector, and can force an unsound company to cease operations. The Superintendent has the authority to take over a company that refuses to introduce remedial actions. All insurance companies are required to maintain adequate capital reserves, and foreign companies must maintain the reserve in Canada. Institutions are allowed to invest up to 70% of assets in real property or equities. A company with more than \$25 million in assets has no limit on portfolio investments in commercial and personal loans. 1992 legislation allows banks to purchase life insurance firms, but restricts them from selling insurance through their branches. Large banks and large demutualized insurers are restricted from merging with or acquiring each other. Provincial regulations concern license requirements and the marketing of products, set education standards for insurance agents, and provide for consumer protection. In a June 2000 report by the International Monetary Fund, Canada is noted for its application of “prudent person” rules and the insurance sector’s overall stability.<sup>68</sup>

### **Recent Reforms.**

*The Financial Consumer Agency of Canada Act* amended several provisions of the *Insurance Companies Acts*. It lowers the minimum capital requirement for incorporation to \$5 million. The Canadian residency requirement for the board of directors has been changed to two-thirds, and at least one non-affiliated board member must attend each meeting. The Finance Minister’s role in the oversight of mergers is defined, as is the Minister’s authority to enforce sanctions for noncompliance. The widely held requirement for companies with assets over \$5

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<sup>68</sup> International Monetary Fund. *Report on the Observance of Standards and Codes: III. Insurance Supervision*. [<http://www.imf.org/external/np/rosc/can/insurance/htm>], p. 2-3.

billion limits individual or entity ownership to 20% of voting shares, and 30% of other shares. After the transition period, companies with less than \$5 billion in equities may become closely held, provided they maintain a 35% public float for voting shares. Firms with assets under \$1 billion may be wholly owned by an individual. For companies that have always been organized as stock companies, the 35% public float requirement applies when assets exceed \$1 billion. A closely held stock company may grow beyond \$5 billion in assets if the public float is maintained.

Insurance holding companies are subject to the same regulations as insurance firms. Consumer protection measures included in the new legislation require firms to issue public accountability statements and participate in dispute resolution through an independent organization or the Canadian Financial Services Ombudsman. Insurance companies are also required to maintain control of financial institution subsidiaries involved in risky activities. Other amendments cover the role of the Minister of Finance in a firm's Internet operations and portfolio investments; expand the power of the Superintendent to intervene in failing companies and force compliance through management reorganization; and mandate a yearly compliance review by the Financial Consumer Agency of Canada (FCAC). Bill C-8 also expands the payments system to include insurance companies. These reforms were enacted to address the changing role of insurance companies in the Canadian financial system.

### Consumer Protections.

The insurance industry safety net is provided through the Canadian Life and Health Insurance Compensation Corporation (CompCorp). CompCorp was organized in 1989, and federal and provincial governments require insurers to join the corporation and pay assessments. CompCorp protects consumers from a firm's insolvency. Insurance policies are covered to \$200,000; cash withdrawal guarantees and segregated funds are covered to \$60,000; and disability and regular annuities are protected at \$2,000 a month. In the event of an insurance company failure, CompCorp regulations provide for another firm to take over policies up to the stated limits, and for the original terms of the policy to be honored. The Canadian Council of Insurance Regulators is responsible for the oversight of segregated funds. The insurance industry also operates the Consumer Assistance Centre to provide customers with information and policy search assistance, and to manage complaints.

**Table 9: Top Five Life Insurance Firms by Assets: 2000**

<b>Company</b>	<b>Assets in \$ billion</b>
Sun Life Financial Services of Canada Inc.	\$33.773
Manufacturers Life	\$29.564
Clarica Life Insurance Company	\$26.677
Canada Life Financial Corporation	\$23.095
London Life	\$17.474

**Source:** Canada Online. Canadian Insurance Industry Facts.

## Trust and Loan Companies

Trust and loan companies serve two roles in the Canadian financial system. Both of these types of companies offer services similar to banks and credit unions: they accept deposits, offer checking accounts, and make mortgage loans. Through their wealth management services, trust and loan companies provide Canadian consumers with financial instruments and services that are not available from other institutions. Recently, trust and mortgage loan company regulations have been updated to improve this sector's functionality in the overall financial system.

### **Trust Companies.**

Trust companies act as trust executors, investment managers, and agents in stock and bond issues. They specialize in estate planning, establishing trusts, and managing funds for charities and pensions. Trust companies were organized to fulfill a need for financial trustees independent of the corporate structure. While banks are still restricted from offering trust services at their branches, many trust firms are now owned by banks, insurance or holding companies. Currently, there are 25 non-bank trust companies doing business in Canada.

### **Regulation.**

Regulation of trust companies depends on whether a firm is incorporated federally or provincially. Federally incorporated firms are regulated by the *Trust Companies Act* and licensed in each province. Financial oversight is provided through the Office of the Superintendent for Financial Institutions (OSFI), and the Financial Consumer Agency of Canada (FCAC) oversees consumer protection measures. Trust companies do not own the trusts they manage, and must hold trust funds separate from other funds. Federally incorporated companies with assets under \$25 million cannot participate in commercial loans, and firms with more than \$25 million in capital require approval from OSFI to put more than 5% of their assets into commercial loans. Limits on the investment portfolio of trust companies allow a maximum of 70% of capital to be placed in real property or common shares.

### **Recent Reforms.**

Under Bill C-8, which went into effect October 24, 2001, several important reform measures are directed at trust companies. The minimum capital requirement for firms seeking incorporation is halved to \$5 million. The board of directors' Canadian residency requirement is lowered from three-fourths to two-thirds. One director who is otherwise unaffiliated with the company is required to be present at all board meetings. The Minister of Finance is given an expanded role in reviewing merger proposals, approving the expansion of internet based services, improving the flexibility of investment strategies, and may sanction companies that do not comply with his directives. The bill also revises ownership regulations, consumer provisions, and regulatory oversight. Ownership regulations for trust companies are based on a firm's equity. If a firm has less than \$1 billion in equity, ownership is unrestricted. If a firm has more than \$1 billion in equity, 35% of voting shares must be widely held and available to the public through Canadian stock exchanges. Consumer protection measures require companies to provide written information concerning financial



products, notify customers of pending branch closures, and issue public accountability statements highlighting contributions to the economy and society. Institutions must join an independent dispute resolution program, and may choose the Canadian Financial Ombudsman.

The *Financial Consumer Agency of Canada Act* also focuses on regulatory oversight reforms. The agency was established to monitor a company's complaint resolution procedures and its compliance with consumer protection regulations. The Superintendent of Financial Institutions is directed to intervene quickly when it suspects that a firm will have difficulty meeting its obligations. The Superintendent may seek court orders for compliance, and can remove directors or senior officers who have contributed to the company's mismanagement. The reforms passed with *The Financial Consumer Agency of Canada Act* are the culmination of Canada's last legislative review of the financial services sector.

### **Consumer Protections.**

A financial safety net for trust companies is provided by the Canadian Deposit Insurance Corporation (CDIC). Deposits up to \$60,000 are insured by the CDIC. Firms participating in the insurance program (or "fund") must meet a capital adequacy requirement that 5% of total assets be held in equity capital.<sup>69</sup> Member institutions fund the CDIC through annual insurance premiums. In 1993, the CDIC worked in coordination with OSFI to develop *Standards of Sound Business and Financial Practices*. Standards were set for liquidity, interest, credit risk, investment portfolio and capital management, and internal controls. The CDIC has the authority to cancel the insurance of any member that fails to follow these standards.

### **Mortgage Loan Companies.**

Residential mortgage loans are the primary financial instrument offered by loan companies. Mortgage loan companies can be deposit accepting or co-operative. Deposit accepting mortgage firms take demand and term deposits, and restrict investment of funds to mortgaged real estate. Customers of co-operative mortgage companies raise funds for member mortgage loans and real estate investments. In 1973, the *Loan Companies Act* was amended by the *Residential Mortgage Financing Act* to include mortgage investment companies, and real estate investment trusts.

Mortgage investment companies issue shares and debentures, and borrow funds. They are not depository, and cannot manage or develop real estate. They are required to maintain a percentage of their investments in residential mortgages, but are allowed to invest in other forms of real estate and equity instruments. Through a Declaration of Trust, real estate investment trusts may be federally or provincially regulated. These trusts are unincorporated, and cannot develop real estate. Members

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<sup>69</sup> Binhammer and Sephton. "Money, Banking and the Canadian Financial System" Thompson Learning, 2001.

hold transferable, equal shares, which are invested in mortgages and real estate stocks.<sup>70</sup>

### ***Regulation and Consumer Protection.***

The regulatory framework for mortgage loan companies mirrors the structure for trust companies. Many of the regulatory reforms for trust companies contained in the *Financial Consumer Agency of Canada Act* also apply to loan companies, as shown in the table below. For loan companies, OSFI is responsible for financial operations oversight, and the FCAC monitors consumer protections. Deposits are insured through the CDIC. The Canada Mortgage and Housing Corporation (CMHC), also known as *Cannie Mae*, provides residential mortgage loan insurance and administers the Mortgage Insurance Fund. CMHC insurance does not cover conventional mortgages, only those obtained under the *National Housing Act*. The purpose of the CMHC is to protect consumers and monitor the safety of the industry. Mortgage loan companies continue to play a vital role in the Canadian financial system.

**Table 10: Regulatory Reforms for Trust and Loan Companies Under the Financial Consumer Agency of Canada Act<sup>71</sup>**

Minimum capital requirement for incorporation	\$ 5 million
Ownership - based on equity: a. less than \$1 billion b. more than \$1 billion	a. unrestricted b. 35% voting shares must be widely held
Proportion of Canadian residents on Board of Directors	two-thirds (2/3)
Consumer Protection	written information on financial products, public accountability statements, independent dispute resolution
Merger Review	Subject to review by the Minister of Finance
Board Meetings	One unaffiliated Board member must be present at all meetings

<sup>70</sup>Statistics Canada. "1980 SIC-E Division K". [http://www.statcan.ca/english/Subjects/Standard/sic/k.htm], p. 6-7.

<sup>71</sup> Department of Finance Canada. Bill Summary. Bill C-8.

## Mutual Fund Companies

Mutual funds are the fastest growing sector of the financial services industry in Canada. Mutual funds are pooled investments in a portfolio of securities, varying in their diversity and level of risk. These open-ended investments are professionally managed and allow investors to reduce their financial risks and improve their expected returns. Mutual funds are classified according to their assets, and include money market funds, fixed income funds, and equity funds. Money market funds are invested in short term securities including federal and provincial treasury bills, banker's acceptances, commercial paper, and guaranteed investment certificates. The value of money market funds is usually set at 10 dollars per unit. Fixed income funds include bond and mortgage funds with long-term obligations and a variable value. Dividend funds and growth funds are two types of equity mutuals. The Canadian mutual fund industry has assets of \$390 billion in 1,400 different funds. Fifty companies are designated as retail mutual fund managers. Banks, trusts, insurance, and mutual fund management companies all offer mutual funds.

### Regulation.

The Canadian mutual fund regulatory system is unlike that found in many other countries in that it primarily regulates the activities of the fund rather than the fund manager. Mutual fund dealers are regulated by the Mutual Funds Dealers Association (MFDA), a self-regulatory organization (SRO) founded in 1998. The MFDA protects investors through compliance reviews, and requires a minimum fee of \$3,000 per dealer. While the MFDA regulates the sales of these funds, the actual fund is regulated by the securities commissions. Mutual fund assets must be held by a qualified custodian, and are subject to oversight by the Canadian Securities Administrators (CSA). The CSA has established registration and prospectus requirements, and rules governing fund operations and sales. Mutual fund managers are prohibited from owning company stock. The major reform for this sector under Bill C-8 extends the payments system to include money market funds. Canadian regulation of the mutual fund industry is intended to provide the flexibility required for future growth.

### Consumer Protections.

In the event of a dealer's insolvency, consumers of mutual funds are offered a limited safety net through the Canadian Investor Protection Fund (CIPF). The CIPF covers separate customer accounts to \$1 million. Member firms finance the organization through their sector's SRO. The CIPF provides immediate coverage to accounts, and sets a deadline of 180 days to file claims. CIPF does not cover losses due to market downturns. Through the establishment of national standards, monitoring of SRO reviews, and the inspection of member companies, the CIPF is able to quickly identify potential problems.

## Summary of Canadian Financial Regulation

The Canadian financial services sector is regulated to ensure the integrity, safety, and soundness of the system. Canada depends on three types of regulation: corporate governance, self-regulation, and direct government regulation. Corporate governance involves the policies and practices of each firm. Since inadequate corporate governance can lead to failure, legislation has been passed to improve internal auditing and reporting standards. Enforcement of standards and rules by an industry or association is referred to as self-regulation. A self-regulatory organization (SRO) is “an organization that has been given the authority and the responsibility to regulate its members. The Canadian SROs have been delegated responsibility by provincial governments to ensure that SRO Members meet agreed-upon standards that are written into the provincial laws governing securities.”<sup>72</sup> SROs provide for a competitive marketplace and are flexible enough to meet the evolving needs of their industries. SROs improve the coordination and consistency of provincial policies and standards. Government regulation includes the laws and statutes governing the behavior of institutions, and the government agencies charged with ensuring compliance.

### The Modern History of the Canadian Regulatory System

For the period 1980 to 1984, 13 Canadian financial institutions declared bankruptcy. In 1985 two banks shutdown (the first in 62 years), followed by several other trust, mortgage and insurance companies.<sup>73</sup> As a result, in 1992 the federal Parliament passed a legislation that presented a new framework with important changes in the system of financial regulation in Canada. Prior to 1992, Canada’s *Bank Act* had traditionally “included a 10-year sunset clause to ensure regular review of the legislation. At the time the 1992 legislation was implemented, it was decided that the breadth and scope of the changes warranted an early review of their effectiveness.”<sup>74</sup> A five-year sunset clause was enacted. The major issues that were approved include:<sup>75</sup>

- ! regulation remained different for each type of institution. As in the past, institutions remained classifiable according to their main function;
- ! upon supervisory approval, the loan, trust and insurance companies with capital of at least \$25 million were able to make unlimited commercial loans;

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<sup>72</sup> Investment Dealers Association of Canada. *The Canadian Regulatory Landscape*. [http://www.ida.ca/Investors/RegLandscape\_en.asp], p. 1.

<sup>73</sup> Binhammer, H; Sephton, P. “Money, Banking and the Canadian Financial System” Thompson Learning, 2001.

<sup>74</sup> National Library of Canada Electronic Collection. “1997 Review of Financial Sector Legislation: Proposals for Changes.” Online. Available: [http://www.collection.nlc-bnc.ca/100/200/301/finance/other\_pubs/html/rev97-ef/fs197/fs11e.html#key]. Accessed Jan. 24, 2002.

<sup>75</sup> The following list of bullets is a short summary of the actual legislation. A complete overview can be found in Binhammer, H; Sephton, P. “Money, Banking and the Canadian Financial System” Thompson Learning, 2001.

- ! companies with smaller capital were restricted to no more than 5% of their assets;
- ! federally incorporated institutions were not allowed to have control over any car-leasing companies, nor to perform any car leasing activities;
- ! investment rules for financial intermediaries have been revised and the prudent portfolio approach was introduced. The Board of Directors of every institution became responsible for setting the rules and procedures for investing and lending. The rules assumed holding a portfolio of assets that matched the liabilities of the entity and was well diversified;
- ! apart from holding companies as their subsidiaries, financial institutions were also allowed to control other entities that performed certain types of activities. These activities were defined in the legislation and included distribution of mutual funds, information services, factoring and other businesses. Financial institutions were allowed to own not more than 10% of the voting shares, or 25% of the shareholders' equity, of other companies;
- ! bank, loan, insurance and trust companies were forbidden to purchase assets or services, lend to, or make investments in certain companies. These included any company that was a major shareholder or performed any means of control over the financial institution;
- ! change of ownership of more than 10% of shares, or any additional increase in an already high interest in the shares, of an institution was to be approved by the Minister of Finance;
- ! when the consolidated capital of a financial institution exceeded \$750 million, the company was to have, within five years, at least 35% of its voting shares traded by public investors on Canadian stock exchanges; and
- ! at least one-third of the members of the Board of Directors of any financial institution had to be independent of the institution.

In 1997, the Task Force on the Future of the Canadian Financial Services Sector made further recommendations to help the system adjust to technological change and financial globalization. Following the 1997 review, Parliament once again mandated a five-year expiration. The comprehensive reforms contained in 2001's *Financial Consumer Agency of Canada Act* are also subject to a five-year sunset clause. The changes had four different directions: to stimulate efficiency and growth, to support domestic competition, to assure consumer protection and improve the regulatory framework.<sup>76</sup>

### **Bill C-8.**

The final stage of the modern reforms was set out by a report called *Reforming Canada's Financial Services Sector: A Framework for the Future*. It was based on the recommendations by the Task Force on the Future of the Canadian Financial Services Sector and the subsequent analysis done by two parliamentary committees: the

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<sup>76</sup> Ibid.

Standing Committee on Finance and the Standing Committee on Banking, Trade and Commerce. The process ended with the passing of Bill C-8 in October 2001, which outlined the fundamentals of the present regulatory system in Canada. The Bill introduced changes to the financial services sector and the ownership structure of the institutions (banks would be allowed to own other banks). It also established a new size-based ownership regime and created the Financial Consumer Agency of Canada.<sup>77</sup> Some of the newly introduced rules included:

- ! **The new ownership regime for banks.** Bank holding companies are classified into three groups according to their equity: over \$5 billion (large), between \$5 billion and \$1 billion (medium) and below \$1 billion (small). Large banks are widely held. No shareholder can control more than 20% of voting shares, or more than 30% of non-voting shares. A medium bank can be closely held. However, it must have 35% of its voting shares publicly traded at a Canadian stock exchange. There are no limitations for banks with less than \$1 billion in equity. Similar rules apply for insurance holding companies.<sup>78</sup>
- ! **Shareholders' influence.** No shareholder is allowed to have major influence in a large bank or a federal insurance company. To ensure that, the bill introduced two rules: the "tainting rule" and the "cumulative voting rule". According to the tainting rule, no one is permitted to be a major shareholder in any subsidiary of a large bank (or demutualized company). The other rule states that a shareholder can control no more than 10% of any class of shares in any group of banks or federal insurance companies connected to a large bank.<sup>79</sup>
- ! **Foreign offices.** Foreign banks are permitted to open two different subsidiaries in Canada: lending branches or full-service branches. A full-service office is allowed to take deposits greater than \$150,000. Lending branches are not permitted to take deposits; they can only borrow from other entities.<sup>80</sup>
- ! **Bank mergers.** A bank is permitted to merge with a trust and loan company; non-regulated lending institutions, or an insurance company. Mergers are also subject to the \$5 billion rule, i.e. if the newly formed merger has more than \$5 billion in equity, it has to be widely held.<sup>81</sup>
- ! **Superintendent's Role.** The Superintendent is granted the right to dismiss senior executives and high company officials in cases of misbehavior, incompetence, poor business record, etc. He is also able to impose fines for violations of the legislation. Moreover, the

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<sup>77</sup> Haggard, Laurin, Kieley, Smith, Wrobel. Bill C-8: An Act to Establish the Financial Consumer Agency of Canada and to amend certain acts in relation to Financial institutions. Library of Parliament. Online. Available: [[http://www.parl.gc.ca/common/bills\\_ls.asp](http://www.parl.gc.ca/common/bills_ls.asp)]. Accessed: Nov. 26, 2001.

<sup>78</sup> Ibid.

<sup>79</sup> Ibid.

<sup>80</sup> Ibid.

<sup>81</sup> Ibid.

Superintendent is allowed to prosecute any director of an entity who had authorized an improper transaction.<sup>82</sup> The Superintendent has the right to approve transactions and business activities of financial entities without the authorization of the Minister of Finance.<sup>83</sup>

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<sup>82</sup> *Ibid.*

<sup>83</sup> *Ibid.*

## Appendix A: Guide to Intervention for Federal Financial Institutions: Deposit-taking Institutions

*No problems/Normal activities*— Routine supervisory and regulatory activities pursuant to mandates of OSFI and CDIC. In addition, both agencies conduct research and analyze industry-wide issues and trends, appropriate to their respective functions.

OSFI activities	Statutory and inter-agency activities/responsibilities	CDIC activities
<p>Incorporation of new financial institutions and issuance of orders to carry on business:</p> <ul style="list-style-type: none"> <li>• review and assess all relevant documents and information</li> <li>• make recommendation to Minister.</li> </ul> <p>Review and assess wide range of applications and requests for regulatory consents required by statutes including:</p> <ul style="list-style-type: none"> <li>• corporate reorganizations</li> <li>• changes in ownership</li> <li>• acquisitions of other financial institutions</li> <li>• transfers of business.</li> </ul> <p>Ongoing monitoring of supervised institutions via information obtained from statutory filings and financial reporting requirements:</p> <ul style="list-style-type: none"> <li>• consider compliance with statutory and other regulatory requirements</li> <li>• assess financial situation and operating performance.</li> </ul> <p>Periodic on-site examinations of supervised institutions as required by statutes:</p> <ul style="list-style-type: none"> <li>• inform management and board of directors of findings</li> <li>• management requested to provide copy of report to external auditors</li> <li>• require that concerns be addressed by institutions</li> <li>• monitor remedial measures if required.</li> </ul>	<p>OSFI informs Minister of status of supervised institutions.</p> <p>OSFI reports to the CDIC on post examination results for individual deposit-taking member institutions and confirms material compliance with standards of sound business and financial practices.</p> <p>Monthly OSFI-CDIC inter-agency meeting held to discuss corporate governance and activities of member institutions.</p>	<p>Process application for policy of deposit insurance and obtain appropriate guarantees and undertakings.</p> <p>Ongoing risk assessment of selected individual institutions via:</p> <ul style="list-style-type: none"> <li>• information available from OSFI, the Bank of Canada and, where necessary, individual financial institution reports</li> <li>• contacts with regulators</li> <li>• rating agency results</li> <li>• review and analysis of results of annual examinations of federal member institutions carried out by OSFI</li> <li>• other sources.</li> </ul> <p>Ensure compliance with CDIC Act and standards of sound business and financial practices by-laws, policy of deposit insurance and CDIC by-laws.</p>



**Stage 1 — Early warning** — Deficiency in policies or procedures or the existence of other practices, conditions and circumstances that could lead to the development of problems described at Stage 2. Situation is such that it can be remedied before it deteriorates into a Stage 2 problem.

OSFI activities/intervention	Statutory and inter-agency activities/responsibilities	CDIC activities/intervention
<p>Management and board of directors of financial institution are formally notified of concerns and are requested to take measures to rectify situation.</p> <p>Monitoring of remedial actions may involve requests for additional information and/or follow-up examinations.</p> <p>OSFI may require that institution's external auditor enlarge scope of examination of institution's financial statements or that external auditor perform other procedures, and prepare a report thereon. OSFI may assign cost of external auditor's work to institution.</p> <p><small><a href="http://wikileaks.org/wiki/CDIC-11-11-11">http://wikileaks.org/wiki/CDIC-11-11-11</a></small></p>	<p>Activities below are in addition to those previously mentioned.</p> <p>OSFI and CDIC coordinate on requested remedial measures to deal with concerns and on establishment of time frame within which situation should be remedied.</p> <p>OSFI's post-examination report to CDIC identifies issues requiring remedial measures, including any material breaches of standards of sound business and financial practices, regardless of whether such issues are treated as formal qualifications to OSFI's report. The status of such issues is reviewed at monthly inter-agency meetings.</p> <p>CDIC notifies OSFI of contemplated intervention measures, discusses results of special examinations with OSFI, and coordinates communications with the institution about its status and placement on "watchlist".</p>	<p>CDIC risk assessment and interventions listed here are in addition to those mentioned previously.</p> <p>Depending on CDIC's assessment of situation</p> <ul style="list-style-type: none"> <li>• CDIC may request additional information from OSFI if available, or from the institution if necessary</li> <li>• CDIC may communicate its concerns to institution and may place it on its preliminary "watchlist" and inform institution of that fact</li> <li>• If circumstances warrant CDIC may conduct or commission a special examination to obtain more information on the member institution and to be in a position to assess the extent of the institution's problem and CDIC's exposure</li> <li>• Institution may pay higher CDIC premiums, related to increased risk.</li> </ul> <p>CDIC may levy a premium surcharge if the institution does not remedy any of the following:</p> <ul style="list-style-type: none"> <li>• failure to follow CDIC's standards of sound business and financial practices</li> <li>• failure to comply with its governing statute</li> <li>• failure to fulfill the terms of an undertaking provided to CDIC</li> <li>• failure to maintain records and information pursuant to provisions of the policies of deposit insurance.</li> </ul> <p>CDIC may request an undertaking from institution or from entity that controls the institution to rectify areas of concern.</p>

**Stage 2 — Risk to financial viability or solvency** — Situation or problems that, although not serious enough to present an immediate threat to financial viability or solvency could deteriorate into serious problems if not addressed promptly, as evidenced by:

- ! concerns over the institution's ability to meet capital and surplus, or vesting requirements on an ongoing basis
- ! deterioration in the quality or value of assets, or the profitability of the business undertaken by the financial institution
- ! undue exposure to off-balance sheet risk
- ! poor earnings or operating losses or questionable accounting
- ! low level of accessible liquidity or poor liquidity management in context of the institution's situation
- ! less than satisfactory management quality or deficiency in management procedures or controls (including material breaches of standards of sound business and financial practices)
- ! other concerns arising from:
  - a financially weak or troubled owner
  - rapid growth
  - non-compliance with regulatory requirements
  - credit rating downgrades
  - systemic issues

OSFI Activities/Intervention	Statutory and Inter-Agency Activities/Responsibilities	CDIC Activities/Intervention
<p>Senior OSFI officers meet with management and board of directors of financial institution and with external auditor of institution to outline concerns and discuss remedial actions. Management and board of directors are formally notified of the fact that institution is being placed on the regulatory &gt; watchlist.</p> <p>External auditor of institution may be required to perform a particular examination relating to the adequacy of the institution's procedures for the safety of its depositors, other creditors or shareholders, or any other examination that may be required in the public interest, and report thereon to OSFI. OSFI may assign cost of external auditor's work to institution.</p> <p>Scope of on-site examinations may be enlarged on increased.</p> <p>Monitoring of financial institution is enhanced as to frequency of reporting requirements and/or level of detail of information submitted.</p> <p>Institution must produce a business plan acceptable to both OSFI and CDIC that reflects appropriate remedial measures that will rectify problems within a specified time frame.</p>	<p>Activities below are in addition to those previously mentioned.</p> <p>CDIC and OSFI coordinate communications with the institution.</p> <p>OSFI immediately notifies CDIC of situation when uncovered, with a formal report to follow. Institution is placed on "watchlist". OSFI sends a "watchlist" progress report at least monthly to CDIC and Minister; report is discussed in regular meeting with Minister. Progress on remedial measures discussed at monthly OSFI CDIC interagency meeting. Institution may be discussed at Financial Institutions Supervisory Committee.</p> <p>Contingency planning commences.</p>	<p>CDIC risk assessment and intervention listed here is in addition to those previously mentioned.</p> <p>CDIC informs management and board of directors of member institution of situation and of the fact that institution is being placed on CDIC's "watchlist" leading to more vigorous monitoring.</p> <p>If institution is in breach of CDIC's standards of sound business and financial practices, policy of deposit insurance, bylaws, CDIC may send the CEO or the Chairman of the institution a formal report pursuant to Section 30 of the CDIC Act. CDIC may advise institution that if CDIC is not satisfied with progress made in rectifying the situation referred to in the above mentioned formal report, CDIC may seek (federal institutions) Minister's permission to terminate the institution's policy or deposit insurance.</p>
<p>Business restrictions appropriate to circumstances may be imposed on institution's order to carry on business or via director of compliance covering such matters as:</p>		

<b>OSFI Activities/Intervention</b>	<b>Statutory and Inter-Agency Activities/Responsibilities</b>	<b>CDIC Activities/Intervention</b>
<ul style="list-style-type: none"> <li>• payments of dividends or management fees</li> <li>• lending or investment powers</li> <li>• level of deposits and other indebtedness</li> <li>• interest rates paid on deposits</li> <li>• other restrictions tailored to circumstances</li> </ul> <p>Progress of remedial measures is monitored via reporting requirements and/or follow-up examinations.</p>		

<http://wikileaks.org/wiki/CRS-RL31459>

**Stage 3 — Future financial viability in serious doubt** — Situations or problems described at Stage 2 are at a level where, in the absence of mitigating factors such as unfettered access to financial support from a financially strong financial institution parent, unless effective corrective measures are applied promptly, they pose a material threat to future financial viability or solvency.

OSFI activities/intervention	Statutory and inter-agency Activities/Responsibilities	CDIC activities/intervention
<p>Management, board of directors and external auditor of institution are informed of problems.</p> <p>A special audit may be required from an auditor other than the institution's own external auditor if OSFI is of the opinion that it is required. OSFI may assign cost of external auditor's work to institution.</p> <p>If financial institution is a deposit-taking institution, examination and monitoring responsibility is transferred to an internal special work-out group within OSFI.</p> <p>Enhanced examinations may be carried out focusing on particular areas of concern such as asset or loan security valuations. Such examinations may involve any of the following:</p>	<p>Activities below are in addition to those previously mentioned.</p> <p>OSFI immediately notifies CDIC of any material new findings or developments, with a formal report to follow.</p> <p>Results and data from enhanced examinations, expanded audits, etc. and from enhanced monitoring are discussed with CDIC.</p> <p>If financial institution is a deposit-taking institution and it is deemed to be, or is about to become, non viable, OSFI sends a formal report to CDIC to that effect.</p>	<p>CDIC risk assessment and interventions listed here are in addition to those mentioned previously.</p> <p>CDIC may seek Minister's permission to terminate the institution's policy of deposit insurance.</p> <p>In order to minimize risk to deposit insurance fund, CDIC may provide institution with temporary financial assistance or provide support for a restructuring transaction by such measures as:</p> <ul style="list-style-type: none"> <li>• acquiring assets from the institution</li> <li>• making or guaranteeing loans or advances with or without security, to the institution</li> <li>• making or guaranteeing a deposit with the institution.</li> </ul> <p>Following receipt of formal OSFI report to the effect that institution has ceased, or is about to cease, to be viable, CDIC may initiate a restructuring by asking the Minister of Finance to recommend that the Governor in Council issue a "FIRP" order, under the financial institutions restructuring provisions of the CDIC Act.</p>

OSFI activities/intervention	Statutory and inter-agency Activities/Responsibilities	CDIC activities/intervention
<ul style="list-style-type: none"> <li>• substantial increase in sampling of credit files</li> <li>• more in-depth review of files</li> <li>• engagement of specialists or professionals to assess certain areas such as quality of loan security, asset values, sufficiency of reserves, etc.</li> <li>•</li> </ul> <p>Depending on situation, OSFI examination staff may be posted at financial institution to monitor situation on an ongoing basis. Business plan must reflect appropriate remedial measures that will rectify problems within a set time frame so as to avoid triggering impaired viability or impaired solvency procedures (See Stage 4). OSFI may order institution to increase its capital. Monitoring of institution may be further enhanced as to frequency of reporting requirements and/or the level of detail of information submitted so as to monitor progress of remedial measures.</p>		
<p>Follow-up examinations may be carried out as required. Depending on circumstances, business restrictions may be enhanced or additional ones imposed on institution. Depending on circumstances, pressures may be exerted on management and board of directors to restructure institution or to seek out an appropriate prospective purchaser. OSFI develops contingency plan in order to be able to take rapid control of the assets of the financial institution if changes in circumstances so warrant.</p>		

**Stage 4 — Nonviability/insolvency imminent** — Severe financial difficulties resulting in failure or imminent failure to meet regulatory capital and surplus requirements in conjunction with inability to rectify the situation within a short period of time; OR

- ! statutory conditions for taking control being met; OR
- ! failure to develop and implement an acceptable business plan, thus making either of the two preceding circumstances inevitable within a short period of time.

OSFI Activities/Intervention	Statutory and Inter-Agency Activities/Responsibilities	CDIC Activities/Intervention
<p>New business restrictions may be imposed on institution or existing restrictions may be expanded.</p> <p>Pressure to rectify situation is exerted on management and board of directors of financial institution through frequent meetings with senior OSFI officers.</p> <p>OSFI notifies management and board of directors of institution of intended regulatory intervention measures that will be taken unless situation is rectified imminently.</p> <p>If statutory conditions for taking control of assets exist and if circumstances are such that there is an immediate threat to the safety of depositors and other creditors, OSFI may take control of the assets of the institution for a short period.</p> <p>If statutory conditions exist, such as failure to comply with order to increase capital, and subject to representation to the Superintendent, OSFI may maintain control of assets or take control of the institution.</p>	<p>Other relevant regulatory agencies (provincial or foreign) are notified of proposed regulatory intervention measures to be applied to institution.</p> <p>If the institution meets any of the conditions that would make it eligible to be wound up pursuant to the Winding-up Act, the institution itself may voluntarily seek a winding-up order.</p> <p>Alternatively, either OSFI or CDIC, working in collaboration with the other agency, may seek a winding-up order. Minister may overrule this decision on grounds of public interest only.</p> <p>All intervention measures applied to deposit-taking institutions at this stage, whether initiated by OSFI or CDIC, are the subject of close coordination between the two agencies.</p>	<p>If CDIC is of the opinion that the institution is or is about to become insolvent, CDIC may seek Minister's approval to cancel the institution's policy of deposit insurance.</p>

**Source:** Office of the Superintendent of Financial Institutions. Available online: <http://www.osfi-bsif.gc.ca/eng/publications/supervisoryguides/index.asp?id=1995>. Accessed: October 4th 2001.

## Appendix B. Acronyms

ABM	Automated Banking Machine
ACSS	Automated Clearing Settlement System is an electronic system through which small value paper-based and electronic payment items are exchanged. It is run and maintained by the Canadian Payment Association.
ASE	Alberta Stock Exchange
ATS	Alternative Trading System
Bank of Canada Act	The Bank of Canada Act of 1934 is the original legislation that created the Bank of Canada.
Bank Rate	The Bank Rate is the rate charged by the Bank on LVTS advances to financial institutions. It is defined to be the upper bound of the Operating Band.
BAX	Canadian Banker's Acceptance Futures
BHC	Bank Holding Company
CDCC	Canadian Derivatives Clearing Corporation
CDIC	Canadian Deposit Insurance Corporation
CDN	Canadian Dealing Network
CDNX	Canadian Venture Exchange
CGB	10-year Govt. of Canada Bonds
CGF	Govt. of Canada Bond Futures
CIPF	Canadian Investment Protection Fund
CMHC	Canadian Mortgage and Housing Corporation
CPA	Canadian Payments Association
CPC	Capital Pool Company
CPI	Consumer Price Index
CSA	Canadian Securities Administrators
CSRS	Canadian Securities Regulatory System
Demutualization	The process of converting from a mutual company to a stock company. A mutual company is owned by its voting policyholders while a stock company is owned by its shareholders.
Edge Act	Legislation that allows National Banks to perform foreign lending through government chartered subsidiaries.
FCAC	Financial Consumer Agency of Canada
FINTRAC	Financial Transactions & Reports Analysis Center of Canada
FNT	Single Stock Futures
FOMC	Federal Open Market Committee



Futures	Contracts to buy or sell a specific amount of some product at a specific price on a specific date in the future. The underlying asset might be a financial instrument (financial future), a stock index (stock index future) or an agricultural product such as wheat, soybeans, or pork bellies. If the underlying asset is a stock index, settlement is made in cash due to the difficulty in delivering a market basket of stocks.
GDP	Gross Domestic Product
Governor	The Governor of the Bank of Canada is the Bank of Canada's chief executive officer and has full control and authority over the business of the Bank.
IDA	Investment Dealers Association of Canada
IPO	Initial Public Offering
IPPI	Industrial Product Price Index
IVIC	Individual Variable Insurance Contracts
LVTS	The Large Value Transfer System is an electronic system for the transfer of large-value or time-critical payments. It is run and maintained by the Canadian Payment Association.
MFDA	Mutual Funds Dealers' Association
Minister of Finance	Canadian Federal Government Cabinet Level position. Primary responsibility is over the Department of Finance.
MSE	Montreal Stock Exchange
OBX	Options on three-month Canadian Bankers Acceptance Futures
OGB	Options on 10-year Govt. of Canada Bonds
Operating Band	The Bank of Canada's 50-basis-point range (i.e., 1/2 of one percentage point) set around the Bank's desired Target Rate.
Option	A contract that gives the right to a holder to buy (call option) or sell (put option) a fixed amount of a security at a specific price anytime before the stated expiration date (for an American-style option). If the holder does not exercise his option, the option expires and he forfeits the amount he paid for the option (the premium).
OSFI	Office of the Superintendent of Financial Institutions
OTC	Over-the-Counter is a market where trades are mainly conducted over the phone.
Private Placement	The offer and sale of securities not involving a 'public offering'. The definition of 'public offering' varies from country to country. A private placement typically at least implies that the stock will be placed only with a limited number of private investors. In the USA, a private placement is one which is exempt from the registration and prospectus delivery requirements of the US Securities Act of 1933.

Prospectuse	A document which must be delivered to recipients of offers to sell securities and to purchasers of securities in a public offering and which contains a detailed description of the issuer's business. It is included as part of the registration statement filed with the SRAs. And with documents required by stock markets, stock exchanges and national competent authorities.
ROE	Return on Equity
RTO	Reverse Takeover
SEC	United States Securities and Exchange Commission
SEDAR	System for Electronic Document Analysis and Retrieval
SPRA	A Special Purchase and Resale Agreement is a transaction in which the Bank of Canada offers to purchase Government of Canada securities from designated counter parties with an agreement to sell them back at a predetermined price the next business day; used to reinforce the Target Rate.
SRA	A Sale and Repurchase Agreement is a transaction in which the Bank of Canada offers to sell Government of Canada securities to designated counter parties with an agreement to buy them back at a predetermined price the next business day; used to reinforce the Target Rate.
SRO	A self-regulatory organization is an organization that has been given the authority and the responsibility to regulate its members.
SXF	S&P Canada 60 Index Futures
SXO	S&P Canada 60 Index Options and Long-Term Option
Target Rate	The rate that the Bank of Canada wants to see in the market for overnight money market financing.
TSE	Toronto Stock Exchange
VSE	Vancouver Stock Exchange
WSE	Winnipeg Stock Exchange
XIU	Options on iUnites S&P/TSE 60 Index Participation Fund

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