A SURVEY OF THE DEVELOPMENT AND FUNCTIONS OF THE CANADIAN CAPITAL MARKET

McMaster University

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BY
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PREFACE

In this thesis, I have attempted in a small way to provide some systematically arranged information on the development and functions of the securities market in Canada.

All too often, the Canadian student of economics is confronted with a wealth of textual material which recounts for him in detail the institutional history of the A merican economy; only rarely can he find information about his own country's economic development, or about the institutions as they exist at the present time here.

I cannot pretend to have done more than break the ground in this study, and as far as I have been able to ascertain, no unified study of this topic has ever been made by a competent and qualified economist. Why, it is difficult to say. The standard work relating to the investigation is Parkinson's Canadian Investment and Foreign Exchange Problems, but it is an uneven work, and it makes no pretense of being an historical analysis. Ronald McEachern's Putting Your Dollars to Work has been valuable to me, but it is a popularized work and incomplete in many ways.

I could wish for another year in which to make this the well-balanced study which I had originally planned, but the limitations of the undergraduate's time and mind being what they are, it is submitted in its present form, being no more than a summary, a plan, from which a cleverer mind than mine might conceivably draw inspiration for a valuable contribution to Canadian economic literature in a practically untouched area of investigation.

To Dr. R.C. McIvor for his patience with my lame excuses for work not done, and for his careful supervision and criticism, my thanks.

J.H.P.

Edwards Hall,
McMaster University,
March 15, 1950.

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Chapter I

AN INTRODUCTION TO THE STUDY

At every stage in the development of complex economic systems, the process of capital formation has been of central importance. Without the aid of saving and investment, roundabout production is impossible; only through continued investment can industrial progress be made. It should not be thought, of course, that capital formation can be carried out solely in the ways to which we are accustomed: in the markets for securities, private investment and so on. Direct control of the process by the government is equally possible, and is strongly advocated by socialist thinkers. But, whatever the institutional framework, the need for saving and for the diversion of spending from consumers' goods to producers' goods is essentially the same.

Although the savings-investment relationship has always been important to economic theory (as well as to industrial experience), it has taken on new significance in recent years as many important economists have come to hold the view that the relationship is not an automatic one regulated by the rate of interest. Realization that a more complete understanding of this relationship seems to be of great importance to the analysis of the cycle adds to the need for study in this field. Moreover, theoretical consideration to one side, it is necessary that the student of modern forms of business should have some information on the development of the institutional structure by which corporations (and governments) obtain funds required for their activities. The Canadian Capital Market, which has developed largely within the last thirty-five years, provides an excellent model by reason of its recent origin and its comparatively simple structure. Moreover the paucity of information on this market leads us to believe that effort so expended is not wholly wasted.

In general, then, this thesis proposes to investigate the history of the Canadian Capital Market, relating insofar as is possible, the appearance of the various institutions to the economic conditions of the period involved. We shall try to evaluate their development as changes in the economic background occurred, and we shall study the present structure of the investment market on a functional basis, attempting to assess the efficiency of the institutions in carrying out the functions assigned to them in the economy. Finally, we shall consider the current problems of the market and make some suggestions for its improvement.

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In his concise survey of corporation finance, Professor Ashley has defined the capital market as follows:

> The capital market is concerned with the investment of funds in long-term securities by the issue and distribution of bonds and shares, and by subsequent trade in them.[1]

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[1]Ashley, C.A., Corporation Finance, (Toronto:

From this definition, which is sufficiently precise for our purposes, several facts of importance may be noted. The first is merely one of terminology. In order to avoid the confusion which is familiar to students of economics dealing with the word "capital", it is wise to point out that, for the sake of style, and at the cost of a certain degree of exactness, we shall use the terms "capital market", "investment market" and "securities market" interchangeably, on the understanding that we are always referring to the market defined above.

It will also be recognized that the securities market can be conveniently defined for purposes of economic analysis into two parts: that which deals in existing securities and that which is concerned with the issue of new bonds and stocks. We will discover, as we proceed, that most of the criticism levelled at the market is directed toward the new securities section, for the secondary markets have done an efficient job in the matter of regulation and self-government in recent years.

This part of the market (the organized securities exchanges) has often been called a close approach to the perfect market of economic theory which requires a homogeneous product, one price, and many buyers and sellers so that the actions of one cannot affect the price. Perfect knowledge on the part of these buyers and sellers as to the existing

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The Macmillan Company, 1947), p. 65.

market is also prescribed. There must be no co-operation or collusion, and there must be free access to the market both for buying and selling.[1]

Considering one widely-held security alone, these requisites are likely to be filled, with the possible exception of the one requiring complete absence of co-operation. Moreover perfect knowledge of the underlying factors which can affect the value of the "homogeneous product" is unlikely in the ordinary investor, nor is it necessary for pure competition. Thus conditions of almost pure competition are the rule rather than the exception in the listed securities markets.

For the most part, the market for new securities contains elements of monopoly, at least at the stage where the securities are distributed by one underwriter (or underwriting group) to the public. At the previous stage it is fiercely competitive with the various investment firms vying with one another for the issues of the corporations and governments.

The clash of economic interests in new security issues is particularly strong, as in all security dealings; and economic motives are at their purest here, so that we must try to avoid judgments based too closely on ethical considerations. One of the prime problems has been to determine at what point the principle of <u>caveat emptor</u> should be applied.

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[1]Based on the characteristics of a perfect market given in R.A. Lester, <u>Economics of Labour</u>, (New York: The Macmillan Company, 1941), pp. 94-103.

In Figures 1 and 2, simplified diagrammatic representations of the market, in its two phases, may be found. These diagrams will provide a quick review of the structure of the capital market to-day to which reference may be made as we proceed.

Two limitations on the study may be noted here. The first is the inadequacy and inaccuracy of statistics dealing with the market. Comprehensive figures for the early periods are simply not available. The second is the fact that much material must be gathered from opinions expressed by various men in the market and therefore conclusions must be carefully drawn and allowance made for bias.[1]

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[1]A scholarly cry of despair in this matter is evident in the following quotation from Jacob Viner's Canada's Balance of International Indebtedness 1900-1913, (Cambridge: Harvard University Press, 1924), p.7. It is the common complaint of the inductive research economist everywhere, but especially of those dealing with Canadian problems:

> Induction from partial evidence, or from incompletely classified data, itself waits upon hypotheses...before it can yield logically convincing inferences. The limitation of specific knowledge of facts is perhaps the chief obstacle to the use of the inductive method. The limitation of knowledge is due to the inadequacy of recorded data; to the difficulty of attribution of effect to cause where a combination of causes produces a joint effect; to the human element in the collection and arrangement of facts which leads to their distortion...and, probably most of all, to the inaccessibility to the student, under conditions usually governing his research, of the facts of mental experience necessary to a complete explanation...of a process in which man plays a part.

FIGURE ONE

THE MARKET FOR NEW SECURITIES

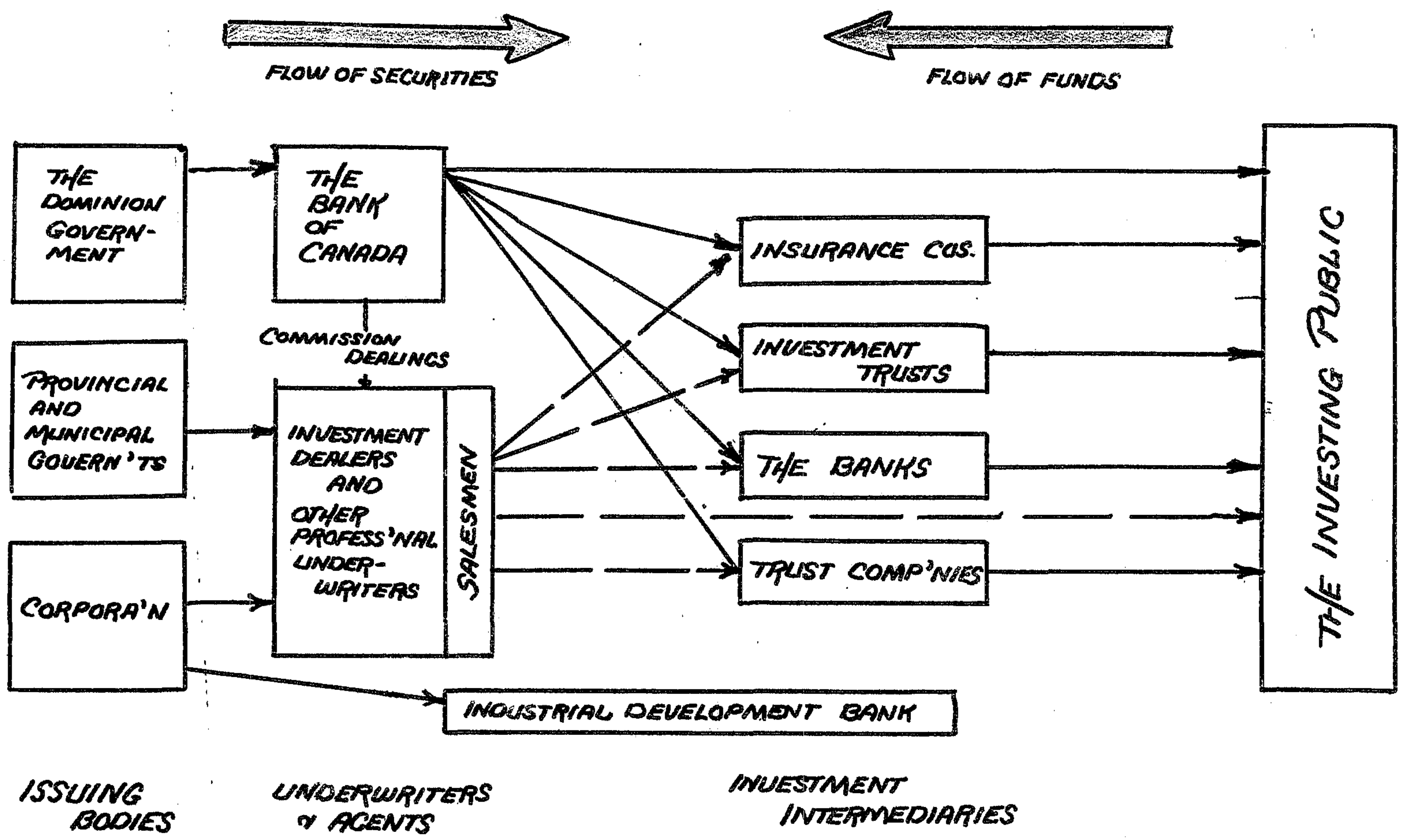
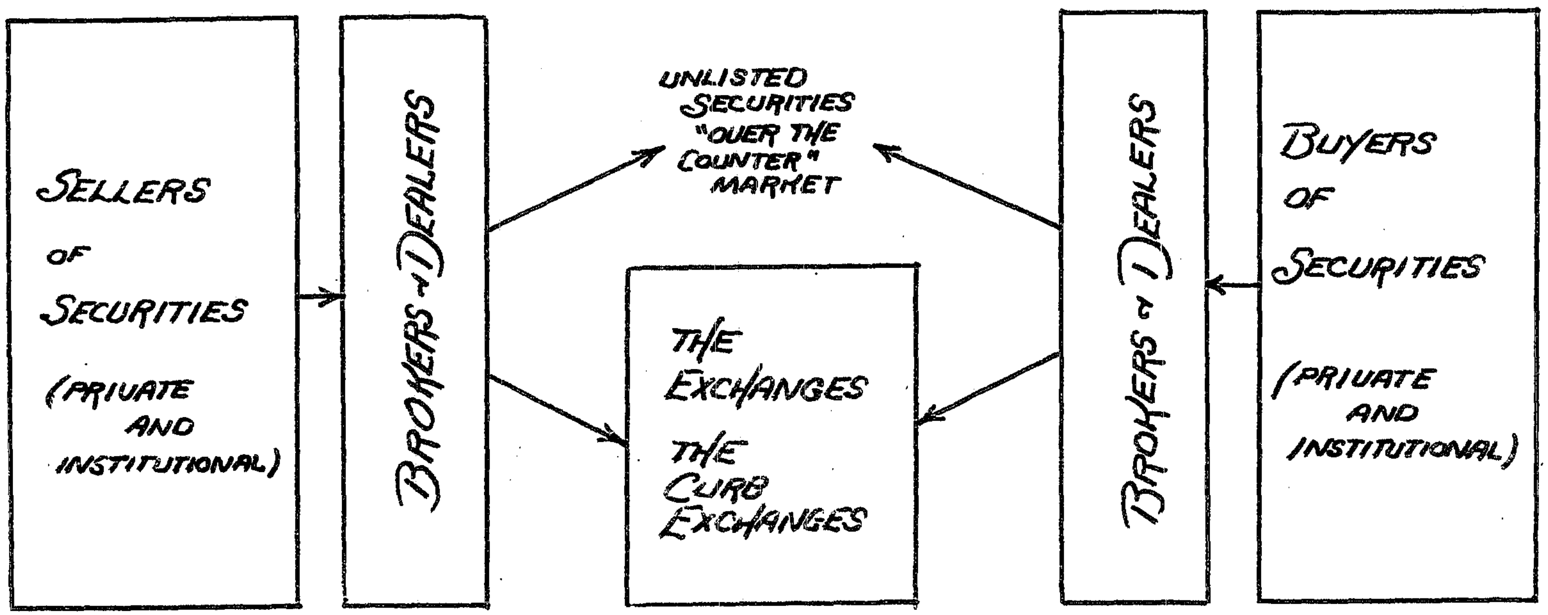


FIGURE TWO

THE MARKET FOR EXISTING SECURITIES



Chapter II

THE EVOLUTION OF THE CANADIAN SECURITIES MARKETS

Where the corporate form is not present, there can be no capital market (except in government securities), no place where buyers and sellers of shares in the ownership of, (or claims against), productive capital goods can meet to transact business. The primitive economy, relying upon the single proprietorship and the partnership as forms of enterprise can develop no capital market. True, ownership of industries may be transferred from one man to another and from one group to another, but each transaction is a separate entity; and sales of such industries or commercial enterprises (usually with one seller and a few buyers) are isolated and far removed from the concept of a perfect market.

It can be seen from this analysis that as long as Canada remained in the early pioneer stage and the opportunities for capital investment remained unknown, there was no need for the growth of an organized capital market within the country. What joint-stock companies there were, such as the Hudsons' Bay Company which had been founded in 1670, had raised the bulk of their funds in England and had there control centred in that country.

It has been suggested that trading in securities appeared in the Canadas after the turn of the nineteenth century. Probably the establishment of the Canadian Banks, which followed fairly rapidly after the first of them, the Bank of Montreal, appeared in 1817, did as much as anything towards establishing a class of stocks for trading. One of the earliest Canadian issues was that of the Bank of Montreal itself, and it was reported thus in the Montreal Gazette (quoting the Montreal Courant) for September 24, 1817.

> Montreal Bank
>
> We learn that the last undisposed shares in the Bank were taken up on Friday last, and that a hundred shares more would have been taken had they not been previously disposed of. The holders now consider the stock much above par.[1]

As it had in England, the earliest security trading in Montreal centred around a coffee shop, "The Exchange Coffee House" in St. Paul Street. As an example of the size of issue that was occasionally taken by the Montreal investors at the time, Bergithon[2] reported a flotation by the Champlain and St.Lawrence Railroad, with a capitalization of fifty thousand pounds in 1832.

By 1850, there were reports of security dealings appearing daily in the Montreal newspapers, but the trading was almost entirely in the banks' securities. In 1852, a

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[1] H.A. Innis and A.R.M. Lower, Select Documents in Canadian Economic History, (Toronto: The University of Toronto Press, 1933), Vol. II., p.372.

[2] Carl Bergithon, The Stock Exchange, (Montreal: The Gazette Printing Company, 1940), p. 11.

stock exchange appeared in Toronto, and in 1863 the Montreal Board of Brokers provided the nucleus for what became the first of the presently incorporated exchanges. This group met daily for half an hour (at noon) in various offices in the city, since it was not until 1866 that a room was rented for the purpose of exchanging shares. The members of this group drew up rules for admittance to membership, commission rates to be charged, and other regulations; all of which they enforced. Listing fees also appeared at this time.

By 1872, the Board of Brokers had taken to calling itself the Montreal Stock Exchange and in 1874 a Charter[1] from the Province of Quebec was obtained. Four years later, the Toronto Stock Exchange was chartered by the Ontario Legislature.

It was in these years in the third quarter of the nineteenth century that the corporation began to come into its own in Canada. Moreover, the expansion of cities and towns (as population became more concentrated) required capital for street-railroads, gasworks and similar projects. The expansion of industry which followed the depressed period in the last quarter-century thus found some of the machinery for the mobilization of capital ready for it.

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[1]A footnote to history was supplied by the Financial Post (February 5, 1949) p. 6. in an editorial on the occasion of the seventy-fifth anniversary of the founding of the Montreal Exchange as follows: "In the exchange archives it is recorded that the first listing fee was spent on champagne for the members."

A shocking example of early corruption!

Yet Canada was still a pioneer country, and much of the required capital was imported from abroad, at least that which was needed by the strongest borrowers such as the Dominion government. This condition had a stultifying effect on the domestic securities market, since in many cases the Canadian investment houses and brokerage firms acted merely as agents for British dealers. However, the Canadian Bond Market, and the underwriting function in the market, may be said to have appeared in the 1880's when the first important Bond Houses were organized: Hanson Brothers in Montreal (1883) and A.E. Ames and Company in Toronto (1889).

In spite of the adverse conditions, both the markets for issued and new securities expanded. In 1874, for example, some 63 issues were traded in Montreal (about 800 shares a day). Of these 63 securities, 21 were banks, 9 were governments and municipals, 2 were telegraph companies, 1 was a gas company, 10 were industrials, 3 were financial institutions and 7 were of a miscellaneous character.[1] Two factors contributed to this expansion, and to the shift toward industrial stocks. The first was the construction of the transatlantic cable which linked the world markets more closely, and the second was the building of the C.P.R., which served to channel funds into Canada by arousing interest abroad. In 1892, the turnover had grown to between four and five thousand shares per day, and the Montreal Exchange found larger quarters.

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[1]Bergithon, op. cit., p. 12.

"The Country of the Twentieth Century"

The end of the depression in 1896 and the turn of the century was the era of real development begin. The increase in population, acting through industrial expansion, led to a rapid growth in the securities markets. By 1901, Montreal was averaging 7000 shares a day, and the value of a seat on that exchange (a rough but usually reliable indicator of the activity there) had risen from $2500 in 1876 to something over $12,000.

The new century opened with a feeling of optimism. The last frontiers were being opened, and the wealth of the west and north seemed to be limitless. Conditions were favourable to optimism, since from 1897 to the end of 1902 there was a period of uninterrupted prosperity and market activity. (See table 1). It is interesting to note in passing that the attitude to booms and slumps has not changed greatly through the years; a now almost forgotten break in prices on November 14, 1902 was reported then as the slump "...which will probably go down on record in the stock market as 'Black Friday'."[1]

In 1903, although this stock market decline continued, the general prosperity of the country did not seem to be un-

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[1]Much of the source material for the historical analysis is drawn from the series called Canadian Annual Review, compiled each year from 1901-1938 by J.Castell Hopkins and his successors. It is a gold-mine of information on Canada which is not recorded compactly elsewhere. It seems to be fairly reliable, although its statistics must be treated with care. Hereafter, reference to the series will be as "CAR". This item is: CAR 1902, p. 314.

Table 1

STOCK EXCHANGE ACTIVITY (1901 - 1913)

Year	Montreal		Toronto	
	Stocks (1000 shs.)	Bonds ($1000)	Stocks (1000 shs.)	Bonds ($1000)
1901	2,834	1,889	1,911	468
1902	2,985	7,834	2,172	2,601
1903	1,394	3,048	1,084	1,051
1904	794	5,249	576	1,166
1905	1,076	5,690	766	1,347
1906	1,275	6,286	742	3,214
1907	700	3,956	436	2,937
1908	1,475	4,500	610	3,578
1909	3,340	5,791	1,443	3,660
1910	2,137	6,125	941	2,829
1911	2,256	5,969	915	1,998
1912	2,350	6,320	1,177	1,715
1913	2,040	5,148	936	1,002

Source: F.A. McGregor, Security Prices in Canada, 1900-1913, (Unpublished MA. Thesis, McMaster University, 1918.)

duly affected. One of the keenest observers of the Canadian economy at the time, B.E. Walker of the Canadian Bank of Commerce, spoke in this way:

> There were far more people speculating than at any time in the history of the country.... Canadians have been fools time and again in sending money into the corn and wheat markets of the United States. They had more money this last time and made a bigger spread, but I think they have been taught a lesson. There is altogether too much stock speculation in all Canadian cities.[1]

The market slump aroused, as market slumps do, the usual finger-shaking reprimands from the bankers and other financial men, and from the public at large. This one seems

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[1]CAR 1903, p. 495.

to have come in for more than its shares. On July 10, 1903, for example, the Baptist Association of Toronto passed a "resolution deprecating the speculative spirit of the times"[1] and Mr. Bourassa moved (and later withdrew) a resolution in the House of Commons for effective measures to control the exchanges and speculation. The Baptists seem to have been closer to a correct analysis than the eminent parliament: the spirit of the time was speculative, and this was reflected at first in the movement of the exchange.

But, apart from the exchange difficulties, the year 1903 was one of continued advance, a condition which persisted through 1906. It was in this upswing that several of the most important investment Houses (Wood, Gundy and Co., Royal Securities, and Dominion Securities) were organized, indicative to some degree of the new opportunities which appeared in the securities market.

The year 1906 was memorable chiefly for the expansion in the Ontario mining industry. Estimates of two or three hundred new companies being formed are given, with an authorized capital of some $250 millions. Yet, in spite of the prosperity, the stock markets were experiencing no new "bull" movement, with activity on the Montreal exchange running at about half the 1902 level.[2] An interesting commentary on the slack market is revealed in the words of Mr. Rodolphe Forget,

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[1] CAR 1903, p. 495.

[2] Table 1, above.

a prominent financier of the time (to the Montreal Star, in September, 1906). His comments on the propensity of Canadians to invest abroad are particularly interesting in view of what happened later, and in the light of what Walker had noticed before.

> The only stationary thing is the stock market. There has been practically no appreciation in our securities. Sir Wilfred Laurier tells us that Canada is the country of the twentieth century.... Yet many of our stocks are lower now than they were a few years ago. There is altogether too much attention paid to the Wall Street market to the neglect of our own. Let us be better Canadians than we have been, and if we buy and sell securities, let us buy and sell our own.[1]

Comments such as this (which were by no means isolated) would seem to indicate that the speculative interests did not find sufficient breadth in the Canadian markets of the period for their activities when the Wall Street organization was close at hand. Moreover, with much of the long-term investment capital pouring in from Britain, there does not seem to have been the incentive to maintain active markets in the Dominion, and so they remained of secondary importance.

The next year (1907) saw important developments in the financial history of Canada, as in the United States where Wall Street was shaken by the "Rich Man's Panic". The year opened on the customary note of optimism as to continuing prosperity, although cautious bankers such as Walker issued their usual warnings. The American economy, insofar as its speculative activity was concerned, had exhibited a variety

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[1] CAR 1906, p. 193.

of danger signals during 1906, visible clearly (to our keen hindsight) in insurance, financial and political scandals, and in an overloading of the credit institutions — especially the trust companies which were doing business as banks and carrying inadequate reserves.

During 1907 the New York Exchange experienced two severe panics (in March and August) before prices collapsed in October when the Knickerbocker Trust Company closed. In Canada, local conditions reacted violently to the depressing stimuli. Some of these unsettling factors in the Canadian economy were an influx of still unemployed settlers, collapse of one of the many western real estate booms and mining scandal in Ontario. Moreover the long expansion of business had finally led to tightening of credit. However, it should be noted that the difficulties in the financial community did not lead to any lengthy commercial depression.[1]

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[1] One of the most interesting things in the available annals of the period is the repeated expression of the opinion by bankers and businessmen that "over-spending" is the cause of crises.

An example of this is as follows, a statement by Mr. James Elliott, General Manager of Molson's Bank, on August 8, 1907: (CAR: 1907, p. 22.)

> "... the people of Canada are spending too much on cigars and pianos and not saving enough."

Other opinions involve such phrases as "over-prosperity" or "not enough money in the country". It should be noted, though, that these are the opinions of the businessmen. Professor James Mavor (the economist of the University of Toronto at the time) attributed the 1907 difficulties to mining speculation in Ontario, land speculation in the Northwest, and a deficient harvest. (Continued on the next page)

The New York panic led to crisis conditions on all the Canadian Exchanges, conditions where were at the same time a cause and a result of the monetary stringency. When the New York prices fell for the first time in March, local prices wavered, hesitated and then dropped severely. This collapse was followed by a period of inactivity, rather than by prolonged panic selling. Rodolphe Forget (at that time President of the Montreal Exchange) attributed this to the actions of the Canadian speculators who were caught in the New York crash and were forced to liquidate domestic holdings to cover their American commitments; further evidence of the secondary position in which the Canadian exchanges found themselves at the time.

At such times of security-exchange panic and monetary stringency, the question of the Canadian banks keeping their surplus reserves in New York call loans was raised. The popular view was that this money should be returned to Canadian industry and commerce. The policy of increasing reserves and gold holdings in crisis was also condemned as adding to the difficulties; but Sir A.G. Drummond (President of the Bank of Montreal) defended the banks' policy in this regard as follows: "... when a conflagration is raging next door it is proper to

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One wonders, in passing, whether the characteristics of more recent crises and cycles are quite different from those of this period, when capital shortage seems to be a likely explanation for the difficulty. This seems to be generally the idea of Eric Lundberg in his Studies in the Theory of Economic Expansion (London, 1937.) where he points out that it is reasonable to expect that a crisis can appear as a result of dislocations in the economy in either direction, i.e. toward oversaving or undersaving with respect to the investment activity.

act with caution and reserve."[1] Significant here is the fact that the monetary stringency was felt most severely in the financial world; perhaps the chief reason for this is that the securities markets were quite obviously the "poor relations" in the Canadian economic system of the period in spite of the expansion. The "important" long-term capital came from England; the "important" customers of the banks were not the markets for securities, or the dealers and brokers. Hence it was only natural that the markets would be the first to suffer in times of stringency. This had a rather curious result to be mentioned shortly.[2]

Another tendency worth noting in Canadian finance at this time is the fact that Canadian capitalists were investing (as distinct from mere security speculation) abroad heavily: in American street-railway companies, Mexican power securities and in such United States industrials as U.S. Steel. This seems to indicate a distrust of the investment opportunities in the country during a period of its most rapid growth. How much this was the result of the weak institutions of the market is difficult to say; yet this weakness itself stemmed from the fact that the market was really doing a job which could be done better elsewhere (except for the minor, unknown issues). Speculation, as we have seen, was more easily carried on in New York. Large quantities of funds were obtained

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[1] CAR 1907, p. 32.

[2] See below, p. 20, on "The International Bank".

in London, and much risk capital was coming into the country from the United States in the form of direct investments.

After this slump, Canadian municipal securities became difficult to sell in London, as the debt of the municipalities seemed to mount at an unhealthy rate, and the number and variety of the issues offered (in orthodox and unorthodox fashion) grew. Distrust on the part of the London market of Canadian issues, as a result of some unhappy experiences with American flotations contributed to the trouble. In 1909, the distrust developed into a sort of unofficial moratorium on the flotation of any new Canadian issues by the London dealers which lasted for several months. "It was a well-timed hint and rebuke."[1]

Comments such as this help us to appreciate the awe in which the British investor was held by Canadian writers, bankers and financiers. There had been a great influx of British funds, but the attitude of complete dependence is rather surprising to us. Canadian business annals give us a picture of the London Market as a stern, unforgiving father ready to chastize his colonial children for the slightest misdeed. Moreover, they did not seem to be able to conceive a prosperous world where Britain had been displaced. Consider the despairing tones of the following:

> If war should inflict great loss upon Great Britain, or, in other words, great destruction of capital, what would be the effect upon Canada? Where would

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[1] F.W. Field, Capital Investments in Canada, (Montreal: The Monetary Times, 1912), p. 127.

> our Government float their loans? Where would our railways sell their bonds? These questions are asked by The Nelson News, which also replies that the required funds might with some difficulty be secured from foreign countries, but it would be at increased rates of interest, which would be a tax upon the prosperity of the Dominion.[1]

It does not seem to have occurred to the writers of the period that Canada might develop sufficiently to take care of much of her own capital requirement. Conversely, further illustration of the restricted Canadian market is provided by the contemporary description of the aim of Rodolphe Forget in promoting the "International Bank" as a bank to specialize in servicing the needs of the financial community.

> Our chartered banks have always regarded Canada's industrial and commercial needs of primary consideration. For this reason, perhaps, stock exchange trading was suffered to some extent, the banks loaning money on call to brokers and withdrawing it at the first sign of pressure from commercial sphere. With the exception of times of panic and extreme depression, nearly all complaints regarding money stringency have emanated from brokers and their colleagues.[2]

By 1913, with the appearance of real war fears, a new monetary tightness checked the expansion. London flotations, which had risen at unprecedented rates in the intervening years of proeperity became difficult; issues of such municipalities as Winnipeg and Toronto were left largely with the underwriters, and the terms on which the London market was willing to lend to the Dominion and Provinces became increasingly adverse (3-3½% to 4-4½%). Municipalities found that

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[1] Field, op. cit., p. 186.

[2] Ibid. p. 116.

they had to pay 5 to 6%, or that they were unable to get funds on any terms. In spite of such tendencies, the total amount of money obtained from Britain reached a new high in that year.

Again, speculative difficulties in western land were partly responsible, as manipulators unloaded on British investors at exorbitant prices. The loss of confidence in Canada is evidenced by the fact that Canadian stocks were selling below the averages in London. While "loss of confidence" was a contributing factor, it is more likely that world demand for British funds was merely rising at a much greater rate than the available supply of capital in this last year before the fatal time in 1914 when the British financial fortress began to crumble away.

Interlude:
On Insurance

The life assurance companies were — and are — among the most important institutional investors. The first of the Canadian companies, the Canada Life, was established in 1847, and invested in bank stocks and mortgages. Other companies appeared in the period from 1870-1880 and there began a period of rapid expansion in the field during the last twenty years of the nineteenth century.

In 1906, Insurance, with a premium income of about $22 millions appeared in the public eye. An investigation in New York State had disclosed mismanagement and irregularity in investment, and the Toronto *World* for some obscure reason took it upon itself to lead a crusade against the Canada Life on behalf of "'injured and outraged'"[1] policy-holders. The upshot of the furore was the appointment of a Royal Commission on Insurance which recommended in 1907 that stricter investment policies be adopted.

The companies complained bitterly, charging that their power to invest in sound enterprises on the advice of their trained investment committees was greatly restricted by the prohibition placed on ordinary unsecured stocks. They maintained that the return on gilt-edge investments was insufficient for their purposes, and unnecessarily limited their activities. Since then, of course, much has been done to liberalize the investment policies, as we shall see when we assess the position of the companies to-day.

Table 2

LIFE INSURANCE IN FORCE IN CANADA ($1000)

Year	Canadian Cos.	British Cos.[a]	Foreign Cos.
1870	6,404	17,392	18,898
1885	74,591	25,930	49,441
1900	267,151	39,485	124,433
1915	829,973	58,087	423,557
1930	4,319,370	117,411	2,055,502
1939	4,469,776	145,374	2,161,112

Source: Canada Year Book 1938, (Ottawa; King's Printer, 1938), p. 958 for 1870, 1885, and 1900.
Canada Year Book 1941, (Ottawa;KIng's Printer, 1941), p. 857 for 1915, 1930, and 1939.

a) Rate of pound-dollar exchange not stated.

[1] CAR 1906, p. 216.

Table 3

INVESTMENTS OF FOREIGN COUNTRIES IN CANADA
1900 - 1913

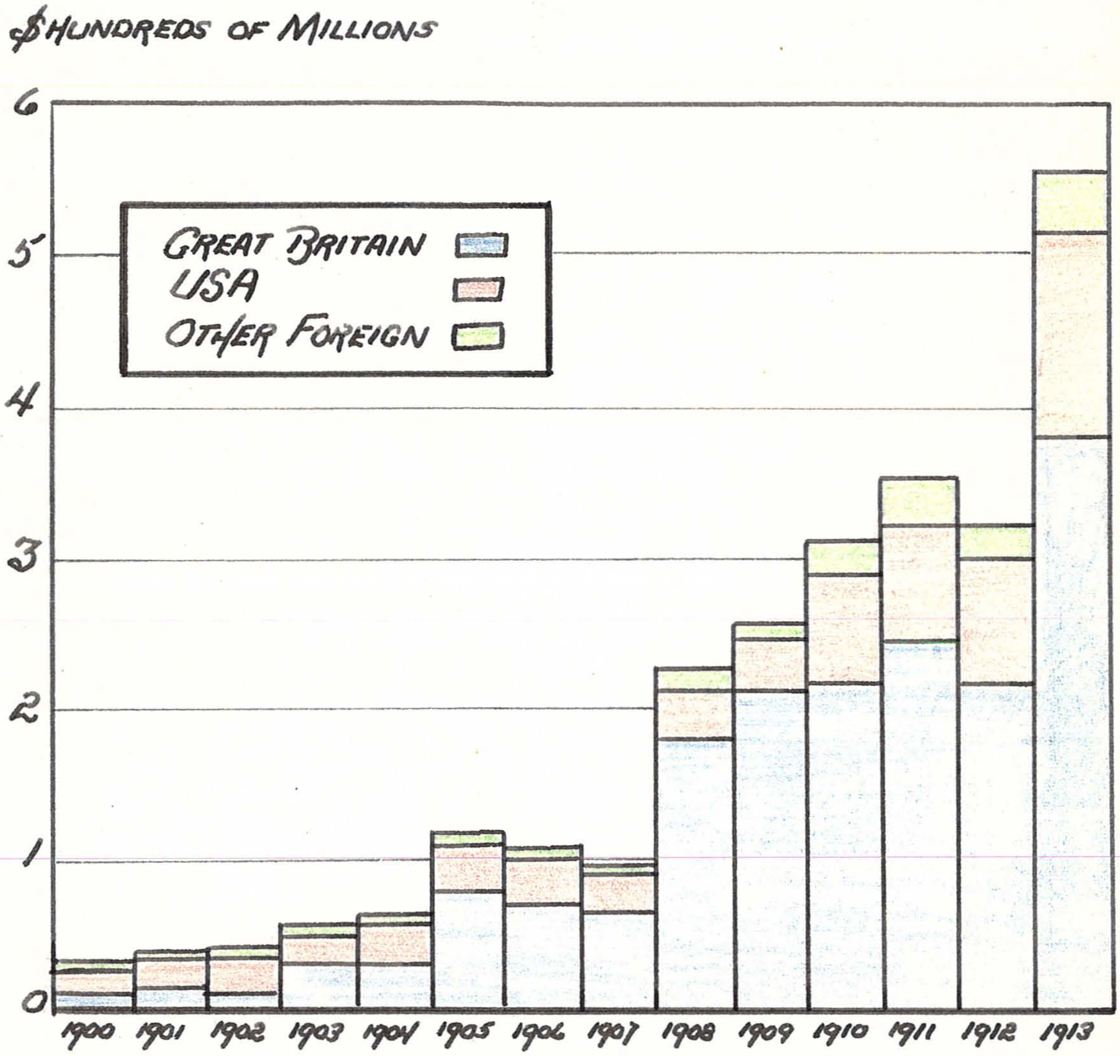
(in millions of Canadian dollars)

Year	British	American	Others	Total
1900	10	18	4	32
1901	15	18	4	37
1902	12	23	7	42
1903	29	22	4	55
1904	30	26	7	62
1905	76	32	4	113
1906	68	30	7	105
1907	65	26	4	95
1908	181	33	8	222
1909	213	36	5	253
1910	218	73	22	313
1911	244	76	28	348
1912	215	82	25	321
1913	376	135	36	547
Total	1753	630	163	2546

Source: After Viner, op. cit., p. 139 (Table XLIV)

FIGURE 3

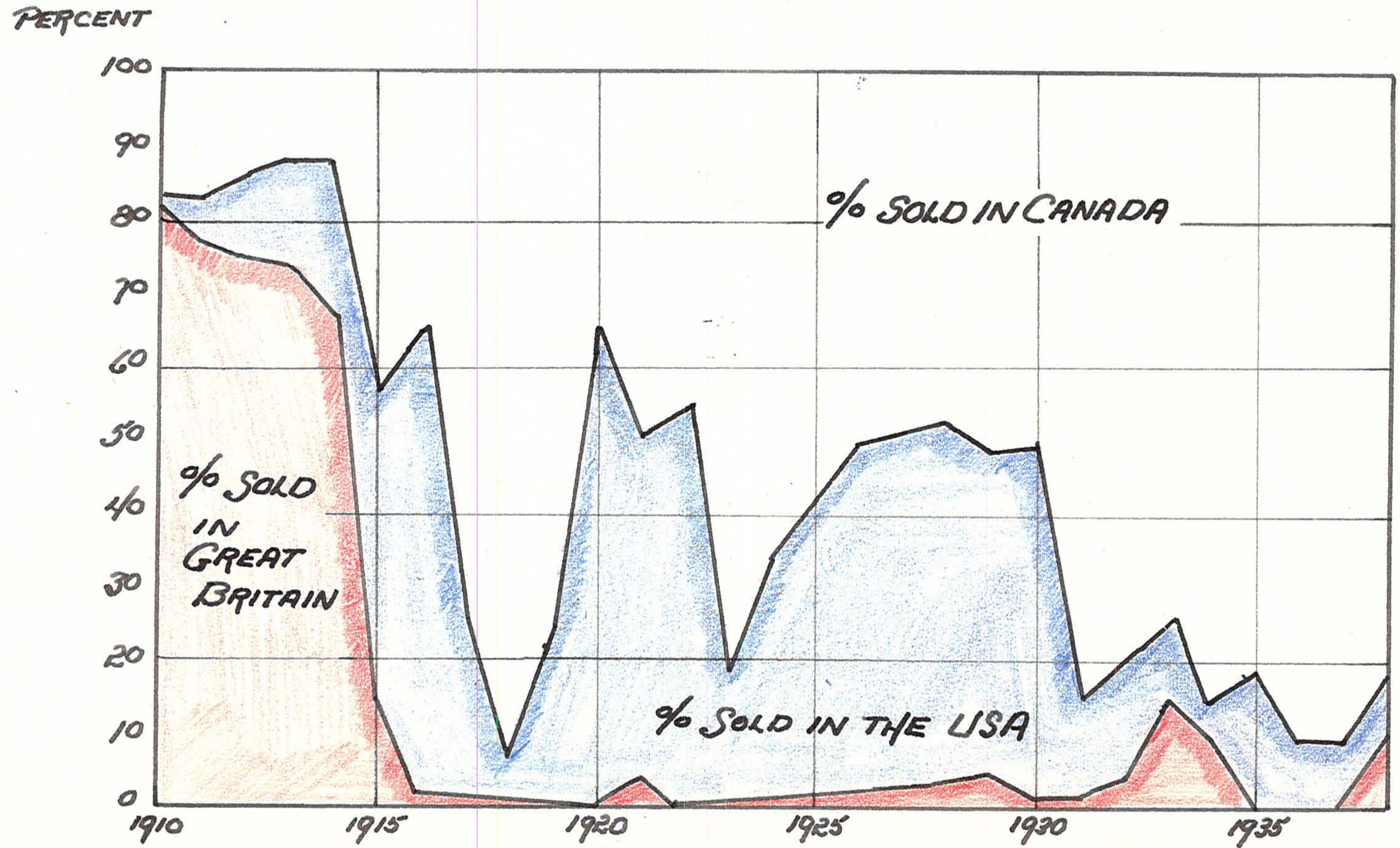
TOTAL FOREIGN INVESTMENT IN CANADA 1900-13



SOURCE: DATA OF TABLE 3
(AFTER VINER, OP CIT., P. 139)

FIGURE 4

PERCENTAGES OF CANADIAN BONDS SOLD IN CANADA, UNITED STATES AND GREAT BRITAIN, 1910 TO 1938 INCLUSIVE



SOURCE: CANADIAN ANNUAL REVIEW 1937-38, p 377-8.

Foreign Investment in the Pre-War Period

It is generally recognized that investment funds must pour in from abroad if rapid progress is to be made in a young country, and Canada's experience has been no exception; as in her political and social relationships, so in the record of international finance, where Great Britain and the United States played dominant roles.

As can be readily seen in Chart 4, the British investor dominated the market for Canadian securities during the latter years of the "wheat boom" from 1896 to 1913. Yet it should not be thought that the United States investments, although quantitatively much smaller, were unimportant. American investments were largely "direct", that is investment in ownership and management of Canadian enterprises, and the establishment of branch plants within the Dominion to take advantage of the Imperial preference tariffs. The British, conversely, were content to a much greater extent with "creditor" investments: government and municipal securities, corporation bonds, and some of the safer, investment-type stocks (banks, railways and public utilities). Stephen Leacock put this attitude concisely:"...the aim is not so much to make money as to keep from losing it."[1]

Table 3, gives Viner's final direct estimates of total foreign investment, and British and American investment

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[1]Stephen Leacock, Economic Prosperity in the British Empire, (Toronto; The Macmillan Company, 1930), p. 220.

for the period. No attempt has been made to revise Viner's estimates, although I have rounded them to the nearest million in the hope of avoiding the spurious appearance of accuracy,[1] which he has given them.

The tables and charts give some indication of the quantitative relationships involved, and the snowballing character of the boom. In this connection, it is well to note that this stage in Canada's development is that emphasized by W.A. Mackintosh in "Some Aspects of a Pioneer Economy", during which an export staple is developed (in our case, wheat). He pointed out that at some stage in the history of the new economy, the foreign aid will taper off, or perhaps cease unexpectedly. Then, only by means of these export staples can the pioneer economy reach the world market and "... pass from the pseudo-prosperity of the settlement boom to the genuine prosperity of a fully functioning economy."[2]

In the case of Canada, foreign aid was abruptly choked off by the war, but the transition was smoothed out by the influx of war orders which allowed continued prosperity and even new diversification.

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[1]These figures are not presented as being any more than hopeful guesses, but they serve the useful purpose of indicating the direction and form of the investment flow. To the reader who may be unfamiliar with the statistical hodge-podge from which Viner was forced to derive his estimates, the discussion in Chapters 5 and 6 of the Canadian Balance... will prove interesting and/or confusing. In spite of this, Viner insists in giving his totals the degree of accuracy of the most accurate (not the least accurate) figure in them, hardly accepted mathematical prodedure.

[2]Canadian Journal of Economics and Political Science, Volume II (1936), p. 460. (hereafter CJE.)

The War Period 1914 - 1919

The situation at the beginning of World War I was complicated by the fact that the stream of foreign funds which had sustained the long prosperity was slowing down.[1] The war, although it provided the means by which the transition might be made out of the pioneer stage, served at first to deepen the depression and increase unemployment, so that the winter of 1914-15 was not particularly pleasant for Canada.

Unlikely the short slump in 1939, which led almost immediately into a wartime bull market on the stock exchanges, the declaration of war in 1914 brought on a world-wide financial crisis, characterized everywhere by runs on the banks, the closing of the important securities exchanges, and the suspension of the payment in specie by governments. The Canadian banking system actually stood up well under the strain, although there was some uneasiness in view of the depressed conditions. Deposits in Canadian Banks fell by only $20 millions, an insignificant amount when compared to the total of over $1 billion in the banks at the time. Emergency powers given at this time to meet the threat of runs laid the basis for the expansion of credit as an inflationary source of funds for the financing of the war.

Both the Toronto and Montreal stock exchanges were closed immediately when war broke out, and did not

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[1]The importance of these funds is indicated by Deutsch's estimate (in "War Finance and the Canadian Economy, 1914-1920" CJE, Vol. VI (1940)) that nearly one quarter of the national income in 1913 was provided by these funds.

reopen fully during 1914, although restricted trading began on the Montreal exchange on September 1, at the July 28 price levels, with the permission of the Governing Committee required for each transaction.

By October 15, regulated trading on the Montreal exchange was expanded, but it was not until October 27 that restricted trading appeared in any form, in Toronto. By the end of the year adjustment to the new conditions was proceeding well, and restrictions had disappeared.

The Bond Market, too, was badly disrupted by the war. In 1913 and the early part of 1914, Canada had been receiving about $1 million a day from Great Britain in loans, and the work of the dealers in acting as agents for this productive source of capital disappeared with the war. The government itself, called upon to make continued payments on capital account, and toprosecute the war "...hardly gave the potentialities of the domestic market a thought and turned hopefully to the imperial authorities."[1] In November 1914, it was announced that $150 million of the British War Loan would go to the Dominions with $60 million designated as Canada's share, under an agreement to pay the cost of Canada's War effort; (an agreement which collapsed in 1915 because of the discount on the pound). The year 1915 saw the last flotation by the Government of Canada for the duration in the London market. In the fall of that year, Sir Thomas White, as Minister of Finance, decided to try an issue of $50 million in Canada, especially since the

[1]Deutsch, op. cit., p. 528.

British government itself was paying 5% by this time at home, and Canada could expect a rather unfavourable reception in London. The first War Loan was floated at 5% at 97½, maturing December 1, 1925, and it was purchased mainly by the financial community. The issue was greatly oversubscribed, and was increased to $100 million.

In 1916, as in 1915, Sir Thomas had recourse to the New York markets for funds, and it was found that Canada's credit continued to be excellent. She was able to secure funds at 5%, whereas Britain, France and Russia were paying 6-7%. This situation, in the absence of the tight exchange restrictions common to the Second War Period led to a considerable export of Canadian Capital to New York to take advantage of the higher rates on the Allies' Loans there.

The first and second Victory Loans of 1917 saw the growth of the widespread "rally" type of selling, and a sales organization which covered the whole Dominion. The familiar dodges of speeches and entertainment - in the interests of patriotism - were resorted to with much success. It was this activity which really established the Investment business in Canada. Before the war the dealers had operated as little more than agents in the larger issues.

The nucleus of an organization of bond dealers appeared as early as 1911, when a group of them organized as part of the Toronto Board of Trade. In June of 1916, however, the Bond Dealers' Association of Canada was brought into being to prevent repetition of governmental errors in distributing the issues, to sell the huge flotations, and to institute a system of self-government. As McEachern put it, they feared the "...gay recklessness with which some bond houses were handling some issues...." and "...the debts being contracted with such flamboyant optimism by many young Canadian municipalities during that enormous period of expansion and western development, 1905-10."[1]

Under A.E. Ames, the Second Victory Loan reached a total of $419.3 million, with 820,035 subscribers, as compared to $260.8 million in the First Victory Loan, raised from only 40,800 subscribers. The extent to which the government was relying on borrowing is indicated by the Order-in-Council of December 1917, which prohibited the issue of securities by the provinces, municipalities and corporations without the consent of the Minister. Subsequently, after protest, the ruling was modified to a mere "approval" of provincial issues, and federal assistance to the provinces. This reliance may be partly explained by the still dominant *laissez-faire* philosophy, the radical nature of extreme taxation, and the absence of the concept of "total war".

In 1917, restrictions again appeared on the stock exchanges, as minimum prices and prohibition of short selling were ordered, since the Victory Loans by siphoning off huge quantities of savings were creating a tightness of the money market. These restrictions did not disappear until June 1919.

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[1]R.A. McEachern, *Putting Your Dollars to Work*, (Toronto: Oxford University Press, 1948) p. 20.

The third Victory Loan (1918) saw about $700 million raised from approximately one million subscribers, in an absolutely unprecedented feat of financing for Canada.[1] Much of the credit for the success of the War financing programme can go to Sir Thomas White, whose work as Finance Minister was almost inspired.[2] Economically, the success is summarized by Deutsch as follows:

> The remarkable rise in the value of exports, the decline in private investment, the general increase in money incomes, the increase in voluntary savings inspired by patriotic motives, all played a part but the role played by the inflation and the consequent expansion of profits was perhaps the most important as is indicated by the fact that over three-fourths of the total war loans were subscribed for by business organizations, financial institutions, and persons with large incomes.[3]

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[1] In The Annals (The American Academy of Political and Social Science), Vol. CVII (May, 1923), Sir Thomas White denied that a $500 million loan could have been floated in pre-war Canada. He wrote:

> The money for the Victory Loans was made as the conflict went along....The money raised by the loans financed further production and sales. (p.213)

Deutsch ascribes the success to the inflationary growth of profits, the traditional source of investment funds, through the "making" of money in the banking system.

[2] CAR-1918 reported that the Toronto World wrote of Sir Thomas in this manner, comparing him to Alexander Hamilton in the words of Webster:

> He smote the rock of the national resources and abundant streams of revenue gushed forth. He touched the dead corpse of public credit and it sprang to its feet. (p. 487)

Rather extravagant praise for any statesman, even Alexander Hamilton.

[3] Deutsch, op. cit., p. 532-3.

Table 4

CANADIAN BOND SALES 1904-1936

The Monetary Times

(in thousands of Canadian dollars)

Year	Dominion	Provincial	Municipal	Railways	Corporation	Total
1936	793,000	118,735	34,356	133,000	202,983	1,282,074
1935	739,300	123,407	44,793	48,400	60,606	1,016,506
1934	400,000	139,868	24,690	32,500	40,903	637,961
1933	440,000	82,889	41,283	1,000	4,385	569,557
1932	226,250	128,217	95,601	12,500	10,550	473,118
1931	858,109	126,239	85,290	121,750	59,432	1,250,821
1930	140,000	160,004	109,648	137,238	220,355	767,245
1929	-	119,961	98,668	199,200	243,331	661,159
1928	-	92,993	27,121	48,396	285,083	453,592
1927	45,000	114,795	72,742	80,000	289,680	602,218
1926	105,000	76,633	65,020	34,500	250,919	532,073
1925	169,333	106,970	46,219	40,925	120,086	483,533
1924	175,000	89,640	88,732	157,375	69,179	579,926
1923	200,000	106,279	83,686	27,500	97,352	514,818
1922	200,000	114,918	87,089	13,505	76,886	492,397
1921	-	160,745	84,777	96,733	61,336	403,591
1920	-	125,993	56,371	96,500	46,050	324,915
1919	763,000	52,374	26,274	35,359	42,930	909,937
1918	689,016	18,605	43,570	19,600	4,565	775,356
1917	650,000	15,300	24,189	17,700	18,850	726,039
1916	175,000	33,173	93,977	22,240	32,240	356,883
1915	170,000	48,105	67,393	33,675	15,933	335,106
1914	48,667	56,100	79,134	59,719	29,315	272,935
1913	34,067	36,850	110,601	65,896	126,382	373,795
1912	25,000	25,640	47,159	45,015	130,124	272,938
1911	-	11,375	30,296	85,611	139,531	266,813
1910	45,000	10,000	49,043	41,090	85,867	231,001
1909	62,500	9,187	31,533	100,803	61,135	265,158
1908	47,665	550	44,815	-	103,327	196,357
1907	-	9,274	14,431	-	58,931	82,636
1906	-	10,000	8,332	-	35,655	53,987
1905	-	346	9,013	-	125,515	134,875
1904	-	11,146	14,684	-	9,344	35,174

Source: CAR 35-36 p. 523.

The Lotus Years 1920-1929

The hectic era from 1920-1929 began dismally enough with a period of foreign exchange difficulties, severe deflation, and the short but bitter depression which followed the First World War.

The neat triangular adjustment which had characterized Canada's pre-war trading relationship with Great Britain and the USA had gone. The pound and the Canadian dollar, now free from the restraints of gold and the artificial restraints of the war years, went to substantial discounts in New York, with some interesting effects on the Canadian securities markets.

Let us review the mechanism of such a situation briefly. If the pound sterling fell from $5.00 to $4.00, the British investor selling $100,000 worth of Canadian securities in Canada could realize £25,000 if the Canadian bond price were par. Moreover, he might be willing to sell as low as £20,000 ($80,000) which was probably the price in pounds which had prevailed at the time of the purchase. The effect of these transactions was to lower the price of Canadian securities in Canadian markets substantially, with severe repercussions on the market for Victory Bonds, which the government was attempting to sustain, and the market for new issues of all sorts. Why should a Canadian investor pay par for new Government bonds when he could obtain similar bonds from the British at "bargain-basement" prices?

This situation was complicated by the fact that such liquidation tended to prevent the Canadian-Sterling exchange rate from falling as low as the American-Sterling rate and by the fact that the Canadian dollar was at a proportionately smaller discount in New York than the pound. Hence the wily British could liquidate holdings of Canadian securities and get more American dollars in New York by a triangular process than by direct dealings.

In a similar way it can be shown that the London market was effectively closed to the Canadian governments. For example, if the Canadian Government issued $100,000 in bonds in England the British would be required to put up £25,000 as compared to the £20,000 in the pre-war market. Or, conversely, the Canadian government would have to contract to pay £25,000 at maturity to get $100,000 rather than £20,000 if the face amount of the loan were in sterling. If there was a suspicion that the pound would return to par - and this was the general expectation - the issue of such bonds would have been very foolish.

On the other hand, the discount with respect to the American dollar had the effect of making Canadian securities appear as bargains to the American, and this may account in part for the American interest in Canada at the time.

In February, 1920, the Government announced the desire to check the European "dumping" of Canadian securities, since this action was playing hob with the working capital of the Dominion. After conferring with the bond dealers and the other financial interests, Sir Henry Drayton imposed an "embargo" on such transactions in the form of a request to the dealers to stop these movements in the hope of checking the strain on the economy, and especially to provide some support for the price of Victory Bonds. Such restrictive measures were not without their critics. The old fear of a loss of British confidence was resurrected. The Royal Securities Corporation wrote in the Financial Times (March 13, 1920) as follows:

> The feeling of the British investor.... was that Canada had no right to keep the pound sterling at a discount and at the same time refuse to accept the consequences of that discount - that Canadians had no right to demand that British Purchasers pay a pound sterling for four dollar's worth of wheat, and to refuse to pay four dollars for a pound sterling of British-owned Canadian securities.[1]

But, in spite of such opposition, the restrictive policies were carried out and extended, until the general situation was ameliorated; but the damage had been done, and despite the improvement in the exchange rates and the return of some British investment as exports revived, the mother-country never regained her dominant position, although many pious hopes were expressed:

> Great Britain, however, had again commenced investment in Canada....With Exchange again normal, this process would greatly expand.[2]

Canada had crossed one barrier on the way to economic maturity by cutting away from the mother-country, but the need for capital was by no means diminished. Direct

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[1] CAR 1920, p. 17.

[2] CAR 1921, p. 25.

investment from the USA assumed increasing importance. "Arterial highways, municipal improvements, commodious dwellings for our working and leisure hours, railways, stock speculation in New York, and industry - notably power and paper - bloomed under the beneficent rays of borrowed capital."[1] The extent of the shift is indicated in the table below.

Table 5 BRITISH AND FOREIGN INVESTMENTS IN CANADA ($ millions)

	1914[a]		1919[a]		1929[a]		1934[b]	
British	2,712	71%	2,607	57%	2,128	36%	2,734	40%
United States	904	24%	1,800	39%	3,609	61%	3,983	59%
Other	178	5%	174	4%	155	3%	96	1%
Totals	3,794		4,581		5,892		6,813	

Sources: After Royal Institute of International Affairs, "The Problem of International Investment", (London; Oxford, 1937) p. 256.
a Report of the Royal Commission on Banking and Currency in Canada (Ottawa, King's Printer) 1933. p.53.
b Canada Year Book, 1936 (Ottawa, King's Printer) p.891.

While the relative fall in the British investments has been remarkable, the absolute level remained almost constant from the beginning to the end of the period. Canada has been indeed fortunate to tap successively two such productive sources of funds for her expansion.

The economic situation during this period was characterized by the increasing importance of the corporation as

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[1] Innis & Plumptree ed., THE CANADIAN ECONOMY AND ITS PROBLEMS (Toronto, Canadian Institute of International Affairs, 1934) p. 225.

many Canadian firms were transferred from "private" to "public" (not in the sense of government) ownership, and by a trend to consolidation in the later years, with a resultant increase in new issues and a much improved turnover of business on the securities market as a whole.

Although the exchange rate in New York rose from 85.7¢ at the end of 1920 to 95.1¢ on December 31, 1921, deflation, especially in farm prices, continued. However, "...in Canada money became easier at the close of the year and Canadian bonds found a ready market at home and in the United States with an upward tendency in price."[1]

During 1922, the general situation was much improved, as an export surplus in commodities served to balance the current account. As the price of wheat recovered, so did the Canadian economy, and the period of transition thus merged into the prosperity of 1926-1929. In 1923, the financial markets were shaken by the first bank failure since 1911, when the Farmer's Bank had collapsed. The Home Bank's failure led to a disquieting series of runs, readjustments and mergers, with several small banks being absorbed. The Stock markets, sensitive to such activities, were relatively quiet during the year and few stocks showed real gains, although elsewhere the economic recovery continued.

Ripples from the Home Bank scandal continued to spread through 1924, leading finally to the appointment of an Inspector-General of Banks.

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[1] CAR 1921, p. 19.

The Bond Market was remarkably active in 1924 approaching a total of $600 million in sales (exceeded only in the war years of 1917-1919). It is interesting to note, in this connection, that 1924 saw the issue of $42 million in Canadian Pacific Railway bonds, the <u>first</u> occasion of a public offer by the CPR in this country.

"One of the most significant industrial and financial phases of the year 1925 was the pronounced movement towards mergers."[1] Such a tendency is characteristic of the upswing of the cycle, and is reflected in the activity on the capital markets. The year 1925, with 20 consolidations involving 68 concerns was the highest year for such activity since 1910 when there were 22 consolidations of 112 firms. Neither of these years approached the 68 consolidations (195 firms) and 62 consolidations (149 firms) in 1928 and 1929.[2] The <u>Report of the Royal Commission on Price Spreads</u> is inclined to the view that many of these consolidations were designed to give profit to the promoters and investment dealers involved, and were of little value economically. In view of the detailed statistics and cases presented there, such a claim seems quite reasonable.

Co-incident with this activity was increased trading and a general upward movement on the Stock Exchanges, following the bullish activity in New York.

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[1] CAR 1925-26, p. 307-8.

[2] <u>Report of the Royal Commission on Price Spreads</u>, (Ottawa: King's Printer, 1935), p. 28.

Trading on the Toronto Stock Exchange increased from 670,000 shares in 1920 to 2 million shares in 1925. About the same time, bond prices stiffened noticeably, and interest rates accordingly fell. The optimism of the period was evident in the statement of J.H.Gundy in The Mail and Empire (January 2, 1927.)

> Financial conditions in Canada at the close of 1926 are more satisfactory than have prevailed at any time since the war. Money has continued plentiful and cheap, and first-class borrowers have had no difficulty throughout the year in having their requirements fully satisfied at favourable rates.[1]

Finance - especially the bond market - was dominated by the corporations to an unprecedented extent in the later years of the decade. In 1927, corporation issues of bonds stood at about $300 millions, twice the 1925 level. It was the first year, according to the Canadian Annual Review, that corporations accounted for more than half the total new issue.[2] This was partly the result of the consolidations, which leaned towards debt-financing, and partly the American influence looking for business investment rather than government bonds. An additional factor was the low interest rate which stimulated refinancing operations. In this year, for example, Shawinigan refunded its bonds at 4½%, a previously unheard of rate for a high-grade Public Utility.

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[1] CAR 1926-27, p. 521.

[2] Note the discrepancy between this and the table given above on bond issues (#4) which while not too serious is indicative of the caution with which the statistics we can find must be treated.

However, activity in buying and selling bonds through the organized exchanges was falling off. This appears to have been caused by the increasingly intensive use of the Securities Salesmen by the Investment Dealers, a trick learned from the results obtained in the war years, and from the American firms' techniques.

The other institutions of the securities market grew rapidly during this period. The Montreal Stock Exchange reached an authorized membership of 85 in 1920, and while this number was reduced to 80 in 1927, the price of seats there, an indicator of the activity, rose from $36,000 in 1920 to a high of $225,000 in 1929. In 1926, the Montreal Curb Market was organized as an adjunct to the Montreal Exchange to take care of the unlisted trade. This exchange was first located in the Canadian Pacific Telegraph building, but grew very rapidly, and was housed in 1929 in an addition to the Montreal Stock Exchange Building, some of whose administrative officers it shares. It has 100 members, the majority of whom are connected with the parent exchange. The bulk of Montreal mining trading is done on this exchange, and its rapid growth is indicative to some extent of the speculative fever. The Standard Stock and Mining Exchange in Toronto, which was also dealing in speculative securities, moved to larger quarters twice in two years (1927 and 1929), and at the top of the boom one seat there sold at $100,000.

The records show that activity on the Montreal exchange rose from 6,751,570 shares in 1926 to 18,990,039 in 1928, and to 23,203,416 shares in 1929. When activity was greatest (1929), the Toronto exchange traded 10,143,736 shares. This yearly volume was almost 15 times that of 1920, the beginning of the period.

In spite of the optimism and the general attitude toward the exchanges, the question of sharp practices was not entirely neglected. Gerald Hanson, President of the Investment Bankers (as the Bond Dealers were then called) emphasized the need for some control, but realized the difficulties which are involved in the securities markets by unnecessary delays. It is imperative to make an issue of bonds or shares when the market is favourable, and it may be unwise to postpone such an issue until the unwieldy machinery of control can approve it. However, the Montreal Exchange, the Montreal Curb Market, the Investment Bankers and some New York firms sponsored a "Financial Better Business Bureau", whose operations - and existence - served to discourage many shady promotion deals. These bureaux expanded into other cities with good effect as time went on.

Much of the increase in share-trading was apparent in the no-par common shares which had become the "fashionable" security, since it was considerably easier to conceal the "water" in such shares than in those with par value. Of importance also was the practise of issuing rights to purchase new issues to existing shareholders, and trading in such rights contributed to the activity on the exchanges.

On the other hand, bond sales came almost to a standstill as the interest in speculation grew at the end of 1928. The speculative activity was cumulative, since it continued to increase rapidly although the margin requirements at the end of 1928 were tightened to 35% as compared to 20% a year earlier and 10% in the previous years.

"And the heavens were opened..." 1929

The year 1929 opened with general optimism befitting the boom, but with undertones of doubt as to the healthiness of the volume of speculation. The bull market which characterized this optimism continued until the latter part of October when the exchanges were shaken by an extreme panic. Friday, October 25, 1929 the Globe reported the turmoil of the day before, i.e. "Black Thursday" in the banner headline: "Speculators shaken in Wild Day of Panic". On the New York Exchange, 13 million shares representing almost 1000 issues changed hands, and many thousands of accounts were wiped out. The Canadian Press reported that the forced selling, as a result of New York losses, led to a near panic in Montreal with sales of 382,521 shares at losses ranging from 1-25 points.

But the end was not yet in sight; on Monday, October 29, a new wave of panic hit New York with a resultant turnover of 16,410,000 shares and a combined activity on the Montreal exchanges of some 730,000 shares. By the end of the day, as an indication of the overloading of the facilities of the exchanges, the New York ticker was 89 minutes late, and the tape record from the New York Curb Market was 133 minutes behind the transactions on the floor of the exchange.

However, from the twenty-ninth of October until November thirteenth, there was a substantial rally. After the latter date came an almost complete collapse, with no further signs of rally, and with general uneasiness and fear.

In order to maintain the solvency of many Canadian brokers, some members of the exchanges consulted with the heads of the banks and it was agreed that the banks would reduce the amount demanded as collateral to 15% on stocks of a value of $30 and to $10 a share on stocks of a value below that amount, as compared to 25% immediately after the crash, and 40% in the previous months. After this action had been taken, some measure of confidence appeared, and the panic had run its destructive course.

Several factors are of importance in any consideration of the panic and its aftermath. One of these is reported as follows in the Canadian Annual Review:

> A rather unusual feature of the 1929 crash in both countries USA and Canada ...was that the vast majority of what were known as the "big" investors and speculators were caught in the sudden downward plunge of the market, before - as is usual after a bull market - they had had time to distribute their holdings, realize their profits, and get out of the market temporarily.[1]

A second characteristic, peculiar to this crisis, was the fact that the market prices of stocks continued to rise for months after business activity had passed its peak. This seems to be evidence of the fact that the exchanges and the

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[1]CAR 1929-30, p. 210.

whole mechanism of the securities market had been divorced from their proper functions of providing the funds for capital formation, and preserving the individual liquidity of capital, to one providing media for gambling for its own sake. There could be no conception of investment in an exchange which "...as one expert observed, was discounting not only the future but the hereafter."[1]

Still another tendency characteristic of this crisis is reported in I.W.C. Solloway's "apologia pro vita sua" entitled Speculators and Politicians (of which more later). This is an interesting document written to justify his own position by one of the principals in the biggest scandal of the Canadian market of the period. In view of this, it must be treated with caution, but some of his observations may be considered as indicative of the trends. He wrote as follows of the relative amounts of margin buying in Canadian and American securities markets.

> I was in our Montreal office one evening during the stock market collapse in November, 1929, when a clerk from one of the Montreal Stock Exchange brokers doing a large business in New York stocks came into the office. He told us their margin clerks had been working until 12 o'clock every night for a week and their customers had lost millions. He said the margin calls they sent out called for anywhere from a few thousand dollars to $25,000, $50,000 and $100,000. I asked the clerk in charge of our margin department to give me an idea of the total of all our margin calls in Montreal office [sic] would amount to that day.

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[1] H. U. Faulkner, American Economic History (New York: Harper & Brothers, 1942), p. 643.

> He advised me that they would aggregate approximately \$20,000. I checked up the margin calls going out and found that the amounts were mostly \$25 and \$50, the largest amount being \$500. (1)

In view of the corroborative evidence such as the Canadian Press dispatches mentioned above, it would seem that the Canadian exchanges, for all their expansion, were still suffering greatly by the tendency for speculative funds to flow to the more active (and volatile) New York market, so that a fall there set off panics at home not through lack of confidence as much as by the forced selling necessary to cover the American losses.

Moving from characteristics of the crisis to causes, a question which will probably never be settled satisfactorily, we can profit from the factors enumerated by W. T. Jackman in the Financial Post:[2]

a) Movement in favour of stocks as investments.

b) Retirement of bonded debt through stock issues.

c) The withdrawal of funds from investments for speculation in stocks.

d) Disregard of returns for appreciation.

e) Borrowing money at 8-10% to invest in stocks yielding 2 to 3% only.

f) Expansion of inexperienced investment companies and brokerage firms.

g) Increase in marginal trading.

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[1] I.W.C. Solloway, Speculators and Politicians, (The Political and Economic Publishing Co., 1933), p. 57-8.

[2] CAR 1929-30, p. 214.

Of these, the last five are probably indicative of a basically unhealthy situation, although a fair assessment of their exact causal significance is considerably more difficult. It is unwise to attribute the crisis to a movement in favour of stocks as investments, except insofar as such a tendency allowed more speculation. Probably items d, e, and g are most important toward explaining what happened. Mr. Jackman also predicted that there would be no serious reaction on industry, but such long-dead prophecies are better forgotten.

Slump and Scandal: 1930 The first half of 1930 saw the confidence in the securities markets still further shaken by the arrest in Toronto of the principals of five of the largest mining brokerage firms in Canada on charges of "conspiracy to defraud". The Financial Post in a series of articles on manipulation in mining shares published in November 1929 opened an attack on many of the current practices, especially short-selling which it characterized as "a cynical exploitation of public confidence and a brutal plundering of the hard-won earnings of the people." [1]This short-selling was not the short-sale transaction by an independent operator who is of the opinion that the market is due for a fall, but rather an offset on the part of the broker.

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[1]CAR 1929-30, p. 218.

Solloway, whose firm of Solloway, Mills and Company was the centre of the trials, defends and explains the practice as follows:

> The danger which can appear almost overnight (when there is margin buying) is - where is the broker going to sell large quantities of securities during time of panic....Ninety per cent. of his customers have no further monies with which to margin their accounts...with the result that... every broker carrying large quantities of securities for his customers would go into liquidation during...times of panic.
>
> So...the main reason for the firm's short position was to insure its solvency and place the firm in a position to be purchasers of speculative securities when there would be no other market or purchasers for them:...[1]

The theory of this is fine, but it is obvious that it is open to many abuses in the form of bucketing, manipulation and fraud. "Bucketing" was one of the charges laid against the firms involved through this short-selling. All the firms so challenged were connected with the Standard Stock and Mining Exchange (which itself was investigated). Several convictions were obtained on a variety of charges and a number of the companies suspended and were liquidated.

In February, 1930, as a result of the uproar, representatives of a number of the provincial governments met in Toronto to discuss ways and means of controlling brokerage activities. Solloway (and others) cried of a witch-hunt, but he had reason to be biased. However, it does seem that the market was to some extent made the scape-goat of the governments in placing the blame for the depression.

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[1] Solloway, op. cit., p. 153-4.

On the other hand, certain valuable suggestions grew out of this conference. The stock exchanges, which were consulted, drew up recommendations which stressed especially the need for uniform standards of security legislation and regulation. At the conference, the maximum penalty recommended for bucketing (which in its common form is a mere gambling on the rise or fall of prices with no purchase or sale being made, although the customer may have received a confirmation slip) was set at seven years, and it was stipulated that securities bought for margin accounts must be taken and held. The confirmation records must give the name of the other party to the transaction and the time of the sale. More stringent listing regulations were regarded as necessary. The exchanges were told that members should be restrained from trading against their clients (as in the Solloway case), and that members should not be a member of a limited liability company, in order to maintain some confidence that all the assets of the brokers backed their firms. How effective this recommendation is, is a moot point; but the idea has some merit.

With the end of this conference, it can be said that a distinct period in the history of the Canadian markets had come to an end; the rest of the decade was a period of readjustment and renewal both in the stock exchanges, and in the market as a whole; an approach to maturity after a brawling adolescence.

The Great Depression and After: 1931-1939

"The nineteen-thirties provided one of the most significant periods in stock-exchange history. It may certainly be called the period of reform, and perhaps the period of renascence."[1] For purposes of analysis, this period has been conveniently divided into four major "events", the first of which we have already discussed as the completion of the previous era.

(1) The collapse of security prices: 1929-30.

(2) The collapse of the British Gold Standard: 1931.

(3) Depression: 1932-3.

(4) Political Crisis and War: 1934-9.

The loss of interest in the exchange of securities, and the market for new securities after 1929 has been variously attributed to the feeling which blamed the markets for the depression a loss of interest in speculation, and a paucity of new issues as a result of industrial retrenchment. Moreover, in addition to the financial crisis of 1929 and the industrial depression which followed, the market was badly hit by the world banking crisis which began with the failure of the Creditanstaldt in Vienna and led eventually to the abandonment of the Gold Standard by Great Britain. This time, however, the market expected trouble and had some time to prepare its defenses.

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[1]Bergithon, op. cit., p. 54.

When the announcement was made, the governing committees of both the Montreal Stock Exchange and the Toronto Stock Exchange, and the major banking interests met on Sunday, Sept. 20, 1931 and decided to keep these institutions open, but ruled that no transactions would be permitted at prices below that at which the security closed in the week previous. A system of minimum prices thus appeared, recalling the regulations of the first war, remaining on some issues until the middle of 1932. Short-selling was forbidden.[1]

On September 21, (the Monday), the Canadian dollar, which had been at par for years fell to a 6½% discount. Tuesday, the Canadian dollar was selling as low as 89¢ in terms of American currency. Before December the dollar was at a discount of more than 20%. As a result of this sudden change in the international position of Canadian currency, there occurred a series of failures among Montreal brokers. On October 5 and 6, McDougall and Cowans (the largest firm in Canada) and Greenshields and Company made assignments, and were suspended from the exchange.

The cause suggested was the calling of loans by United States institutions from which money had been obtained before the monetary crisis. There was considerable selling of Canadian securities as a result of the uncertain international situation, and these failures caused a further price slump. The

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[1]Short-selling was prohibited on the NYSE also. The London exchange closed for three days, as did the other continental exchanges, except the Paris Bourse.

shock was severe, but its effect was mitigated when the Banks announced that they had been only moderately involved through the brokers' collateral loans. The basic, underlying cause of the failure was, of course, the continued deflation of stock prices, serving to undermine the brokers' businesses. There were other failures later, but they were of lesser importance and effect.

The year 1933 was one of general stagnation in industry, but it was characterized by flurries of activity on the exchanges, and in the bond market. Proposals were advanced during the year for the establishment of a Bond Exchange, but opinion among the dealers was so divided that nothing came of the idea. Noteworthy at this time also was a temporary increase in flotations in Great Britain, with the first issue of Dominion Bonds in London in 18 years. These bonds were sold at par to yield 4%.

At the end of 1933, the Standard Stock and Mining Exchange, which had never properly recovered from the mining scandals and the continued deflation was amalgamated with the Toronto Stock Exchange. The new exchange, which took the name of the Toronto Stock Exchange, was divided into industrial and mining sections; and was to have a combined membership of 113. The statements issued at the time indicated that the "...main purpose of the consolidation was to bring together two already extensive organizations in order that operations might be co-ordinated and the single trading body become relatively more important amongst the world's stock exchange organizations."[1]

In 1934, a renewal of market activity was apparent, and a variety of events indicated attempts to improve the market and its institutions. Most spectacular occurence in the financial world, and probably least significant, was the dismissal of George Drew as Securities commissioner in Ontario, after a squabble with the attorney-general, Mr. Roebuck. Of much more importance, to both the market and the economy as a whole, was the establishment of the Bank of Canada to provide an efficient central bank, and to carry out the policy of cheap money, which had become a popular way of fighting the depression, in theory at least.

In 1934, it may be noted also that the Investment Bankers' Association changed its name to the Investment Dealers Association, in accordance with the provisions of the revised Bank Act restricting the use of the term "Banker".

The year also saw the last major revision of the Dominion Companies' Act (under the Hon. C. H. Canan, the Secretary of State). Although valuable new provisions were included with respect to the auditing of the companies' books, and the publication of reports and prospectuses, the revision was generally half-hearted. While the legislators seem to have realized the importance of control of the corporations in the public interest, other considerations such as the fear of a loss of revenue if the Act were made too strong dominated

[1]CAR 1934, p. 387.

their actions. "There was little contentious debate...and rapid progress was made with the bulky document."[1] That the Act, in its revised form, left much to be desired, was apparent in the sweeping modifications which were recommended in 1935 by the Price Spreads Commission (see below).

The Liberal Victory in the general election of 1935 saw a general rise in the price levels on the stock exchange. Mining stocks were particularly active under the influence of the increase in the price of gold to $35.00 an ounce. Use of borrowed money for security trading had declined noticeably, and most of the buying during the bull market was for cash. Of considerable interest to a study such as this is the change in tone adopted by the writers with respect to the work of the Capital Market. It was no longer regarded as the esoteric (and almost sacred) business of the financiers, and therefore of little importance to the general public. Much of the material referring to it speaks in the direction of control. Consider, for example, the following report of a radio address by Mr. R. B. Bennett, January 9, 1935 (The Globe):

> He denounced the evils of "stock-watering" as constituting a definite impairment of the economic system. "Notwithstanding the legislation of recent years," he continued, "the protection of the investor must be improved. It is still inadequate. There must be stricter Governmental regulation of finance in this field so that improper practices may be detected in time and effectively dealt with. The ravages of the promoter who operated in the period of 1929 to 1930, cannot now be repaired, but we can at least see to it that he does not again operate in the same way." Mr. Bennett closed his fourth address with a reference to those who, might describe his reform policies as "radicalism". He anticipated that

[1] CAR 1934, p. 88.

> charge. " Selfish men, corporations without souls, those fearful that the Government might impinge upon what they have come to regard as their immemorial right of exploitation, will whisper against us." He said, "We fear them not."[1]

Perhaps the most comprehensive criticism of Canadian Securities market conditions came in 1935 with the report of the Price Spreads Commission. The critique of the market was only indirect, but the suggestions were worthwhile. The attack on the use of paid-in surpluses was necessary, as were suggestions for added publicity to be given to reports. Similarly, standards of disclosure were recommended for annual statements far exceeding those even now practised.

The report also wisely emphasized the necessity of making Directors responsible for representations made to the public either directly or indirectly in connection with any general offer of securities. Directors should also be made responsible for publicity given to reports, and should be held to account for business transacted by the provisional or "shadow" directors. Speculation by directors in their companies' shares should also be forbidden.

Valuable also were the suggestion of restricting the classes of shares to common and preferred, the outlawing of management shares, and that advocating full voting power, be given to all shares, common and preferred. The recommendations to require "adequate" consideration for shares are also noteworthy.

Probably the most significant suggestion - although it has never been put into operation - is that recommending

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[1]CAR 1935-36, p. 3.

the establishment of a special Securities Board as part of the proposed Federal Trade & Industry Commission (also a neglected idea of the Commission). The function of this Board were listed as follows:

a) To review and investigate the capital structure of all companies incorporated under the Dominion Companies' Act and desiring to issue stock to the public.

b) To pass on all issues of bonds or stock after careful consideration.

c) To scrutinize advertising and publicity material accompanying such issues.

d) The Board does not have power to approve these issues, merely to reject unsatisfactory ones.

e) No investment house or company whose proposed issue has been received and not rejected should be allowed to make reference to that fact in its advertising.

The general tenor of the report is summarised in this sentence: "The whole trend of law should be towards putting the managers and directors in a trustee capacity, with respect to all security holders."

This report was quite bitter on the subject of promotion, and whether the Investment dealer and the promoter act in socially desirable ways, a question we shall investigate in the next part of this thesis. Control was proposed, since it was felt that the amount of capital lost by recklessness far outweighed that which might be frightened off by regulations.

Generally, the Report did not have much praise for the way in which the existing institutions were being handled. Unfortunately, but in line with the usual treatment accorded to Royal Commissions, few of the recommendations were put into effect.

Under the pressure of such opinions, however, the market was prepared to clean its own house to some extent. Typical of the trend to effective self-government was the series of regulations reported by Bergithon concerning the Montreal Stock Exchange for the period. In 1932, the members began to be required to report monthly on their collateral borrowings. September 1933 saw the introduction of minimum margin rules. The year 1934 was notable for the appointment, by the exchange, of a consulting auditor and the incorporation of auditing regulations into the by-laws. Customers' men and their activities were regulated by the Governing Committee in 1936; and in 1938 the rules on advertising by members were made more stringent. How much these measures aided in the recovery of activity is difficult to estimate. It seems fair to say, though, that they did contribute substantially in the revival of confidence in the exchanged.

Of interest is the development, in 1935, by the Dominion, through the Bank of Canada, of the use of three-months Treasury Bills. They had been used experimentally in 1934 to provide a means of obtaining funds between the time the fiscal year began and the new inflow of tax revenue.

An indication of the efficiency of the new central bank, and the success of its policy of lowering interest rates is the fall in the rates on these bills from 2.85% for the first experimental issue in 1934 to .746% at the end of 1936.

While there was emphasis on low interest rates, both to ease the burden of government debt and to stimulate private investment, the bond market of 1935 showed a distinct contrast to the high prices paid in 1934; various factors combined to make it " thin and nervous". Some of these factors are as follows:

First, and probably most disturbing, was the power-contract legislation which repudiated certain agreements between the Ontario government and Quebec public utility companies. This clash led to a fall in the price of the bonds of the companies and the Ontario government. As a rebuke to the government - and using tactics reminiscent of the activity of the London investors in the pre-1914 period - the dealers failed to submit tenders for a $15 million Ontario issue. The government then offered $20,000,000 in 2%-2 3/ 4 year and 3% -5 year debentures at par through the Ontario Savings Offices. The Canadian Annual Review reported that this issue was subscribed largely by institutional and gold-mining interests.

A second upsetting feature was the proposal by G. G. McGeer, Mayor of Vancouver, that a 50% cut be made in interest payments on the city's funded debt. This proposal was never acted upon, but the injurious effect can well be imagined.

Similarly, the victory of the Social Credit party in Alberta and a serious crop failure endangered the securities of the western provinces and municipalities.

Of particular importance was a widespread misunderstanding of a pre- election speech by Bennett which seemed to imply (although this was denied) that the Dominion would force conversion of its bonds to lower rates of interest. It was the normal system of call and conversion which seems to have been advocated by Mr. Bennett, although the statement made was ambiguous. Prices did not recover until late in 1936, and then because of an accumulation of idle funds and a rising confidence.

The provincial bond market was dealt a vicious blow when the fears about Social Credit policies proved justified. Alberta defaulted two issues at maturity: $2,846,000 6% bonds due A pril 1, 1936 and $1,109,000 6% bonds due November 1 of that year. A further announcement was made in May 1936 that only 50% would be paid on all government obligations. These defaults came after Aberhart had refused to accept financial assistance from the Dominion Government on the terms suggested by them, since he felt these terms gave the Dominion considerable control over the finances of the province.

After all this, 1937 had an auspicious beginning on the exchanges, which was reversed by the bursting of the "inflation bubble" in the United States. There was some recovery toward the end of 1938. The market was quiet, and the speculative interests were extremely wary of the activity of the government, in view of the tightening of the various Securities Acts. In Ontario, for example, the powers of the Securities' Commission were widened considerably, and made retroactive. There was vigorous protest by the Conservative opposition, since it was Premier Hepburn's avowed intention of investigating certain companies with which Conservative Arthur Meighn was connected during his service with the Hydro-Electric Power Commission. Such actions are indicative, in some degree, of the ease with which matters concerning securities and the capital market can be subverted by political considerations.

Similar amendments to the British Columbia Securities Act[1] provided increasing control in an effort "to maintain confidence in the investment market." Among the changes were the following provisions: (1) the company must inform the Securities Board of any change in its basic status (such as failure to strike expected ore bodies); (2) stock salesmen were prohibited from canvassing residents either by telephone or in person. (3) Conviction of fraud in securities carries a penalty of a $25,000 fine and 6 months' imprisonment. (4) The government is empowered to publish a corrected version of any false information given by a company. (5) The government can halt the sale of any security on the exchanges or outside them. (6) Brokers must submit to a government audit at any time. Certainly such provisions are indicative of stricter control than in some of the other provinces, and much

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[1]CAR 1937-38, p. 502.

of the present conflict and controversy arises from such differing standards of regulation.

The bond markets in the last years of peace were characterized by a scarcity of new issues and an increasing demand for securities as funds fled from the growing menace of war in Europe. The interest rate remained low, therefore, and a wide differential appeared between the yield on short - and long-term bonds, probably as a result of the cloudy international horizon. The stock markets, too, had been discounting war for many months, and prices were at depressed levels.

The period was one of self-financing for Canada; maturing issues of the Dominion payable elsewhere were gradually replaced by issues payable within the country. This had a favourable influence on the rate of exchange of the Canadian dollar in foreign markets at a time when export markets for goods were very restricted by nationalistic tendencies in various foreign countries, as well as the growing international political tension in Europe and Asia.

Then in August 1939, the long wait came to an end, and the axe of war fell again for the second time in an eventful quarter-century.

Chapter III

THE STRUCTURE AND FUNCTIONS OF THE MARKET

The Market as a whole: The Flow of Resources. As Lavington, in his comprehensive study of the English Capital Market has quite correctly pointed out it is the distribution of resources between present and future uses which is of basic importance.[1] However, insofar as the securities market is concerned in the process of capital formation, it is involved with the movement of money and claims, and not particularly with the underlying movement of productive resources controlled by this money-flow.

The abstraction of the monetary aspects of the process from the "real" economic aspects is inclined to be socially dangerous. For example, the Report of the Price Spreads Commission made numerous references to flotations of securities and consolidations in industry which do not appear to have been economically justifiable, but which were primarily designed to provide the Dealer with the proceeds of a clever manipulation. But more of this as the analysis is developed.

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[1] F. Lavington, The English Capital Market, (London: Methuen & Co. Ltd., 1929), p. 65.

Generally, the function of the capital market is to ensure the effective channelling of the community's savings into investment. At one end of the chain of activity in the market is the community as an aggregate of individuals in their roles as consumers of goods and services, and as receivers of income in the various forms of wages, rent, interest, and profits.

At the other end of the process is that part of the community which is engaged in seeking out new possibilities for profit through production, either to satisfy a demand which exists, or through guessing correctly that if such-and-such an article is produced, a demand for it will appear which will be sufficiently strong to make that production profitable. Frequently, of course, new investment changes not the direction of production, but rather the technological framework in which the existing complex of goods and services is created.

The market for securities is designed to sell to the community shares in the profits of these innovations and expansions in return for an advance of a given sum of money. The traditional theory of the supply and demand for loanable funds indicates that the rate of interest acts as the equating price in the market. This equating mechanism has been, in my opinion, grossly over-rated. It is true that the bond market may be judged quite readily by the rate of interest. But the issue of stocks of all sorts, and subsequent trade in them can hardly be reduced to such a concept. While the purchaser of common stock <u>may</u> consider yield in the form of the relationship between earnings (or dividends) and prices, it is certainly foolishly precise to consider such transactions as closely regulated by changes in an interest rate. Moreover, the evidence seems to indicate that it is not the rate of return which, in the past, has attracted either the savings of the "little man" or the funds of the professional speculator, but rather profits arising from a swift increase in capital values.

To the extent, then, that the market has been divorced from the underlying process of diverting resources to capital formation, it is not fulfilling its proper function. Typical of this separation is the attitude so frequently spoken of in the financial press as "dealing in prices, not values". To the economist, this phrase has a strange sound: for what is price, if not value? Value, in the latter sense, is the worth of the share as a fractional claim in ownership of the firm. "Price" is rather the worth of the share, for itself alone, as a security in the market at a given moment; and this price may be ohly distantly related to the worth of the firm. To a certain extent, this abstraction is the result of the existence of the organized exchanges. It has been suggested that the liquidity afforded the investor by the working of the exchanges has lowered the payment necessary to compensate for difficulty of disposing of his holdings. This is quite true. It is also true, unfortunately, that this liquidity leads to more irresponsibility and carelessness on the part of the investors. The investor who knows that he will have to keep his shares come hell, high water, or receivership will be more inclined to investigate thoroughly than he who knows that it is possible to dispose of his holdings at the first sign of trouble.

At this point, the complexity of the whole savings-investment problem becomes apparent. The funds used by the market may come from current savings, from the creation of new money (an increase in M), or from net dishoarding (an increase in V). The accepted theory of loanable funds sets up a supply schedule on this basis.[1] S is the supply of loanable funds from voluntary savings. M is the increase in cash as a result of credit expansion. I is the investment demand for loanable funds. H is net hoarding, also a demand for loanable funds. If net dishoarding exists, it will naturally show in this diagram as an increase in the supply of loanable funds. The rate of interest, equating the demand and supply in total is determined at point P. As we have indicated, this analysis seems to put undue weight on the interest rate as a price. Moreover, it gives no idea of the process of capital formation. It also seems to give a false impression of stability in the market, although it is

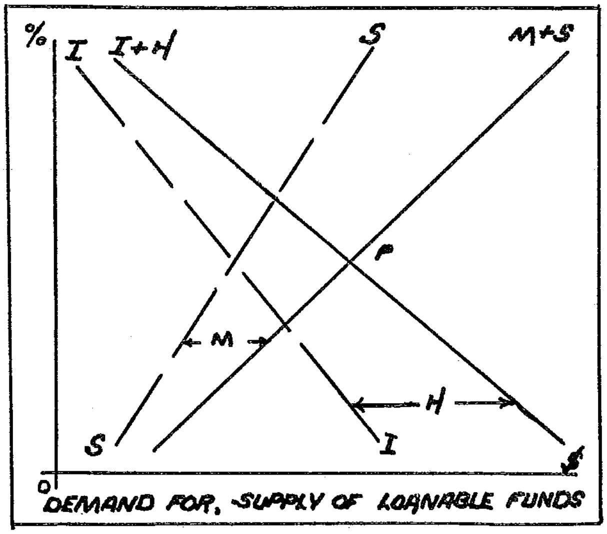

Chart 5

[1]G. N., Based on Halm, <u>Monetary Theory</u>, (Philadelphia: The Blakiston Company, 1946), p. 327-9.

always carefully pointed out that these curves are constantly changing position and shape.

In the series of diagrams below we have attempted to illustrate some of this instability with regard to the stock market section of the capital market. It is common knowledge that at low price levels, general demand for securities is small. At higher (and rising) prices this demand rapidly grows stronger - as a result of more speculators entering the market. Thus, on the assumption of general optimism as to prices (a bull market), the demand curve over a significant range will slope <u>upward</u> and to the right. Similarly, the entrepreneur will offer more and more securities at levels which ensure a good price, as will present security holders. Hence the supply curve also slopes upward in the normal way.

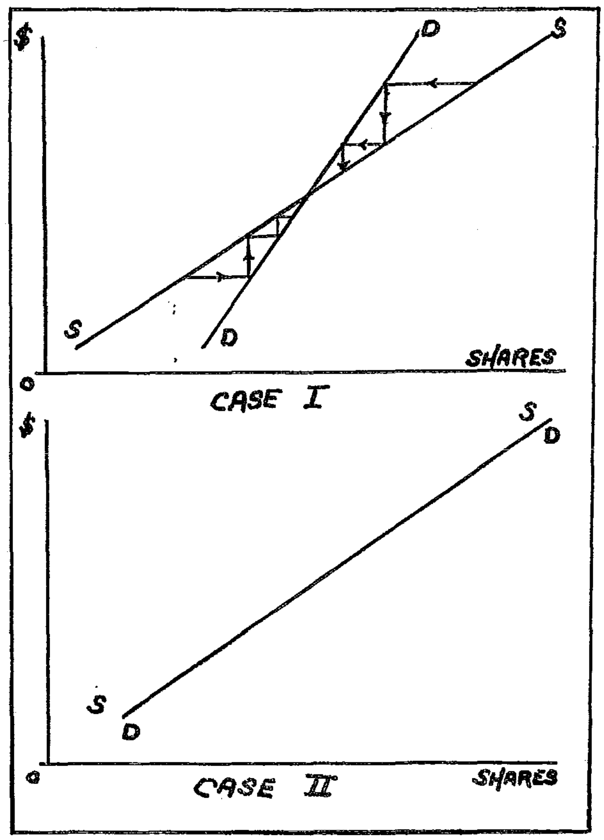

Chart 6

Case I (at the left) indicates a position where prices tend to an equilibrium, assuming no changes in the curves. Case II (below left) indicates no tendency toward an equilibrium, even though the curves do not change. Case III indicates a position for "explosive" variations. Here any price except P causes a rapid movement away with no equilibrium until the curves have shifted.

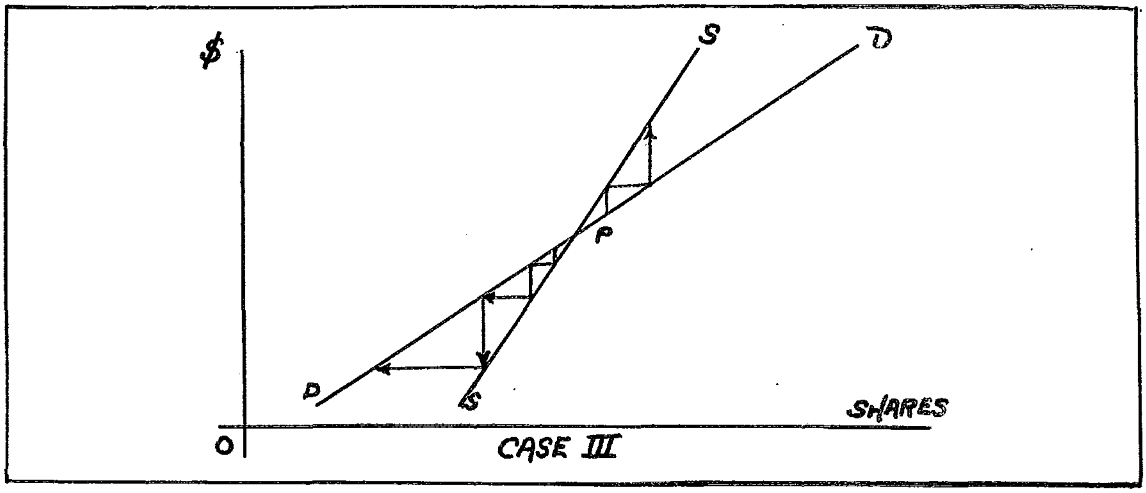

Chart 7

With such situations possible in a large section of the market it is difficult to imagine an interest rate as an equating factor.

The following concepts may be of assistance in guiding our thinking on the process of capital formation. Certain steps can generally be distinguished in this process:

(a) Saving; the refraining from purchasing consumption goods and services.

(b) The act of foregoing cash liquidity by purchasing securities.

(c) The receipt of cash by the entrepreneur who has issued the securities.

(d) The actual purchase of capital goods.

Only those transactions which result in the complete movement through all four steps can properly be called investment. In the diagram on the next page, such transactions are of the type A-A. The market for existing securities includes only the first two steps above, and their converse acts — dissaving and a desire for liquidity - and is represented by the transaction B-B. Such transactions provide individual liquidity, but not necessarily a real transfer of savings from cash to capital goods. In fact, the market may be the instrument for substantial dissaving if losses are sustained over a period.

Two limiting factors should be noted in the above analysis. First, the steps may not occur in the order listed. Secondly, the last two steps may be considered generally as one, so that only the other two segments may be distinguished in the capital market. It is doubtful whether this analysis of the process can be extended to the economy as a whole.

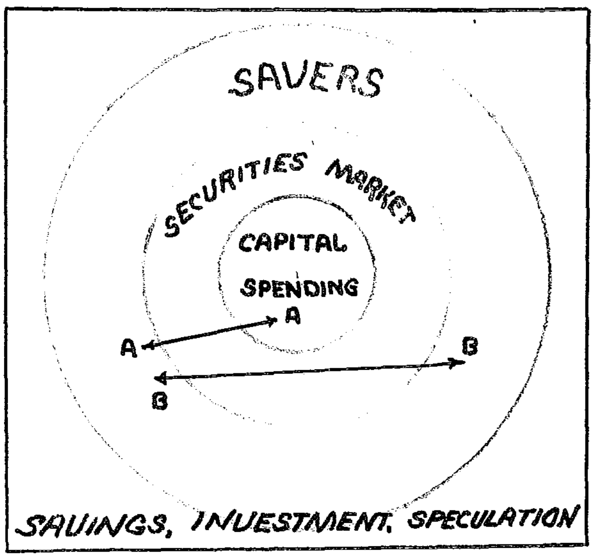

Chart 8

The activity of the entrepreneur is determined by the expectation of profitability in his business on the one hand, and by the state of the market on the other. This last concept is, as we have indicated, considerably more complicated than a mere "rate of interest". Probably his actions are determined greatly by (a) the general price level in the securities market (b) his expectations as to its future movements. The decision to provide finance capital, or to purchase securities, is partly independent of the decision to purchase capital goods described above. It is motivated on one side by the return (the interest rate?), the price of the particular securities, the general level of the market (both actual and expected) and the expected profitability of the enterprise. On the supply side, funds for such financing operations would be determined, at a given level of savings, by the strength of the desire for liquidity — Keynes' liquidity preference.

It is thus conceivable, although unlikely, that saving and financing may take place in the absence of the final important movement by which the funds are transformed into capital goods. Moreover, it is possible that capital goods may be produced in the absence of saving, through an increase in M, or through dishoarding to provide funds. The first situation may well have occurred in 1929, when business actually turned downward several months before the bull market broke into the panic.

To summarize: the present theory of capital formation is inadequate insofar as it explains many of the phenomena of the capital market. Some possible situations have been indicated as evidence of this, and the process of capital formation has been broken into saving, financing, and investment to clarify the diverse functions of the new securities market as compared to that in which existing securities are traded.

Bearing this general analysis in mind, let us now consider the various institutions themselves.

The Underwriters - The Investment Dealers

In the activities of the Investment Dealer, we come to the nerve-centre of the capital market, and of the capitalistic system itself. It is primarily through his function that whatever correlation which is to be developed between the borrowers and lenders of funds comes. Yet it should not be thought that all the Investment Dealers carry on this important work. The smaller firms in the field are primarily merchandisers of securities, mere distributers, as opposed to the larger underwriting and distributing houses.

The large Investment firm, having accepted an issue of bonds or shares from a corporation, municipality or government, is charged with the necessity, in its own interest, of seeing that this issue is sold at a price sufficient to give him a profit. The underwriting or insurance function, under which the issuing body is guaranteed a certain amount is thus mixed and merged with the distributive function of the dealer. It may be justifiably argued that the Investment Dealer by accepting an issue places himself in the position of guarantor: he stakes his reputation and his future income on the continued soundness of the issues he has distributed. While this is true, it is also true that since the dealer is interested in his profit, he may be tempted - in times of optimism - to accept issues which normally he would reject, since he realizes that such issues will be absorbed easily into the buoyant market. As Lavington states:

> There is not, therefore, an identity of private and social interest in the work of the securities market; the natural social safeguard does not exist here as it does in the work of the banks; hence much capital supplied...for negotiable securities...is partially or wholly lost.[1]

By this, of course, is meant the fact that in the activity of the banks, the interests of the banker are identical with those of the depositor. The survival of the banker, as a banker, depends directly on his preservation of the funds of his depositors intact. The Investment Dealer has no such direct restraint. At some points in the process , his interests are diametrically opposed to those of his customers, as his is essentially a "selling" relationship to them. He may be more directly allied with the issuing corporation.

This close relationship between the investment dealer and the corporation is characteristic especially of North American markets. As Mr. Jackman said, "In England many new issues are actually distributed through treasury shares being sold on the stock exchange and the proceeds going to the credit of the company."[2] In Canada, with the exception of issues of speculative mining shares, this is almost never done; the issue is specially distributed through some investment house. The North American system has the advantage of maintaining the liaison between the originating organizations and the dealers, making for quicker issue and development, but this is achieved only by sacrificing a measure of protection to the purchaser.

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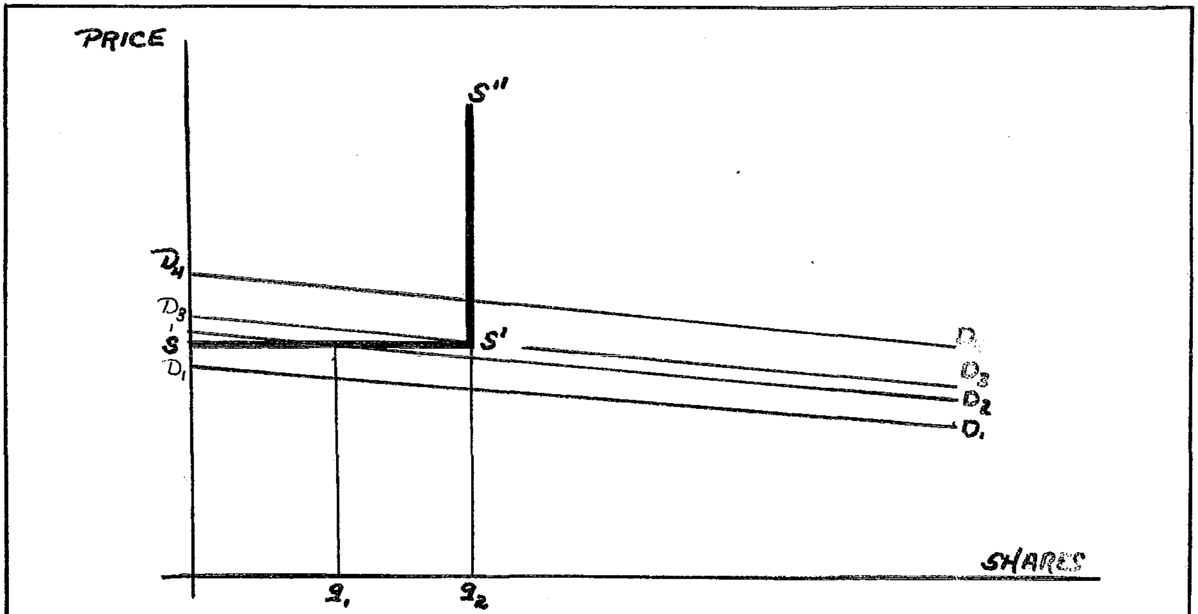
[1] Lavington, op. cit., p. 182.

[2] H. R. Jackman, "The Long-Term Capital Market" in J. F. Parkinson, (Ed.), *Canadian Investment and Foreign Exhhange Problems*, (Toronto: University of Toronto Press, 1940.), p. 143.

Under the situation which exists in the issue of a single flotation of securities, the demand and supply curves may show some interesting configurations. The quantity of securities in the issue is represented below by the vertical straight line which meets the horizontal segment of the supply curve at the underwriters' price. That is, the underwriter will sell any amount of securities, up to the size of the issue, at a price which is predetermined. Beyond that, though an infinitely high price be offered, no further supply of that issue is forthcoming. (The supply curve is S-S'-S'')

Demand for any one particular issue of securities is almost perfectly elastic in an active market. If the price asked by the underwriter-distributer is significantly above the going price for similar securities, the amount taken will decrease very rapidly. (See diagram.)

Chart 9



SUPPLY & DEMAND FOR A PARTICULAR ISSUE IN AN ACTIVE MARKET

This analysis also illustrates in some degree the difficulties faced by the merchant of securities. If he should misjudge the market significantly (represented by the demand curve D_1-D_1), he may find the whole issue left on his hands. If he misjudges the market (i.e. the demand) even slightly, as for the curve D_2-D_2 much of the issue may remain in his possession, and he will be forced to reduce the price or to hold the remainder of the flotation until the general level of the market rises. If he expects a demand of D_3-D_3, he will have estimated correctly. Contrariwise if he sets his price at S-S', and the market stands at D_4-D_4, he will find his issue snapped up, and the profit made in all probability by other interests. He will in effect have, cheated both himself and the issuing corporation.

The necessity for swift action in the issue of securities is thus underlined and emphasized, and part of the resistance of dealers to government control may be explained on this basis. The supply of any particular issue is a combination of a fixed quantity to be disposed of, and a fixed price. The demand, conversely, is extremely volatile, and dependent in some measure upon external factors, This explanation may also account for the tendency of the dealers, especially in speculative issues where demand is unusually variable, to use high-pressure tactics to create a demand where one does not naturally exist.

In one sense, we have been getting the sequence of the analysis confused by consideration of the distributing function of the Investment Dealer before we understand his activity as an "originator". Ideally, he investigates the requests of enterprises for capital, accepting only those which he believes to be economically sound. This is part of the legitimate activity of the promoter, and to some degree it is this confusion of function which has led to trouble in the past. "It is this...function which the investment dealer cannot adequately perform as well as he might [sic] so long as he is forced into the position of gaining a living from the competitive merchandising of securities, depending on volume and turnover for his profit and having a very expensive overhead to support."[1]

In summary, then, the investment dealer may be said to combine the economic functions of (1) selection of enterprises, (2) insurance or underwriting, and (3) sale and distribution of securities. Such a combination seems to have led to unfortunate results, indicated above.

The main criticisms of the Investment Dealers, aside from this confusion of function are as follows:

(a) The ordinary issue of shares or bonds is not open to smaller enterprises. Few issues of less than $500,000 are handled, by reason of the cumbersome machinery which must be put in motion to accommodate any issue.

(b) New and untried ventures are also penalized since they find difficulty in persuading underwriters to accept

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[1] Jackman, op. cit., p. 142.

their issues, and since the fees demanded are high.

(c) What has been termed "unsuitable packaging" of securities. The large bond denominations especially are directed toward the institutional buyers, greatly restricting their attractiveness to the broad field of purchasers.

(d) The criticisms of manipulations, misrepresentation and stock-watering may be conveniently lumped together under the heading of "unethical practice".

(e) Misdirection and overdevelopment of resources as a result of honest errors of judgment are also important. Such conditions were found noticeably in the pulp and paper industry at the end of the 1920's. As late as 1934, J. H. Gundy in an address to the Investment Bankers Association said: "Things of this sort have been the cause of a great many people losing their money, and they are very difficult things to stop, because back in our minds we all have the old British tradition: 'Live, and let live, and devil take the hindmost.'"[1] This attitude is, at best, a feeble sort of rationalization for one of the major weaknesses. It seems to indicate an irresponsibility of the system, a failure to account for its weakness in selecting issues. However, whether a government board would prove any more efficient in the long run leads us into the problem of social and economic motivation and to the philosophical implications of the socialist proposals.

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[1] Financial Post, June 30, 1934. (Clipping)

Perhaps the most sensible suggestion for the improvement of the market in this area of activity comes from those who support the establishment of an organized bond exchange, similar to the existing stock exchanges. Proposals for such an organization were advanced, as we have seen, particularly at the time when the market was becalmed by the depression. The typical position was stated in an article in Saturday Night,[1] suggesting that bond exchanges be formed, with strict control of issuing and dealing in bonds. All bonds were to be listed, and salesmen were to be controlled by the exchange. The author pointed out that bond prices are influenced by the fairness of the salesman, the investment firm, and the degree of knowledge possessed by the buyer. Moreover, he pointed out that it is difficult, even for the dealer, to set prices at which to offer securities, and that such difficulties would be removed by the price-reports from an exchange.

He further suggested that the objection to such an exchange would be its interference with the flow of new issues, now sold under high pressures. It was pointed out that overpriced issues would be left unsold if an exchange were operating, and the underwriter would have to shoulder his responsibility. No longer could a demand be "generated" to take an issue out of his hands, and this would add considerably to the difficulties and hazards the underwriter must face.

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[1] "K-L", "Bond Exchanges for Investment Control", Saturday Night, August 4, 1934, p. 17.

Moreover, it was suggested that these exchanges could control and regulate both the publicity concerning new issues, which to-day is primarily selling literature and inclined to an optimistic outlook, and the valuation of assets (an important question in bond purchases).

In effect, the article advocated the separation of the distributing and underwriting-originating functions, thus following the English model closely. It does seem strange that the efficient markets and machinery available to existing securities could not be adapted to the extremely important primary market, thus ensuring much more of the desired flexibility inthe capitalistic system, and a more efficient method of distribution. It is not the intention of such proposals to restrict the operations of capitalism, but rather to retain its best features by permitting its basic processes scope for action.

Before proceeding to discuss the market for existing securities in the organized exchanges, it is well to summarize briefly the organizational set-up of a typical Investmemt Dealer's office. The principal departments are those for delivery, statistical analysis, trading and sales, along with the originating or new business sections, and the general activities of the partners in contacting governments, industries and clients.[1]

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[1] See T. F. Moore, "The Investment Business", <u>Financial Post</u>, May 28, 1949, p. 14.

The delivery department is in charge of the physical movement of and clearing of the securities, and for accounting for incoming and outgoing securities and cash. It is responsible for dealings with the Foreign Exchange Control Board, transfer taxes, insurance, call loans and the other mechanical tasks of the office.

The statistical department is responsible for the compilation and analysis of financial statements, preparation of prospectuses and similar materials, and computation of bids and tenders. In addition, the department arranges to obtain information required by salesmen and clients, analyses portfolios, and studies and correlates other general statistical series to market conditions. This section also arranges syndicates and other marketing arrangements and combinations.

The trading department is the heart of the investment business. Here are the telephone, teletype, telegraph and cable connexions. This part of the office is in touch with the market conditions, and from it trading is carried on both for clients, and for the firm's account. The work is arduous and exacting. "To be a successful trader requires an excellent memory for figures, the ability to make quick decisions and the possession of a flexible mind alert to changes in the market trend and observant of current financial news."[1]

The sales department is in charge of the actual visiting of clients and writing of sales literature. Its importance is significantly mentioned in this article advising the young

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[1] _Loc. cit._

man who is intending to enter the bond business as follows:

> The years spent in the sales department are an important part of his training - the majority of executives in the bond business reach the top through the sales department. The majority of executives are producers of business.[1]

The Secondary Market: The Stock Exchange

It will not be necessary for us to consider in detail the technical aspects of the activity of the stock exchange. It is rather our purpose to evaluate the position of the exchange in the process of capital formation: its direct functions and its efficiency.

Economically, the function of the exchange is to provide liquidity for the individual holder of securities through maintaining an active market in the shares listed. Otherwise, the supply price of capital would be considerably higher than it is at present; for while any valuable property can be sold immediately - if the price is low enough - that is small consolation to the person who required funds for shares on short notice. Under the present system, he can be sure of selling in a reasonably wide market and at a fairly acceptable price.

Hence the existence of the organized exchanges, and hence also the tendency of the larger exchanges to dominate the market at the expense of the smaller ones, since by their size they attract the investors and speculators, and also since they must attempt to maintain their position by restriction

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[1] *Loc. Cit.*

on the trading activities of their members outside the exchange itself. The Canadian situation is dominated by the Toronto and Montreal organizations. The Winnipeg, Vancouver and Calgary organizations, established in 1903, 1907 and 1913 respectively are insignificent by comparison.[1]

It has also been suggested that the relative levels of the market provide an indication of and a guide to the most profitable distribution of new investment. If an industry's securities remain at an abnormally depressed level over a long period, relative to the market as a whole, few underwriters would feel optimistic about issuing stock for a firm in this business. Thus the market, at a given time, and over a period provides a rough barometer of the relative levels of business experience and expectation. Originally, speculation in the market was a type which aided this differential valuation, since the speculator guessed that a stock was selling at less than its intrinsic or investment worth. His purchase of it, in order to profit when the price returned to normal, would have an equilibrating effect itself; and a socially desirable effect on the market as a whole.

However, as Moulton has pointed out, the stock market has been used in recent years for speculation in a new way which may not have such an effect. That is, there has been speculation, not on the relative values of individual securities, but on the general swings of the market as a result of

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[1] The Financial Post reports the formation of an Edmonton exchange under the stimulus of the present oil boom.

fluctuations in business activity. In this speculation, much of the value of market pricing may be lost in the major movements. Buyers and sellers trading on this basis accentuate rather than mitigate the swings, since they "pile on" gleefully in rising markets and withdraw (for the most part) when a downtrend appears.[1]

The exchange provides a meeting place for brokers for the buying and selling of securities, and it is equipped to supply, swift, accurate information as to the price and volume of transactions. It also sets up certain standards of disclosure for the securities which are listed for trading. The world exchanges are linked by wire into one large market for added efficiency, in trading and in the communication of information.

Typically, the exchange is merely an association of its members, and not a separate corporation. On the Montreal Stock Exchange, for example, seats may be obtained by election and purchase.[2] After the election, in which one negative vote in five will prevent the applicant from obtaining the seat, he has ten days in which to complete his purchase from one of the members.

The government of the exchange (MSE) is centred in the governing committee of eleven: eight of whom are members of the exchange, and three who represent the members' partners.

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[1] H. G. Moulton, Financial Organization and the Economic System, (New York & London; McGraw-Hill Book Co., 1938), p. 225-6.

[2] Bergithon, op. cit. p. 17 ff.

The specialized business of the exchange is run by a series of sub-committees, appointed from among the members of the governing committee. Such committees are the Committee of Arrangements (overseeing the auditors); the Listing Committee; the Admissions Committee and so on. In addition to these groups, the hired staff of the exchange functions under a General Manager, himself responsible to the elected governors.

In the Montreal organization, as in the other exchanges, Bergithon distinguished types of traders or brokers. The first, and most numerous type are the commission brokers, who take and execute orders for their clients at the regular rates. The floor brokers are secondary agents who assist the other members as required in the trading, receiving 1/10 of the regular commission for this service. The "professionals" are traders for their own account, usually large speculators. These men come close to the economic model of the professional risk-taker. Lastly, and usually connected with the larger firms are the arbitrage brokers, whose function is to carry out equalizing transactions between the various markets.

It may be asked what advantages, aside from the increased liquidity, are to be gained by a corporation in having its shares listed on one of the organized exchanges. As we have indicated, it is some evidence to the informed investor that at least certain minimum amounts of information have been revealed and that nothing especially damaging has been found. For example, the Montreal Stock Exchange requires wide distribution of the stock, a sound financial position, and management of good repute. Moreover, in addition to giving this required data to the exchange, the company must agree to publish annually a balance sheet, and statements of income and surplus, and to release and publish dividend news, and information on bond interest, allotments and rights.

The requirements for the Montreal Curb Market are similar but less stringent, since this market provided a market for distributing speculative issues, and is an intermediate step between the highly regulated exchanges and the unorganized over-the-counter market where speculative or inactive stock is traded. A listed stock has the advantages of enhanced collateral value---often a major consideration; and certain amount of added prestige and advertising value, both through space given in newspapers to the reports of such firms and in the use of the public relations offices of the exchange.

In addition to their economic functions, the exchanges have in recent years acquired the additional duty of acting as a regulatory body, by setting commission rates, by preventing fictitious sales, by guarding against members' failure by the surprise audit and investigation, by regulation of publicity, and in the case of the Toronto exchange at least by requiring separation of the brokerage and underwriting functions in members' firms. In this way it is hoped to maintain both the efficiency of and public respect for the market.

The Investment Intermediaries:
(a) Investment Trusts

One of the most important trends in the present-day development of the capital market is the increasing institutionalization which is apparent on the buying side of the market. Particular evidence of this is the influence of the life and general insurance companies, and the investment trust companies in the mobilization of savings. Perhaps the place of the investment trust holds most interest for this study.

The theory of the Investment Trust Company (to be distinguished from the Trust Company, more important in its fiduciary capacity) is in general quite simple. It is an attempt to provide diversification for the small investor, and expert management for those who are unable to afford the services of professional counsel. It is, in effect, co-operative investment. As a form of business, the Investment Trust appeared in England in the 1860's primarily to provide a means of investing in a variety of high-grade foreign securities with which the individual investor could not make himself sufficiently familiar. By using this device, the greater yield available on such stocks and bonds could be more easily obtained. For many years, these trusts were quite successful, but from 1886 to 1891 their numbers grew at an unprecedented rate, and many were weakened by being forced to buy second-rate securities. Others adopted the dangerous practise of emphasized the profits which they were making on paper as the prices of their holdings rose, one of the faults which later discredited American trusts.

Between 1890 and 1894, a period of strain and stress shook the London market and many of the investment companies went under. After this time, a period of consolidation, the trusts went forward on a more conservative basis. Profits on trading were set aside to cover future losses, and only interest and dividend income was paid out to the owners.

The form was practically non-existent in North America until the 1920's, when it grew quickly under the influence of the bull market. Here the old difficulties arose again. The aim of the American trusts was primarily capital gain; their earnings were therefore principally "profit on the sale of securities". Such companies do well in a rising market, but it is clear that they will come to grief in time of collapse - as many did, so that the Investment Company was widely distrusted during the 1930's.

The Investment Trusts can be differentiated on the basis of type; there are radically differing forms. Generally, they are either open-end or closed-end trusts; these in turn may be either management trusts (on which the portfolio changes) or fixed trusts. Moreover, a trust may be a "specialty" trust (concentrating on a particular type of securities such as pulp and paper) or a general trust. The Investment Trust must be clearly distinguished from the "Holding Company", which it resembles in form. Ideally, the Investment Trust aims for wide diversification of its holdings; not control aimed for in the activity of the holding company.

The closed-end types — common in the 1920's — do not buy and sell their own shares continually to provide liquidity. The price of their securities is determined by the open market. Usually, such securities sell at a discount from their asset values. In effect, these organizations are ordinary corporations whose sole assets are either a fixed or variable list of securities; bonds, preferred or common stock.

The open-end trusts, the more popular form to-day, have great possibilities in the future development of the capitalist economy, to my way of thinking. These trusts may be either management trusts or fixed trusts., but they are most often of the former type. Their most significant feature is that they are self-liquidating. They buy and sell their own securities at fixed prices, based upon the current market value of the underlying shares which provide the assets of the trust. These prices are changed regularly as the asset values change. The trust shares are not listed, as the trust itself undertakes to provide a market for the shares. This type of institution is not common in Canada, where most of the existing companies are management trusts of the closed-end type dating fromthe 1925-30 period. In the United States, the Massachusetts Investors Trust (MIT) is the classic example of the open-end form.

At present, as in all periods of prosperity the trusts are enjoying a boom, for a number of reasons.

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[1]<u>Financial Post</u>, August 27, 1949, p. 9.

First, with improved management in the newer trusts, brokers and dealers can recommend them with few reservations, Moreover, since their shares are normally low-priced, they are an example of "security packaging" suitable to the smaller investors' needs. Regular purchase of investment trust shares is thus easy. Moreover, the accounts so invested get expert attention at low cost, almost equivalent to that of an Investment Counsel. (Normally, it is not worthwhile for the investment counsel to take accounts of much less than $25,000.)

The potentialities of the Open-end trust lie principally in their use in educating people who normally do not invest their savings in anything more risky than a government bond. In the United States, for example, it is estimated that only about ½ of 1 percent of the population are shareholders in corporations. "Fifteen years ago, stockholders outnumbered trade union members two-to-one but do-day the picture is just reversed —— union members outnumber stockholders two-to-one."[1] The small investor has been badly used by the market in the past. In a system of properly managed investment trusts, seeking out the best investments in both new and established enterprises, and properly divorced from both the corporations and the issuing houses,[2] there is a possible source

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[1] _Financial Post_, September 10, 1949, p. 18.

[2] The League of Social Reconstruction, remembering the financial fiasco of the early 1930's writes as follows in _Social Planning for Canada:_ "The formation of investment trusts....a delightful method of selling otherwise unsaleable securities to the public." (p. 310).

of protection; "the trade union" of the small investor. Such unions would be strong enough to match in power, and to bargain on equal terms with, the issuing investment dealers, and the corporations. It is conceivable that properly handled investment trusts will provide one of the means whereby the much-touted shortage of risk capital may be alleviated. However, more of that question in due time.

The Investment Intermediaries: (b) The Insurance Companies

Perhaps the most significant form of institutional investment in the modern Canadian capital market is that provided by the combined activities of the Life, General & Fire insurance companies. It is reported that in 1948 there were four and a half million life assurance policyholders in Canada, with total life assurance in force of $13.1 Billion. Support for this huge amount requires about $3.75 million to be paid as premiums yearly. The huge growth is best appreciated when it is considered that in 1900 the total insurance in force was $431 million ($81 per capita) compared to the total to-day which amounts to $1040 per capita.[1]

Insurance in Canada has been very well managed and controlled. No one has ever lost a dollar through failure of a company to meet its contractual obligations. This has been accomplished by responsible management, and strict investment regulations, which arose principally out of the work of the Royal Commission noted earlier.

Under the Canadian and British Insurance Companies Act, certain general classes of investment may be made. In

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[1] Financial Post, April 2, 1949, p. 17.

view of the importance of this investment in the capital market, it is well to summarize the fields available:

First, government securities of any country in which the country carries on business; Dominion, provincial or municipal securities and their guaranteed securities. Corporation bonds which are fully secured by real estate or equipment are also eligible for investment. Debentures (unsecured promises to pay) of corporations may be purchased in companies which have paid interest for 10 years, and common stock dividends for at least five years.

Preferred stocks which have paid dividends for at least five years are also eligible. If the issue is new, it is eligible if dividends have been paid on the common for the five year period. Common stock is eligible if $4 (on no par) or 4% on par stock has been paid for at least seven years. The insurance company may not purchase more than 30% of the stock of any corporation. (This is to prevent the insurance companies from coming into active control of enterprises across the country.) Common stocks may not comprise more than 15% of the company's assets.

Life insurance companies cannot own shares in other life insurance companies. Mortgages may be taken on real estate up to 60% of the value of such real estate. Real estate may be acquired for head office use, or as a result of foreclosure. Loans may be made on the security of the companies' own policies.[1]

These restrictions have been modified by the introduction of the amendment affectionately known as the "basket

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[1] Based on McEachern, _op_. _cit_., p. 244-5.

clause". This enables the companies to invest up to 3% of their assets in a variety of otherwide forbidden items, such as revenue-producing real estate; revenue bonds of public bodies and more risky (or technically ineligible) corporate securities.

The basic problems of insurance investment have been summarized as (1) safety of principal (2) diversification (3) some liquidity (4) the highest return possible, consistent with the other requirements. Perhaps the most vexing problem in recent experience has been the long, steady fall in the gross interest rates: from about 6.2% in 1925 to something under 3.6% in 1948. With this fall in rates, the companies have been forced to turn more toward the equity securities to maintain their competitive position. If properly managed, this will probably prove to be valuable, since more funds will be released for risk capital ventures. The necessity for such activity has been recognized, but until recently only the Sun Life maintained what was an "unorthodox" investment policy by heavy equity investment. Typical of recent opinion is that of G.G. Ryan (former President of the Investment Dealers):

> It is my personal belief that if these savings are to be put to their best use, a broadening of the field of institutional investment, and, in particular, a more extensive investment in promising common stocks of Canadian corporations are essential [sic]."[1]

With this consideration of the most important institutional investors, we may turn to a more general consideration of the problems arising from this institutionalization.

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[1]Financial Post, June 25, 1949, p. 13.

First, insofar as life insurance has increased in importance, the savings pattern has been made more rigid; for many people consider life insurance expense as a current expense, a cost and not savings at all. "Whereas the total of other forms of personal savings is one of the most unstable and volatile elements in the economy, life assurance savings are among the most stable because of the long-term nature of the contracts."[1] This may provide a source of real concern in the economic pattern; for unnatural rigidity anywhere can do much damage.

Moreover, there has been a significant increase in the "involuntary savings" effected through retained earnings of corporations, unemployment insurance schemes and the like. "While this form of forced savings is not new, the proportion of earnings retained is subsequently greater than formerly."[2]

As a result of the apparent effects of both income and succession taxation, in securing more equitable distribution of income, we can foresee that more of the savings are going to come from institutions to the market. Unfortunately, banks, insurance companies, trust companies and government agencies have the habit of investing in debt, not equity. This has been the effect of producing a disproportionately high dividend yield relative to the interest rate, a feature of existing conditions in the United States.

Little effort is needed to increase the equity holdings in existing companies; the real problem lies in financing

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[1] Financial Post, May 21, 1949, p. 26. (Digest of address of Sir George Barstow to annual meeting of Prudential Assurance Co.)

[2] Ibid, p. 21.

new, small companies in a capital market dominated by institutional buyers. Some steps have been taken in the right direction by granting tax relief to these small companies. Just how far the ordinary institutional investor can be expected to go in providing this equity capital is still an open question. Certainly it is not his normal function. For this reason, it is possible that the investment trusts may be able to fill the gap left as the "capitalistic" individual investor declines in importance.

Probably much of the problem is psychological, a reflection of the desire for "security" so prevalent in an unsettling age. It is a fact, however, that in an advancing economy everybody can't have secure investments. Thus, if we have destroyed our class of risk-bearers it is conceivable that we may have to create a new class, or a new institution to fulfil this function in the economy.

The Investment Intermediaries
(c) The Investment Counsel

Of little importance on the Canadian scene is the group of professional men who give actual advice on investment procedure; buying and selling. For their service, they charge their clients a fee, which McEachern indicates is usually less than 1%. Of necessity, the number of clients which can be served is small, and a man of great ability is needed. In view of their limited value to large accounts alone, this type of intermediary does not seem to warrant an important place in the market, especially as institutionalization and equalization continue.

The Investment Intermediaries
(d) The Trust Companies

The principal function of these institutions has been to lend money on the security of first mortgages. The funds which enable this activity to be carried on are derived from the stockholders, from savings deposits, and from the sale of debentures. Yet they are by no means merely mortgage companies; and in recent years there has been an important trend to expansion of these "department stores"[1] of the financial world.

Besides this function, they act as trustees, executors, or administrators of estates; and they have an expanding business as financial agents for individuals, municipalities and corporations. In the last case, their branches in stock exchange cities have very important transfer departments for registering the stockholders of the corporations.

As with the insurance companies, their investment problems have been intensified by the long-term decline in interest rates. However, specialized investment departments have grown up to secure a maximization of safety and yield. The investments of trustees are restricted in the direction of high-grade bonds even more narrowly than those of the insurance companies. This is, of course, one of the foremost dangers of an institutionalized market.

The corporate trust business — where the company acts as trustee for an issue of bonds or debentures is of only indirect importance to the capital market; yet this device

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[1] Ashley, op. cit., p. 68; citing Moulton, op. cit., p.337.

has allowed efficient use of mortgage bonds by the market. Of more spectacular importance is the function of the trustee in the case of default, when it is responsible for protecting the bondholders. Macdonnell, writing in Parkinson's Canadian Investment...Problems, has an ingenious metaphor to describe this function:

> To use medical terms, the trustee having acted as midwife when the issue was created, now that the patient is ill finds itself called upon to discharge the function of a physician. If the patient has an incurable malady it may be that the trustee will have to discharge the duty of undertaker.[1]

The largest Canadian Trust companies are the Royal Trust, the Montreal Trust, the National Trust, the Toronto General Trusts, the General Trust of Canada, and the Canada Trust Co. Several of these are reportedly connected with the chartered banks. The assets of each of the largest approach $1 billion.

The Investment Intermediaries (e) The Place of the Chartered Banks.

Classically, the commercial banks have no business in the affairs of the capital market, their function being to provide the working capital of the nation. During the war years, however, and during the depression, the portfolios of the banks were increasingly filled with government and other securities. The bankshave also entered the capital market to provide short-term credit to the dealers and underwriters, on the security of the issue involved. Brokers' loans (for margin buying) have declined in importance since 1929, as have

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[1] J.M. Macdonnell, "The Trust Company and the Investor", in Parkinson, op. cit., p. 182.

commercial loans in general. Douglas Gibson[1] attributes this decline to the increasing importance of corporate savings, the use of bonds and shares and the easier access to the capital market for the larger companies as this market has become stronger. In summary, the chief contribution of the chartered banks is probably in maintaining the market for short-term securities, and for long-term securities which are approaching maturity.

The Bank of Canada

Inasmuch as it provides one of the neatest available summaries of the activities of a central bank, the preamble to the Bank of Canada Act is usually the preamble to any discussion of it This analysis is no exception; herewith, the Preamble.

> Whereas it is desirable to establish a Central Bank in Canada to regulate credit and currency in the best interests of the Economic life of the nation, to control and protect the external value of the national monetary unit and to mitigate by its influence fluctuations in the general level of production, trade, prices and employment, so far as may be possible within the scope of monetary action, and generally to promote the Economic and financial welfare of the Dominion:...[2]

Insofar as the securities market is concerned, the Bank of Canada has importance because of its open market operations: buying and selling government bonds to control the price level ofthose bonds (and hence the interest rate) and acting as financial agent and originator for new and refunding issues of Dominion securities. It is in the bank that the terms of these securities are decided, and it acts as chief agent.

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[1]Gibson, J. D. "The Trend of Bank Loans and Investments in Canada", in Parkinson, op. cit., p. 156.

[2]The Bank of Canada Act, 24-25 George-V, Chapter 43 (1934).

The Bank of Canada must also use the capital market in its task of regulating the credit base of the country's economy by changing the cash reserves of the chartered banks. In the absence of a sensitive short-term money market, this function is also carried on by open-market operations. The importance of the capital market to government policy, and of government policy to the market can clearly be recognized in this situation.

The bank's position in the market is thus seen to be very complex: it is buyer and seller in the secondary market, and originator, underwriter, distributer and agent of the issuing body all in one in the primary market. These are some of the direct guises under which the bank enters the market. Indirectly, by changing the quantity of money in the economy, the bank has considerable effect on all phases of the market's activity. The necessity for wise management in the bank, and for sound decisions on the part of the government in determining what the bank shall do is thus underlined.

The Foreign Exchange Control Board, as a section of the bank, also exerts great influence on the market. Organized to prevent, among other things, a flight of capital from the country, the board has interfered widely in the free purchase and sale of securities on an international basis. During and since the war there has been considerable criticism of the board's restrictions as discouraging to stock buyers abroad, especially prospective American purchasers of Canadian securities.

While this may be true, the Financial Post has pointed out that the book value of American investment had increased by about $500 millions from 1945-49 through direct investment and corporate reinvestment. The Post asks: "How much more direct investment we could have reasonably hoped for, or digested under recent conditions of supply and employment is, of course, something which no one can sensibly answer."[1]

It cannot be denied that the machinations of the Foreign Exchange Control Board have exerted unpleasant effects on the market. There was widespread unhappiness at the decision of the government to place the Canadian dollar at par in the year after the war, for reasons similar to those outlined in the section dealing with the situation following World War I.

Nor can it be denied that the Board has done excellent work in protecting the domestic capital market from the shifts in the external value of Canadian currency which, as we have seen, had such an adverse effect on the market institutions when they occurred in the early 1920's and in 1931.

The Industrial Development Bank

The other adjunct to the central bank has a unique position. It is not strictly part of the capital market, yet its potential importance is sufficient to warrant an extended discussion here.[2]

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[1]March 19, 1949, p. 1.

[2]Based on S.R. Noble, "The Industrial Development Bank", Canadian Banker, Vol. 52, 1945, p. 40-46.

One of the important criticisms of the market has been its ineffectiveness in supplying credit to small - and medium-sized businesses on long-term instruments. This type of credit is outside of the province of the chartered banks; yet the Investment Dealers have been unwilling to take up such firms' issues of securities for reasons noted above.

More important, even if an issue of bonds or shares is made publicly by one of these small businesses, it is often difficult to dispose of, since savings which are available for security purchases naturally turn to the more important enterprises where the dependence on individual personality is less, and where there is more likely to be an active market.

The Industrial Development Bank is a wholly-owned subsidiary of the Bank of Canada, and came into being by an act of parliament passed on August 15, 1944. While the Industrial Development Bank and the Bank of Canada have the same directors, they are autonomous institutions with different functions. The authorized capital of the Industrial Development Bank is 250,000 shares, par $100, all held by the Bank of Canada. The bank has power to issue debentures up to three times the paid-up capital. It has thus a maximum of $100 million to lend or guarantee.

The Bank has very wide powers as indicated in this excerpt from the preamble to its act:

> Whereas it is desirable to establish an industrial development bank to promote the economic welfare of Canada by increasing the effectiveness of monetary action through ensuring the availability of credit to industrial enterprises which may reasonably be expected to prove successful if a high level of national income and

> and employment is maintained, by supplementing the activities of other lenders and by providing capital assistance to industry with particular consideration to the financing problems of small enterprises:...[1]

It can loan directly to enterprise on any security available to the chartered banks, and it can accept mortgages on real estate or chattel mortgages on equipment. The bank may also undertake to guarantee loans, or it may purchase or underwrite securities. Since the bank can accept no deposits, there is no problem of maintaining liquidity, and its loan policy is a matter of its own discretion.

Limitations in the Statute on the policy of the bank are few. In order to ensure that the bank is not diverted from its purpose of providing credit to small industrial concerns, it is provided that no more than $15 million should be loaned in sums exceeding $200,000. No limitations on the term of loans are prescribed. In practice, most of the loans have been made payable in installments over periods ranging up to five years. Similarly, the majority of the loans have carried an interest rate of 5% in spite of the fact that the "handling" costs on the smaller loans would warrant some sort of rate differential.

The staff of the bank, which in 1949 comprised about one hundred people, included 10 engineers, 8 lawyers, 8 or 9 accountants and 6 or 7 insurance experts.[2] These experts are charged with investigation of the applications received

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[1] The Industrial Development Bank Act, 8 George VI., Chapter 44 (1944).

[2] Financial Post, August 6, 1949, p. 9.

by the bank and with making the decision as to what credit will be advanced. This careful attention may lead to some unorthodox restrictions on the enterprise, as a condition under which credits will be given. For example, the bank may require that no increase be made in executive salaries, dividends or capital expenditures without the bank's consent. Moreover, this expert investigation has often enabled the prospective borrower, having received an acceptance from the bank, to obtain credit elsewhere on favourable terms.

The activity of the Industrial Development Bank is directly in the field of risk capital — not merely current financing. If the shortage of risk capital becomes more acute, this institution can play an important role in alleviating the condition. In order to make certain that the bank's lending is channelled into the most worthy enterprises, it is provided that loans can be made only to "industrial" enterprises, a term which generally excludes both service establishments (such as garages, barber shops, etc.) and the distributive trades.

It is obvious that the Industrial Development bank will not reach the stature of the chartered banks on a loanable fund of only $100 millioh. However, it has been pointed out that there is a high economic multiplier in new investment, so that the sum total of loans by no means measures the effectiveness of its contribution to the economy. When it first began to function in November 1944, it aroused considerable hostility in banking circles, since it was erroneously regarded as a competitor. "That early hostility has largely disappeared to be replaced generally by passive scepticism as to its value."[1]

Actually, of course, the assistance given by the bank to a business probably makes it a better risk for the credit given by the chartered banks. The chief objections to the bank seem to be in whether its existence is necessary, and if so, how effective an instrument it is in carrying out its function.[2] At present, it is hard to make a valid assessment. That will come when the bank is faced with the tribulations of a downswing.

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[1]McEachern, *op. cit.*, p. 311

[2]As an example of the type of financing done, the Financial Post (August 6, 1949, p. 9.) mentions the case of the Laurentian Silk Mills Ltd. of Cap de la Madeleine, P.Q. This company was incorporated in 1937 to make silk fabrics. It was hard pressed by the 1945 yarn shortage and required $300,000 to build its own mill.

Public financing was impossible under the then existing market conditions. The Industrial Development Bank authorized $150,000 and a spinning mill was build.

Laurentian Mills was able to enter the open market in 1947 with $700,000 in mortgage bonds and $500,000 in common stock, which private investors purchased, so that the original loan was retired three years before maturity.

Table 6

APPLICATIONS HANDLED BY THE INDUSTRIAL
DEVELOPMENT BANK
1945 - 1948

	1945	1946	1947	1948	Total
Authorized	97	169	177	143	586[a]
Refused	160	103	97	159	519
Withdrawn	228	105	113	89	535
Total	485	377	387	391	1640

[a]Of a value of about $39 million. as at July 31, 1949 about $22 million were outstanding.

Source: Financial Post, August 6, 1949, p. 9.

Chapter IV

CURRENT PROBLEMS OF THE MARKET
COMMENTS AND CONCLUSIONS

The Buyers of Securities We have now completed our survey of the place of the capital market in the Canadian economy, except for some discussion of the elements which make up the demand for securities, and such problems of the present market as the shortage of equity capital. These subjects of analysis are fundamentally interrelated, as we shall see.

The first type of buyer of securities is the individual investor, especially those people who are making $5000 or more (of whom there were some 76,000 in Canada in 1947.)[1] This class has sufficient income to save if it so desires, and in earlier years the individual investor was the first and most important source of loanable funds. Latterly, of course, his activities have been modified considerably by the investment intermediaries.

Traditionally, according to C. P. Fell,[2] there have been eight major channels for the investments of individuals: 1) cash in deposit in banks, 2) life insurance and annuities, 3) stocks, 4) bonds, 5) mortgages, 6) equity in residential

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[1]McEachern, op. cit.,

[2]C. P. Fell, "The Individual Investor in Canada", in Parkinson, op. cit., p. 126.

or farm real estate, 7) investment in private business, and 8) other land and improved properties. Of these eight, only the first four channels may lead through the capital market; and only in the case of stocks and bonds is it reasonably certain that the capital market will be involved.

Mr. Fell attributed the increasing importance of these latter forms of investment to an increase in per capita income, the continued development of the corporation, and the development of the market itself with its opportunities for speculation. In the case of bonds, the rising importance is connected with the introduction of the "merchandising" methods in the 1920's, to the collapse of the land speculation which had made item eight a great factor in the early years, and to the educational results of the Victory Loan campaigns in both wars. In the lower income brackets, of course, most contact with the market is restricted to purchase and sale of government bonds.

The second type of security buyer is the business firm. Firms usually have two widely differing motives for investment. The first is the investment of funds not immediately required in the business for short periods. The second involves permanent investment in subsidiary firms or related industries. This latter type of investment _may_ lead to important risk-bearing on the part of existing firms. The temporary investments, however, are more likely to be of a "principal-protecting" character, often short-term government issues.

Perhaps the most important influence of firms as investors comes in their activities not as buyers of securities, but in avoiding the market. Corporate savings arising out of earned surpluses and depreciation funds may allow investment without entry into the market. Such by-passing may be dangerous, since there is no positive check on the expansion of industry through the selective function of the market. Yet, economic forces do provide a check, since it is unlikely that an unhealthy or unprofitable industry will be able to expand on the strength of corporate saving within it. At a rough guess, it would seem that substantial corporate savings are a sign of substantial net revenue (a surplus of actual profits over normal profits). Many writers have wondered how much more dangerous this non-market investment is, than investment in new securities sold by an enthusiastic investment dealer. In view of our analysis, it seems likely that corporate savings are at least as desirable, and probably are less wasteful than market investment itself.

Stollery[1] found heavy corporate saving in the flour, petroleum, automotive, textile, merchandising, food, printing and publishing industries in Canada. Corporate savings have been of importance in private companies which have grown to any size, and also in the expansion of Canadian branch plants. Mining companies, by their nature as extractive firms, must use earnings in a constant search for new sources of supply if they expect to maintain their identities.

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[1] C. W. Stollery, "Canadian Corporate Savings", in Parkinson, op. cit., p. 220-228.

Lastly, securities are bought by the investment intermediaries analysed above, and by the controlling institutions such as the central bank. Here the emphasis is again of necessity turned toward safety of principal.

The Shortage of Risk Capital

Thus we come to a consideration of the problem which is presently attracting much attention in the financial press of both this country and the United States. Here, too, our fortunes are bound up with those of the Americans, who have traditionally been the source of much of the Canadian equity capital (even when the British were pouring in vast quantities of capital for senior securities). The Financial Post,[1] as evidence of this, notes that about one-third of the total investment in Canadian manufacturing plants is represented by American-controlled firms, including all the automotive industry, two-thirds of the petroleum industry, 60% of the rubber and one-third of pulp and paper industries. Moreover, recently, much of the money for the Labrador iron mines and the Alberta oil development has flowed in from across the border. A safe conclusion to draw would be that when large quantities of risk capital are needed in Canada, we turn to the resources of our wealthy neighbour.

Yet it is not enough to say this and then relax in smug confidence, for it is in the American market that most of the fear of this shortage lies. Fundamentally, the thesis

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[1] August 13, 1949, p. 11.

is that the use of the income tax and succession duties as instruments for equalizing the distribution of the national income has destroyed, or is destroying, the traditional source of equity capital, the well-to-do individual investor. There is not, therefore, sufficient capital being diverted to this type of investment. To add to the trouble, the population seems to be turning indiscriminately from intelligent risk-bearing to a desire for safety and security. Typical of the position taken is the following quotation from Emil Schram, (then President of the New York Stock Exchange):

> There is plenty of capital available — capital which is ready as it always is to go to work. It is channeling itself easily...into standard reservoirs...— into savings accounts, homes, government savings bonds, life insurance, etc. This is as it should be, except that there is more than enough capital available for these types of investment and conservation. Essential corporate needs for capital stands [sic] unfilled.[1]

Again, the position was summarized by Robert Wilson of Standard Oil of Indiana, rather aptly, in two sentences:

> (1) Those who know the facts about common stocks don't have the money.
> (2) Those who have the money don't know the facts.[2]

In an attempt to remedy these conditions, the New York Exchange and several important brokerage firms have embarked on extensive advertising campaigns. Canadain firms have begun similar educational drives.

Yet it is not at all certain that we can accept this analysis, for there are notable inconsistencies. Consider the following:

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[1] Financial Post, March 12, 1949, p.3.

[2] Financial Post, June 4, 1949, p. 4.

> It is true that the "small man's" capacity to assume risk is limited, but there are many corporate securities in which the risk element is negligible, particularly when bought with expert and conscientious advice. Widespread dispersal of the ownership of Canadian business is most desirable, not only for the owner's monetary welfare, but for its effect on their thinking and on their understanding of how our business system operates.[1]

Advocating such wide ownership of securities is one thing, bus discussing "riskless" securities is quite another. If the evil we are facing is a shortage of equity capital for new and untried enterprise, selling "General Motors common" to the proletariat is unlikely to remedy the difficulty. This line of reasoning leads us to wonder whether or not the persons who are most worried about this "shortage of equity capital" are not worrying about something entirely different, that is, the fact that there is considerably less speculation in existing securities to-day than the financial community would like. It is wise, therefore, to differentiate sharply between the problems of a shortage of equity capital and a lack of exchange activity. It is quite possible that the investment and brokerage businesses are overexpanded. It is to be hoped that if this is true, the adjustment won't be in the nature of greater inflexibility in the economy.

Assuming the problem of risk investment to be valid, we can whole-heartedly support those who advocate tax relief for new enterprises, either by reduction of the corporate tax or through further concessions on the personal tax level. Yet it must be remembered that this advocacy of tax relief

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[1] <u>Financial Post</u>, April 23, 1949, p. 1.

is reminiscent of the arguments advanced in favour of tariff protection for new industries. Once an industry has secured such tariff aid, it may develop an infantile outlook which prevents it from reaching to adult responsibility. However, since tax relief would be general, the risks of abuse would be less than if aid were granted to particular industries, as in the case of tariffs.

Legislation and Control

The protection for the investor is provided in a great variety of statutes, such as the various companies acts, the securities legislation of the provinces and the criminal code (especially in regulation of fraud and manipulation). Admittedly, the market has come a long way since Manitoba passed its "Sale of Shares" Act in 1912; but as an indication of the market's ability to resist regulation, it is well to note that not until 1930 did Nova Scotia, Quebec and Prince Edward Island pass legislation to regulate security dealings. McEachern, after noting the difficulties which legislators face in drawing up such bills in defining profit, acceptable amounts of sale pressure, appropriate risk, etc., says:

> In its essence, therefore, securities legislation and administration is an attempt to codify and enforce a community conscience about these things.[1]

At present, the chief source of irritation in the legal phases of the market is the lack of integration among

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[1] McEachern, op. cit., p. 232.

the laws of the various provinces. The Financial Post, editorializing on this problem, stressed the necessity for Ontario to maintain strict control of her markets on the basis of adequate legislation, since it is in this province that most of the stock issues originate. It is necessary that the other provinces have confidence in the efficiency of the Ontario mechanism of control. "In the past, at least," said the Post,[1] "there has not always been that confidence.[2] It must be established firmly before there can be any real hope of the other provinces entrusting the main job to one province."[2]

In addition to control by governmental agencies, there are regulatory bodies within the market itself. We mentioned the regulating activity of the exchanges. Similar control is exercised by the Investment Dealers' Association, which can examine firms of which the financial position is suspect. All members must submit to an audit at least once a year.

It is indicated, however, that much is still to be done in assuring a minimum standard" of honesty in security

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[1]June 11, 1949, p. 6.

[2]As an example of this lack of confidence consider the following statement by J. S. Smith, British Columbia superintendent of brokers: "One man recently granted an Ontario brokerage license had as his qualification the fact that he had been for five years promotion manager of a clothing firm." Financial Post, July 23, 1949, p. 1.

dealings of all kinds. Perhaps the words of the <u>Report of the Royal Commission on Price Spreads</u> should guide those persons active in regulating the market and its activities.

> We have, indeed, no right even if we had the desire, to take away from the citizen "his inalienable right to make a fool of himself". We do, however, feel that we have the right to attempt to prevent others making a fool of the citizen.[1]

[1] <u>Report of the Royal Commission of Price Spreads</u>, <u>op. cit.</u>, p. 38.

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