

Northern lights

THE CANADIAN SECURITIES MARKET OFFERS STRONG BUSINESS POTENTIAL FOR A RANGE OF SERVICE PROVIDERS AS IT CONTINUES TO DEVELOP.
ROGER AITKEN REPORTS



Although Canadian national fortunes revived during 2004 when benchmarked against a series of stiff challenges that faced the country in 2003 (power failures, floods and a SARS crisis), a report published by a Senate committee on national security last March concluded over two years' study by declaring that poor co-operation among federal and provincial governments left the nation unprepared for potential disasters.

The news, however, is not all bad. In fact, the country is in fairly good shape on the macro-economic front and there is a healthy spirit of entrepreneurialism. International ratings agency Fitch was prompted last August to upgrade Canada's

long-term foreign currency sovereign rating to 'AAA', reflecting general government budget surpluses and strong GDP growth.

A minority Liberal government was elected in the federal elections in June and is headed up by Paul Martin, former finance minister. Handling the conflicting interests of 10 provinces and three territories will not be a smooth ride. Quebec, which accounts for around a quarter of Canada's entire population, has had a lingering desire to become a sovereign state, though most agree that issue has, for now, been defused.

Despite some long standing rivalries and political differences, the US and Canada are inextricably linked. Their bilateral relationship is possibly one of most extensive

anywhere on the planet, evidenced by the sheer volume of mutual trade - at over \$1bn a day in goods, services, and investment income.

Whilst the Canadian securities market is just a fraction of the size of the US, almost 30 per cent of its transactions settle with counterparties across the border. Not surprisingly Canadian market players have intimated a wish for closer synchronisation with their southern neighbours. The national central securities depository, the Canadian Depository for Securities Limited, has been a participant in the Depository Trust Company (DTCC) since 1979.

At a market level, the Toronto Stock Exchange (TSE) performed solidly during 2004, with 1,397 listed issues registered. The benchmark S&P/TSE Composite Index rose 9.8 per cent in the year to end of November 2004, while the Canadian Mid-Cap Index surged 16.3 per cent higher.

Canadian exchanges have been fairly proactive in attempting to provide enhancements for facilitating cross-border trading. In December 2004 'Multiple Give-Up' was launched, enabling Toronto Stock Exchange and TSX Venture Exchange investors to have extended choice in clearing and settlement decisions. The function allows firms to direct large or multiple orders to their choice of participating organisations for execution, but have the various trades tagged for clearing by one clearing firm.

"Simply put, we are levelling the playing field for our participants," stated Rik Parkhill, senior vice-president for trading at TSX Markets. Launching a US dollar book also assisted in resolving

inefficiencies in dual-currency trading of stocks.

In turn the nation's investment fund industry saw total net assets reach €267,909m in 2003. Whilst the asset value is below the €300,464m achieved in 2001, in contrast to the US industry trend between 2001-2003, Canada's numbers have been slightly more resilient.

Many custodians view the Canadian Capital Markets Association (CCMA), the securities industry trade group that is chaired by Gerry O'Mahoney, chief operating officer of TD Waterhouse Canada, as continuing to do a sterling job. As an almost unique organisation, it is populated by all the leading securities industry players - including stockbrokers, transfer agents and investment managers. Custodians are well represented on the board and several lead major committees. Indeed, RBC's José Placido is vice-chair, while Thomas C. MacMillan, CIBC Mellon president and chief executive officer, was formerly chairman.

The focus today is to position the Canadian market to perform same day trade matching on all institutional trades. To this end, last October the CCMA recommended at a conference in Toronto that Canadian market participants adopt either centralised or local matching methods in adopting a phased approach to same-day matching of post-trade instructions. A new steering committee has the goal of securing a 75-percent trade matching level (T+1) by the end of mid 2006 and 100 per cent within two years.

This is the area where Canada appears to be lagging behind the US and it is also where cost/benefit considerations are strongly supported by the industry. Last November, CDS, the national depository, stated that: "Improving the timeliness and efficiency of institutional trade matching is central to achieving straight-through processing."

Indeed, one way that CDS is enabling institutional trade matching is through the development of an interface that will accept matched

institutional trades from an external trade or virtual matching utility (VMU). Whilst complexities make it virtually impossible to definitively compare the marketplaces of Canada and the US, an assessment from Capital Markets Company (CAPCO) revealed that Canada's STP readiness potentially lags the US by 14 months. Interestingly, the country was ahead of the US in other areas, such as the immobilisation of securities certificates.

While a strong Canadian dollar has counteracted the impact of rising oil prices (denominated in US\$), a survey from BENCHMARK®, the investment analytics arm of RBC Global Services that maintains a comprehensive universe of Canadian pension plan and money managers, revealed that the surging Canadian currency, was bad news for balanced pension funds in Q3 2004 as currency losses on foreign investments largely erased market gains at home.

"Most Canadian pension plans do not hedge foreign exchange exposure and were walloped by [our] strengthening dollar this quarter," commented Don McDougall, director, BENCHMARK, RBC Global Services.

The domestic pensions industry has witnessed some interesting times of late, with deficits, rights to surpluses and restrictive investment rules focussing minds. Air Canada is a high profile example, having been beset by financial problems and seeing a mismatch between its pension scheme assets/liabilities - posting a C\$1.3bn deficit on a solvency basis on its 10 defined benefit (DB) plans.

An unusual 30 per cent cap on foreign investment by domestic institutions can be circumvented through the use of derivatives. Some argue against retaining a rule that can be so easily bypassed, while other custodians suggest that Canadian pension plans should have a domestic and conservative focus in any case.

Despite some unresolved issues, 2004 was a relatively good year for pension market returns. And,



PLACIDO

Industry recognition of RBC shows our client-centric approach is working.

according to a 2003 Actuarial Report, plans to amend the Canadian Pension Plan (CPP), a mandatory pension plan established in 1998 that covers all citizens, through legislation called 'Part 4 of Bill C-30', should clarify employer contributions and ensure the CCP's future financial sustainability. It might also offer up servicing opportunities for custodians and administrators, given that an investment board has been set-up to invest CPP surpluses in the market.

Not surprisingly the pensions market has proved fertile ground for the leading servicing providers. For CIBC Mellon's MacMillan, satisfying the unique needs of pension and other deferred income plans is paramount and it certainly helps if you can draw on half a century of experience servicing the pensions industry. As a trustee and custodian the bank covers the broad array of its clients needs - from the receipt of contributions, to the payment of pension and benefit cheques.

The outsourcing trend towards back office processing in Canada continues apace, benefiting several service providers. Penson Financial Services Canada, Inc, the largest independent clearing firm in Canada, has positioned itself within the market as a niche player. Twenty years ago it was a fairly arduous job to outsource back office services, but a kind of 'silent revolution' appears to have been taking place to the extent that 50 per cent of Canada's

200 member firms take the outsource route. Penson believes that over the next few years, there will be just 10 self-clearing firms in Canada. Of the 205 IDA firms in the country, 55-60 per cent outsource. With a market share of around 30 per cent, Penson is winning business and recently secured mandates from LiquidNet, Orion and Dominick & Dominick.

Despite Canadian banks being 'big' on their own home turf, they are having to scratch collective heads about how to achieve further growth. Brenda Lum, vice-president and senior banking analyst at Dominion Bond Rating Service (DBRS) says that in contrast to the US the Canadian banking sector is generally far more mature and holds limited opportunities for further expansion. (Canadian-based DBRS scored a major breakthrough in 2003 when it gained 'NRSRO' status from the US SEC, reflecting much disciplined work by the agency under its President & CEO, Walter Schroeder.)

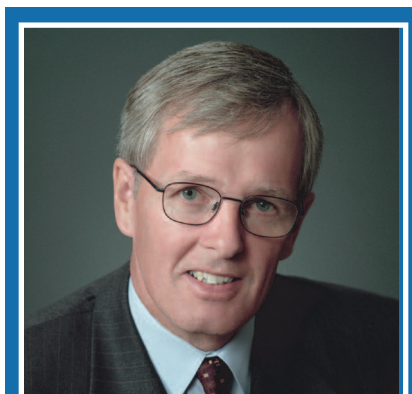
Looking specifically at the custody business, Canada represents one of the most consolidated markets in the world. Nowadays it is a vastly different one from that which existed in the late 1980s and 1990s.

While a clutch of leading players currently dominates the market - including the home grown Royal Bank of Canada (RBC), US/Canadian venture CIBC Mellon, and State Street - service levels do not appear to have been adversely affected. As in the US and elsewhere in western Europe, clients continue to demand more and more from their custodians in terms of STP, real-time information, value-added services and efficiencies, and a move up the value chain by service providers is already apparent.

Despite a reduction in the number of custodians serving the market, Tom MacMillan at CIBC Mellon, a 50/50 joint venture between Canadian Imperial Bank of Commerce and Pittsburgh-based Mellon Financial Corporation, insists that institutions still have a good choice. "A decade ago when you had ten providers it may have appeared

that you had more choice, but in reality levels of service were poorer. It should also be realised that back then there were a group of practitioners in the market which didn't really have the wherewithal to make the required investment. Now you have three or four providers, which can be regarded as world class, in addition to some regional providers as in the province of Quebec." Other players such as IBT Trust Company (Canada) are also present in Toronto, providing global and domestic custody as well as back/middle office outsourcing.

Gary Enos, executive vice



MACMILLAN

The Manulife win underscores our position in Canada.

president, and head of State Street's Offshore and Canadian Investment Services and Alternative Investment Services, says key developments during 2004 for State Street included the launch in January of the securities lending industry's first-ever Canadian cash collateral fund. This allowed Canadian-based lenders to collect additional returns for their securities on loan. And, last October the company conducted the first triparty securities lending trade in Canada.

In terms of mandates, the custody market is far from static. Commenting on some of the reasons for changes in custody providers, MacMillan says: "Change is due in large part to some of the big pension plans being mandated every so many years to go out to tender. On the non-pensions side we have seen some

consolidation among companies, which has prompted a new look at who is providing the custody arrangements. I think there has been a reappraisal of the value of the custodian today, whereas in the past it was a case of companies not wishing to change a custodian that had been in place for years. Also, as companies come under pressure to reduce costs and provide better information on the corporate governance side, people are increasingly agreeing to see what the competition has to offer."

As Canada's second largest provider of custodial services, CIBC Mellon's development mirrors the consolidation theme and the common need to invest in IT and gain scale. In May 1999 it acquired the custody business of Bank of Montreal, then Canada's fifth largest bank, followed up by Toronto Dominion Bank in 2002. Currently, the bank serves the requirements of over 1,200 custody clients, as well as pension funds, investment funds, insurance companies, foreign insurance trusts, governments, corporations, foundations and endowments with domestic and global assets. As of December 31, 2004 assets under custody stood at C\$71.7bn - up from C\$55.7bn in December 2003.

Signalling the importance of its position in the market, the company recently secured a \$60bn Manulife Financial Corp custody mandate - the largest business win in its history. As Manulife's sole custodian, it will be providing services for general, segregated and mutual funds in Canada, plus some additional US-based Hancock's Canadian business. MacMillan says that the process of converting the business was going to plan and reflected that the win was the culmination of many things including great team work. The fact that there was fairly intense price competition on this mandate reinforces the view it is still a very competitive market place.

"This was a tremendous effort all round and certainly underscores the CIBC Mellon position in Canada. One of the largest, most sophisticated

companies in Canada has chosen us as its custodian. Among the factors that played a part in influencing Manulife, the world's fourth largest life insurance company, was our technology platform and service model. As well as liking what they saw generally, Manulife was looking for a custodian to make it more efficient and secure faster information to run its business. Recognising our expertise in areas such as real-time reporting and trade processing, corporate actions and client service was pleasing," MacMillan stated.

CIBC Mellon was also appointed in October 2003 as sub-custodian provider for the Nordea Group, becoming the primary Canadian sub custody provider to Nordic financial services companies. MacMillan says the appointment was a "key win".

The bank's core offering includes daily NAV calculations for mutual fund clients and benefits payments for pension plans, while added-value services include securities lending, performance measurement, risk assessment and analytics, which are offered through Russell/Mellon Analytical Services.

On its securities lending side the company made two new appointments within its global securities lending (GSL) group during the year. Rob Ferguson was promoted to vice president, product and client service and Jeffrey Alexander was elevated to director, business development. Ferguson assumed responsibility for managing GSL's client service, while Alexander is leading a team focused on growing GSL's business.

As Canada's largest custodian, Royal Bank of Canada (RBC) has more than C\$1.6trn in client assets under administration. It is also a leading provider of treasury management services providing a full suite of electronic cash management services. RBC Global Services facilitates a high volume of domestic and international payment services for clients around the world, and is the largest processor of Canadian dollar payments in Canada.

Through RBC Global Services, specialised transaction processing

STAYING POWER: THE CANADIAN DEPOSITORY FOR SECURITIES

The Canadian Depository for Securities Limited (CDS) was incorporated in June 1970 as a private not-for-profit business corporation. It is the country's national securities depository, clearing and settlement hub, supporting the Canadian equity, fixed-income and money markets. Offices are located across Canada in Toronto, Montreal (1976), Vancouver, Calgary and Halifax - spanning five time zones - providing services in French and English and dealing with two distinct legal systems. In 2002 the CDS' Disaster Recovery Plans were successfully tested.

CDS holds in excess of \$2 trn on deposit and handles around 50m securities trades a year, of which 13.5m are cross-border transactions. CDS' most important platform and system is CDSX, which enables OTC and broker-to-broker trade matching, and provides for next day (T+1) or

same-day (T+0) settlement.

The number of shares traded has increased 106 times over the last 35 years. The depository's owners include the leading Canadian banks, members of TSX Inc. and the Investment Dealers Association of Canada (IDA). Four independent directors from outside the securities industry sit on the board of CDS that comprises nine shareholder directors.

The CDS has custodial relationships with the DTCC, Japan Securities Settlement & Custody (JASDEC) and Euroclear France, and is a qualified depository under the terms of the UK's FSA. While the Bank of Canada regulates CDS's CDSX at a federal level for clearing and settlement payment obligations under the 'Payment Clearing and Settlement Act', in Ontario, CDS is regulated by the Ontario Securities Commission under the Securities Act.

services are offered for its business, commercial, corporate, and institutional clients in domestic and select international markets. Key businesses include global custody, investment administration, and correspondent banking.

José Placido, executive vice-president of RBC Global Services commenting says: "To be consistently recognised for superior service and an ability to adapt products and services to meet the needs of our clients exemplifies how well our client-centric approach is working." And, not wishing to stand still, in July 2004 a redesigned RBC Global Services web site was launched (www.rbcglobalservices.com/iis), which provides convenient access to the bank's custody and investment administration products, services and online tools.

While Canada presents a mosaic of structures and regulations, it does have a well developed and sound

securities infrastructure. Looking over the horizon it would be hard to say whether the Canadian custody market could consolidate any further. The possibility of new market entrants is by no means beyond question, but if the CIBC Mellon experience is anything to go by it would appear existing players are a hard act to follow.

According to Tom MacMillan: "I'm not discouraging anybody to come in and start up a new initiative and it's not impossible. But in our case it has taken time to get to where we are with a brand name, established banking relationships and 1,400 employees (combined GSS and trust businesses). Clearly, you can't suddenly come in to the Canadian market. It's one thing to say you've got great technology with a view to bringing it to Canada, but it is quite another to form a company, staff up, get the technology linked in with depository and understand all the Canadian regulations." **ICFA**