Scotiabank's Submission to the Competition Policy Review Panel

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"There must be a far greater recognition of consolidation and other processes of global commerce in our domestic policy. As a smaller economy, we have to play to our strengths, build on strategic sectors and focus on priority markets."

January 10, 2008

Scotiabank

Executive Summary

This submission provides Scotiabank's response to the Competition Policy Review Panel's consultation paper, *Sharpening Canada's Competitive Edge*. We believe the competitive challenges facing Canada are significant and that tackling these challenges should be a key priority of both government and business. Having built a strong macro-economic framework, we need to do more than "sharpen the edge." Canada needs to orient a range of policies – market structure, competition, investment, trade – toward strategic sectors and the ability of firms to succeed as truly global competitors in international markets. At the same time, Canadian businesses need to be more aggressive in their pursuit of growth opportunities abroad. Too many corporations are overly focused on the domestic market.

We comment on each of these elements – competition, investment and trade – based on our history as one of Canada's largest companies and its most international bank, operating in some 50 countries worldwide. We have experience competing against the world's largest banks, some of which are from home markets smaller than Canada's.

Our recommendations, based on the lessons we have observed, are both guiding principles and specific policy changes – all of which are aimed at encouraging a more aggressive approach by government and business, working together to build on Canada's strengths in international commerce, just as other smaller economies have done to create global corporations. Canada's immediate and future economic prosperity depends on a corporate base that creates and maintains internationally successful corporations.

The importance of this is underscored, not by debate over annual investment inflows and outflows, but by whether Canada is succeeding to the extent that it must in the process of globalization. We believe it is imperative that Canadian corporations gain scale through mergers and acquisitions, and that the head offices of large, internationally focused corporations stay in Canada.

Canadian businesses cannot ignore the competitive advantage that scale provides, and truly global scale cannot be achieved unless Canadian firms participate in the global consolidation taking place across sectors. By doing so, the head offices of large, internationally oriented corporations will remain and grow in Canada, bringing considerable economic benefits, not the least of which are high-paying jobs, international management expertise, tax revenue and indirect employment for various supporting services. It is far harder growing mid-sized companies into the top tier than it is supporting the success of the ones already there.

To accomplish this, we must act now. Structural changes in key sectors have been set aside for years, and further delay increases the risk and uncertainty already imposed on Canadian corporations. We urge the panel to focus its attention on actionable next steps. There must be a far greater recognition of consolidation and other processes of global commerce in our domestic policy. As a smaller economy, we have to play to our strengths, build on strategic sectors and focus on priority markets.

Open and supportive legislative and regulatory regimes that provide operating flexibility matter more than ever. Corporations must be free to act and react quickly. Policy must take a long-term perspective to opening all sectors toward international competition, with appropriate transition periods for adjustment. Above all, a global perspective is essential, so that legislation and regulation is assessed in terms of global standards and practices to ensure a level playing field for Canadian corporations with our international competitors.

In the case of our own sector, financial services, we recommend that the government eliminate the specific ownership limits in banking and rely on the minister's discretion (fit and proper test) to assess foreign bank investment. Through this approval process, Canadian control over the Canadian banking system will be maintained, although an individual transaction may be permitted that is in the national interest.

Similarly, we recommend that the government allow direct branching for foreign banks that wish to accept retail deposits in Canada, on the conditions that prudential controls can be maintained through other means and that the home jurisdictions of foreign banks are similarly open to direct branching.

Before the banking sector is open to foreign acquisition, we believe it is critical to allow Canadian banks to re-structure and adjust, including the option to merge. In so doing, Canadians can rest assured that any proposed bank merger will be judged by standards that are significantly higher than those in other jurisdictions.

We urge the panel to examine differences in Canadian corporate and securities policies and practices compared to other jurisdictions to limit their impact on Canadian competitiveness. A level playing field in the market for corporate control seems to be an obvious goal, and we identify areas we believe need particular attention.

Finally, we ask that the current trade and investment focus of the federal government on the Western Hemisphere become a sustained and long-term strategy to pursue markets in which Canada has a comparative advantage (e.g., related to geography, history, socio-economic policy expertise and industrial capabilities). This means a stronger push, not only in trade and investment initiatives, but across Canada's foreign policy, for more integrated relationships in North America, Central and South America and the Caribbean.

In summary, we look forward to further opportunities to contribute to the panel's work. We believe it is essential that the federal government take immediate steps to execute on its Advantage Canada plan, and that an aggressive approach is taken to linking our domestic policy framework to the realities of globalization and international commerce.

Submission to the Competition Policy Review Panel

Introduction

Scotiabank appreciates the opportunity to provide comments to the Competition Policy Review Panel (the panel) on its consultation paper. The paper sets out, in our view, the right questions to prompt an essential public discussion of economic competitiveness.

We are fully supportive of the goal of the panel, which is "to foster the development of Canadian businesses and to maximize the opportunity for Canadians to capitalize on global trade, investment and competition." We believe the panel has correctly identified that there are "domestic conditions" that affect whether Canadian firms are able and aggressive investors at home and abroad.

Much attention has been paid to factors at the macro-level, such as government fiscal policy. There are equally important factors at the micro-level, where government policy affects sectors and firms in terms of their commercial operations and investment decisions.

On the whole, the economic fundamentals in Canada – the macro-level factors – are very strong, and the government's management of these fundamentals should be commended. A stable monetary environment, a competitive fiscal framework, a transparent legal and legislative regime – all of these macro-economic factors contribute to Canada's economic competitiveness.

In today's global economy, however, those conditions are not sufficient. The public and private sectors share a responsibility to move beyond these factors to build greater industrial competitiveness. Government needs to provide a policy framework that consistently and effectively supports the international competitiveness of its key sectors. In particular, there is more work to be done on micro-economic policy and regulation that affect market structure, competition, investment and trade. At the same time, business needs to more aggressively pursue growth opportunities abroad, as too many corporations across sectors are still too strongly focused on the domestic market.

The federal government has issued an economic plan, *Advantage Canada*, that provides the right framework going forward. In addition to identifying a reduction in business taxes, it focuses on:

- improvements to the regulatory and competition frameworks,
- a leading-edge financial system, and
- greater openness to trade and investment.

We urge the panel to focus its attention on actionable next steps in these priority areas to assist government in the execution of *Advantage Canada*, and we urge the federal government to move quickly to improve policies that support our country's international competitiveness following the report of the panel.

In this submission, we draw on our experience as an international bank based in Canada, operating in some 50 countries. We focus our attention on the key elements of *Advantage Canada*, particularly policies affecting investment. We have seen the tremendous value of an international orientation. We are always looking for opportunities for investment to strengthen our capabilities in Canada and to grow in international markets. We believe the two go hand in hand: a strong Canadian base is essential to our growth in foreign markets and our future truly is in international growth. The future is global, not only for the Bank, but for the sector and for the country.

As a member of the Canadian Bankers Association, we have contributed to, and support, the submission it is providing the panel. Our submission complements the CBA's by focusing on the following specific areas:

1. Guiding principles based on Scotiabank's international experience
2. Inward investment policy and sectoral investment regimes (Questions 1 and 7)
3. Headquarters and policies to support the growth of Canadian companies (Questions 2 and 6)
4. Competition policy (Questions 12)
5. Canadian outward investment policy/Trade policy (Question 4)

Scotiabank also looks forward to an opportunity to contribute to the panel's work beyond this submission.

1. Guiding principles

From our perspective as an international bank based in Canada and our extensive experience competing against the largest banks in the world in key markets, in particular throughout this hemisphere and in Asia, several principles can be identified that contribute to international competitiveness:

1. Canada must identify, support and play to its strengths. Our country has a relatively small domestic market without the clout and natural international recognition of much larger economies. Canada must build on its key strategic sectors and focus on its priority markets.
2. Given the pace of change in global markets, opportunities must be seized today. Canadian governments and businesses must be more aggressive.
3. Government must act with a long-term planning horizon so that strategic adjustments can be made with appropriate transition periods for the private sector.
4. Flexibility in the regulatory environment that allows corporations to act and react quickly is critical. Open and supportive legislative and regulatory regimes that provide operating flexibility matter more than ever.
5. A global perspective is essential, especially with respect to markets and scale. Legislation and regulation must be assessed in terms of global standards and practices to ensure a level playing field for Canadian corporations with our international competitors.

We are at a critical juncture in the course of economic globalization. Canada can and must seize the opportunity to build, grow and acquire global businesses.

With these principles in mind, we turn to specific questions raised in the consultation paper and our recommendations.

2. Inward investment policy and sectoral investment regimes

Panel Question #1: *"Should Canadians be concerned about foreign takeovers of Canadian firms?"*

Globalization has been the dominant economic trend of the past half century, and it will continue to be a powerful force affecting all nations, companies, and individual workers for the foreseeable future. Adjustment to globalization is one of the most critical strategic policy challenges of our time.

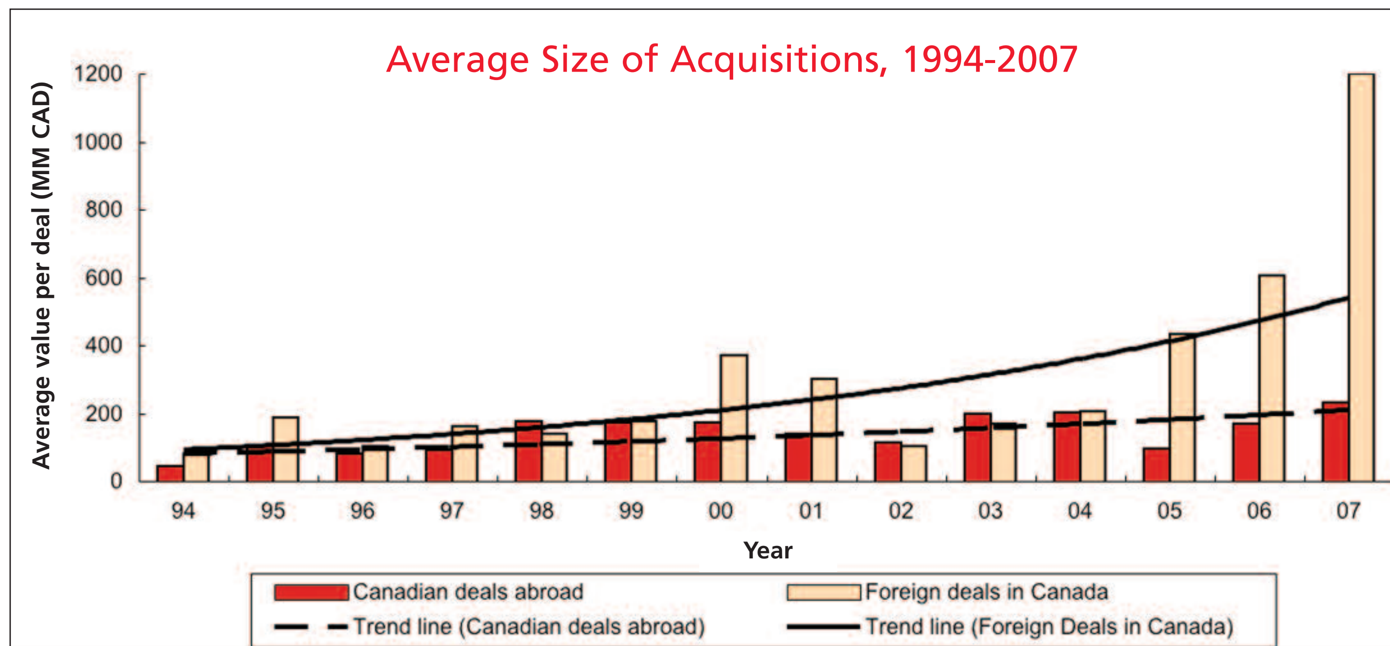
One of the recent effects of globalization has been to draw attention in Canada to the net loss of large corporate icons – the debate on the "hollowing out" of corporate Canada. Much of that debate has focused on annual inflows versus outflows of investment. In our view, given that there will always be shifts in the country's net investment position in any one year, this should not be the focus of attention.

What is more important is how, as a country, we are adjusting to and succeeding in international markets as they globalize. The panel's consultation paper has helped re-orient the focus along these lines. The country needs to turn its attention to the measures that need to be adopted to strengthen Canada's standing in the global economy – irrespective of one's personal views on whether, or how quickly, hollowing out is occurring.

In this context, we believe it is important to highlight two issues that have a significant impact – the size of acquisition deals and the value head offices bring to cities and national economies. It is striking how little research exists in Canada on both counts, and we believe a good understanding of these issues is essential to guide a proactive public policy on international competitiveness. We encourage the panel to consider the work SECOR Consulting (of which we're a sponsor), the Conference Board and others are doing on these and related topics.

For the purposes of this submission, we provide some comments in this section on the size of acquisitions, and we provide comments on the value of head offices in section 3.

To answer the question posed in the consultation paper, we believe Canadians should only be concerned with foreign takeovers to the extent that it is symptomatic of our failure to participate and succeed in the global process of consolidation. Based on the information the panel provides in its consultation document, Canada consistently acquires relatively small companies abroad while losing relatively large ones to foreign acquirers.[1] Indeed, for the last 14 years, Canada's 4,329 acquisitions abroad were, on average, less than half as large as foreign acquisitions in Canada. For the last three years, the average acquisition in Canada was more than four times bigger than the average Canadian acquisition abroad. In 2007, the average foreign acquisition in Canada was more than five times bigger than ours abroad. The following graph shows average deal sizes over the last 14 years, as well as the growing imbalance between the trend lines (exponentially smoothed).



Considering how volatile annual M&A activity is, we are struck by the remarkable consistency in the fact that foreigners acquire larger companies in Canada than Canadian companies acquire abroad: in only three years (1998, 2002 and 2003) were Canadian acquisitions abroad on average (slightly) larger than foreign acquisitions in Canada.

[1] Competition Policy Review Panel, *Sharpening Canada's Competitive Edge* (October 2007), p. 39.

We believe that Canadians must reconsider questions pertaining to scale in a global rather than strictly Canadian framework, and ask if we are currently equipped to reap the full benefits of globalization and consolidation. As it stands, Canada's biggest companies are significantly smaller than companies that are leading consolidators and have their eyes on our biggest companies.

To illustrate, the *Financial Post*'s Special Issue "FP500" (June 2007) ranked Scotiabank as the country's 10th largest public company (measured by revenue) and as the third-largest (measured by assets).[2] Royal Bank was ranked as the country's biggest public company on both measures. But, on a global scale, Canadian banks are small. Some of the biggest global banks are now bigger than all five Canadian "big banks" combined. In the same FP500 ranking, Alcan ranked as the country's seventh-largest company (measured by revenue) – just about the size to attract interest from much larger foreign consolidators.

Projected into the future, the recent trend suggests that Canada could become an incubator for global companies – making acquisitions at a relatively early stage in the global growth game, growing those companies while under Canadian control, and finally losing them to global giants that are generally much larger than Canada's biggest companies and much better positioned to be acquirers in the global marketplace. Based on our experience in growing our global operations and the benefits we've seen in terms of head office employment, this trend is not going to be to Canada's long-term advantage.

This holds true for the financial sector generally. We agree with the government's views in *Advantage Canada* that Canada's financial system will need to adapt to "global developments such as consolidation of institutions and exchanges."[3] *Advantage Canada* notes that Canadian financial institutions are among the most international companies in our economy, and that Canada must build on this strength.

We believe public policy must be informed by a deep understanding of consolidation and other developments in the global economy. It must take a strategic and long-term perspective so that Canadian strengths are enhanced. We are of the strong opinion that protectionism is not the answer. It is not constructive. It is regressive. Instead, Canadian policy must be framed in global terms, and include a clear emphasis on an environment that enables our companies to effectively compete in globally consolidating markets.

Panel Question #7: *"What changes, if any, are required to Canada's sectoral investment regimes to minimize or eliminate negative impacts on Canada's competitiveness (with focus on financial services)?"*

Canada will be in a better position to win in global markets if we gear our policies toward a deliberate transition to full and open competition. Canada's companies and governments must work together to turn the recent foreign acquisition binge involving some of Canada's biggest and best companies into a positive inducement for corporate Canada to become more aggressive international acquirers.

Advantage Canada is accurate in noting that "the policy framework must also support the global development of our financial services industry so that it may realize fully its potential and maximize its contribution to the Canadian economy."[4] To be consistent with this objective, Canada should look to eliminate the sectoral investment regime in financial services. Despite concerns that have been raised in the past about the need for this regime, such a move is fully compatible with the principles of Canadian ownership and government control over the sector. In addition, it would bring Canada in line with the practices of most other jurisdictions and, combined with removal of the subsidiary requirement for foreign bank entry, would raise the level of competition in the Canadian market.

[2] Financial Post Business Magazine, Special Issue, *FP 500: Canada's Largest Corporations* (June 2007), pp. 52-53.

[3] Government of Canada, *Advantage Canada* (2006), p. 82

[4] Government of Canada, *Advantage Canada* (2006), p. 82.

Specific sectoral ownership restrictions in financial services are generally not practiced in foreign jurisdictions. As currently conceived in Canada, the ownership regime is a "belt and suspenders" approach. Like governments in other jurisdictions, authorities here have the right to review large bank mergers and to maintain control/sovereignty with the "fit and proper" test. However, in addition, and unlike most other jurisdictions, the government of Canada maintains formal ownership restrictions that prevent foreign banks from acquiring more than 20% of the voting shares and 30% non-voting shares of Canadian banks.

Although the minimum equity level in relation to the application of these restrictions was recently raised to $8 billion from $5 billion, this policy effectively prevents the largest players in financial services from being open to foreign acquisition.

When combined with the residency requirements for members of boards of directors, this creates a disincentive for investment compared with what is a fairly open sector in some competitor markets.

The IMF, in its recent report on Canada, states that this restriction prevents potential competitors from entering the market on a large scale through the acquisition of existing networks. It echoes our recommendation to eliminate barriers to acquisitions:

> "Reducing barriers to acquisition of large banks, including foreign entities, would foster contestability and innovation in the financial system.[5]"

We believe the formal ownership limits should be eliminated along the lines recommended by the Task Force on the Future of the Canadian Financial Services Sector. This task force reported almost 10 years ago that the objectives served by wide ownership – Canadian control and the separation of finance and commerce – continue to be valid objectives. They argued that while the sector should remain Canadian-controlled, it does not follow that every major institution must be Canadian-controlled. They recommended that additional flexibility in the ownership policy be considered to achieve national policy interests.

One example might be where a major Canadian financial institution faces financial difficulty. Another might be when a major bank is unable, for reasons of capital or other business constraints, to expand its business in Canada even though it might add an important competitive force. In either case, the minister of finance should have the flexibility to allow a transaction that maintains the benefits of a Canadian-controlled financial sector, while furthering objectives of safety and soundness or enhanced competition. The task force recommended that the government should have the power to approve the acquisition of a large Canadian institution by a widely held, regulated foreign financial institution.[6] We agree, and we believe the "fit and proper" test – without the formal ownership restrictions now in place – provides the minister with this flexibility.

A reliance on the fit and proper test would have the following benefits:

1. It would give the federal government the flexibility to allow a merger/foreign acquisition if it is in the national interest. If a foreign acquisition was considered, the Canadian government would still be able to maintain control and sovereignty over the Canadian banking system (e.g., by concluding that similar moves would no longer be in the country's interest).
2. It is consistent with global practices, where national and prudential interests are protected through regulation and supervision. In addition to the minister's discretion when approving a takeover, the government asserts considerable influence and sovereignty over its financial system through its supervisory powers. Banks are unlike other corporations in terms of the amount of regulation and supervision applied to them. There are countless mechanisms and opportunities for governments to

[5] IMF, "*Canada – 2008 Article IV Consultation, Preliminary Conclusions of the IMF Mission*" (December 17, 2007), para. 15.

[6] Task Force on the Future of the Canadian Financial Services Sector, *Report of the Task Force: Change, Challenge, Opportunity* (September 1998), p. 87.

assert their authority over banks, regardless of their nationality. Our long experience (more than 100 years) as an international bank operating in some 50 countries around the world is that regulatory measures, along with moral suasion, have been effectively practiced by governments regardless of ownership, and that this will always be a characteristic of the financial system.

3. It would bring Canada into line with the dominant practice of most jurisdictions by eliminating one of the most frequently cited "protections" afforded Canadian banks, and it would potentially open up the sector to more competition. It would allow Canada to have a consistent and coherent approach to open trade with other markets.

Clearly, as alluded to by the panel, governments manage investment in their largest domestic institutions and many countries are careful to ensure all of their top banks do not fall to foreign acquirers. However, cross-border mergers among the largest banks in the world are occurring, and most jurisdictions are open to this possibility. For example, England's sixth-largest bank, Abbey National, was bought by Spain's Banco Santander in 2004. Germany's second-largest bank, Hypo & Vereinsbank (HVB), was acquired by an Italian bank, UniCredit Group, in 2005. At roughly the same time, Italy's central bank came under extreme pressure for its attempts to shield one its banks, Banca Antonveneta, from foreign acquisition. In the end, it was acquired by the Netherlands' second-largest bank, ABN AMRO, which, more recently, was acquired by a consortium of foreign banks in 2007.

Canadian financial institutions such as Scotiabank will continue to look outside our home market for acquisitions. In fact, as Canada's most international bank, we have aggressive growth plans in international markets, and we are constantly investigating acquisition opportunities. As Canadian financial service companies become increasingly active in foreign markets, the regulatory regime and any perceived restrictions to foreign banks will come under increasing scrutiny. Restrictions, such as Canada's ownership limits, work against Canada's interest in opening foreign markets to Canadian investment. It is not sustainable or beneficial for Canada to maintain a policy that prevents acquisition here while pushing for increased access to markets abroad.

Along the same lines, we recommend that the government consider the elimination of the subsidiary requirement for foreign banks in Canada – so long as OSFI's prudential considerations can be addressed through other means. For years, the subsidiary requirement has been cited as a barrier to competition in Canadian banking, as it discourages foreign banks from accepting retail deposits because of the cost of setting up a separately capitalized subsidiary. As a result, this requirement is said to "protect" Canadian banks from competition.

The requirement may serve valid public policy objectives such as prudential control; however, if there are ways to achieve the same objective through other means that are less onerous and not seen to be protectionist, they should be pursued. In our international experience, we have encountered this requirement and we would benefit from its removal in those jurisdictions. Canada should lift or replace the requirement on a reciprocal basis with other markets where it has been eliminated and press harder with other countries, including the U.S., to reach a similar compromise.

Overall, by eliminating the sectoral protections in financial services, Canada's government would maintain supervisory and regulatory control over the sector and over the merger and acquisition process. It could increase the competitiveness of the market and it would maintain the legitimate goal of Canadian ownership of the banking system (which, as in other jurisdictions, does not imply that *all* banks have to be Canadian owned).

3. Headquarters

Panel Question #2: *"How important are company headquarters to Canada's economic prospects and ability to create jobs and opportunity for Canadians? How important are global divisional head offices? What factors influence their location?"*

As an international bank headquartered in Canada, we have firsthand knowledge of the value head offices provide cities and countries. As we have stated previously, we believe that, in addition to the individual experiences of Canadian corporations, there is a need for research and broad-based evidence regarding head offices in Canada in order for the panel to consider this question. The work of SECOR Consulting and the Conference Board of Canada should be important contributions in this regard.

Our experience suggests that Canada's head office count is only one dimension and, more importantly, that the head office's size, decision-making power, and presence of corporate-level support functions are critical. Some observers have pointed to the fact that the headquarter count in Canada has grown in recent years, reducing or eliminating the concern over hollowing out. For example, a Statistics Canada report notes that, "between 1999 and 2005, foreign takeovers in Canada had a small but positive effect on the number of head offices and head office employment."[7] However, in our view, both the size of the companies and the type of headquarters involved are more important than the aggregate count.

From our own operations in Canada and abroad, we know that there can be significant differences between types of "head offices." While "global divisional" head offices, noted in the consultation paper, may have the decision-making authority to operate on a global mandate, this is not always the case. In many instances, divisional head offices are regional and quite distinct from several functions in the corporate headquarters. For instance, there are more than 7,000 employees in our Toronto head office compared to the 128 staff in our Asia Pacific head office located in Hong Kong.

The difference in size is significant, and helps explain our view that even a large number of divisional head offices may not replace the loss of a single home headquarters of a large cap Canadian company. While "head office" employment may increase in aggregate in Canada, the real question is whether the employment is in key functions and part of the critical mass of a fully functioning corporate headquarters. Some head office jobs may be "kept" following a takeover, but the value of the corporate head office may nonetheless be lost.

A large part of the value of head offices derives from the real decision-making power that is concentrated geographically in the location where the CEO, the board of directors and the executive management work. Our executive team in Toronto is backed up by hundreds of jobs classified as "management" and "senior management," and several support functions that work centrally from Toronto for our global operations – including such departments as Accounting, Finance, Global Risk Management, Global Transaction Banking, Compliance, Legal, and Economics (a total of some 2,000 jobs). These departments generally employ very highly skilled and well-paid workers.

There are many benefits to the economy from this type of employment, beyond the obvious tax revenue. There are spillovers in terms of knowledge and employment for related suppliers and professional services firms, educational links, and international managerial experience that returns to Canada. The clustering of supporting industries – e.g., law firms, consultancies, accounting companies and IT firms – is far more likely and significant around the corporate head offices of large multinationals. This is the "multiplier effect" of head office jobs that has been demonstrated to be significant in the case of financial services firms in Canada.[8]

[7] Statistics Canada as quoted in the Toronto Star, *Hollow Times for Corporate Canada,* (June 25, 2007).

[8] See, for example, The Boston Consulting Group, *Financial Services at the Crossroads: The Current and Potential Role of Financial Services in the GTA"* (1997), esp. p. 13 and pp. 20-21.

Headquarters usually have their primary stock listing where they are located and they generally like to be close to the source of financing. Consequently, the loss of head offices can lead to significant loss of business for financial services companies. As companies globalize, of course, they seek financial services providers that operate in the markets where they have operations and/or seek a secondary listing. For this reason, some of Canada's largest companies turn to foreign banks that have the scale to serve their needs. A recent example was Alcan's acquisition of Pechiney, for which none of the Canadian banks proved to have adequate scale to win the financing.

Another measurable way in which the presence of the CEO and senior management contributes to the local economy is philanthropy. Our executive team is involved in numerous ways in charitable endeavours, and we spend 75% of our charitable budget in Canada (significantly more than the proportion of our operations in Canada).

Financial sector senior executives are also high-calibre members of boards of directors (in short supply in Canada) and university advisory committees (benefiting the teaching curriculum). One very topical example is Toronto's objective to build a global centre of excellence in financial services education – a goal our executive team supports by volunteering time, input and strategic advice that is critical to this endeavour.

More generally, we are enthusiastic supporters of the idea that Toronto could become a financial services hub that ranks among the best in the world (Toronto is currently ranked #13).[9] Predictably, we are not the only the city in the world with this objective. Cities such as Chicago (ranked #8), Sydney (ranked #9), Tokyo (ranked #10), Paris (ranked #11), Boston (ranked #12), San Francisco (ranked #14) and Dublin (ranked #15) are all working hard to climb the ranks. Many take the same sort of strategic approach that we are recommending to supporting and building their financial services sector.

In addition, globalization has led to new players entering the worldwide competition for financial services business. Banks from emerging markets (i.e., China, Russia, India, Brazil, South Korea) have recently surpassed some Canadian banks in the global rankings. The rise in rankings of new financial service hubs, driven by the growth of new globally ranked financial services firms, should also be taken into account.

On this point, we welcome the efforts of the federal and provincial governments to work in their areas of jurisdiction to improve the business environment for financial services, but there is more that can be done – moving beyond statements of purpose to actual strategies and actions that are aimed at developing strategic sectors. To take one example, there is a clear trade-off for competitiveness when governments fail to eliminate punitive capital taxes applied exclusively to financial services firms, notwithstanding claims that governments are interested in developing globally competitive financial institutions. Such a tax is currently applied federally as well as in most provinces (e.g., although Ontario has accelerated the elimination of its capital tax on manufacturing to 2008, it is retaining it for financial institutions until 2010). The issue is not whether a government can afford to eliminate a capital tax, it is whether it can afford to apply one, given the competition to attract capital and the economic benefits that stem from it.

Overall, we strongly believe that Canadian policy must be aimed at fostering globally competitive sectors and companies – and that the corporate head offices of such firms will play a critical role in Canada's future economic prosperity. To this end, we support the work of SECOR Consulting and the Conference Board, which will shed greater light on the qualitative benefits of maintaining the headquarters of large cap companies in Canada.

[9] City of London, *The Global Financial Centers Index 2,* (September 2007), p. 11.

Panel Question #6: *"What changes to the ICA and Canada's investment review regime would help Canada address the challenges and complexities of the modern global economy, within the constraints of Canada's international obligations?"*

We support the government's review of the Investment Canada Act (ICA). We concur that the complexities of the issues raised are considerable and discuss below recommended actions to address existing disparities in the legal framework governing poison pills, M&A review periods, and the legal liability for directors. Our observations stem from our experience with the boards of publicly traded companies in Canada.

We understand that some of the issues we raise involve provincial securities laws and would have to be addressed by several layers of government within Canada (or as part of a single national securities regulatory regime for Canada). We point to three key discrepancies:

1. Several foreign jurisdictions give their companies the right to adopt indefinite poison pills (making themselves essentially immune to takeover). By contrast, Canada has one of the most liberal regimes, in which it's a matter of when, not whether, a poison pill will have to be dropped. The results were illustrated in the Alcoa bid for Alcan – where Delaware law protected Alcoa by permitting indefinite poison pills to guard from hostile takeover, while no such rights were available to Alcan.
2. Foreign jurisdictions also have the flexibility to extend the M&A review period, whereas this does not appear to be a factor that is considered by Canadian authorities. For example, the European Union extended its review of the friendly Inco-Falconbridge combination – making it one of the longest in recent memory. But Canada did not extend its review of the hostile Xstrata-Falconbridge bid, which was a dynamic that eventually contributed to the CVRD-Inco acquisition. We believe that the government of Canada should have the authority under the "net benefit" test to extend the review period in an effort to explore (possible) options that may be of greater net benefit to Canada than those bids already on the table.
3. The government of Canada should also consider whether Canadian directors of publicly owned companies are on a level playing field with foreign directors when it comes to legal liability around hostile foreign takeovers. For example, the Ontario Business Corporations Act subjects directors to legal liability (in the form of class action suits) if they fail to observe the dual obligation to:
    - act in "the best interest of the company" (i.e., support the superior bid, even if hostile); and
    - not engage in conduct that is "oppressive or unduly prejudicial to or that unfairly disregards the interests of any security holder, creditor, director or officer of the corporation."[10]

In the case of a hostile takeover, the focus is exclusively on the short-term interests of shareholders rather than the longer-term interests of the company, even when the shareholder base has shifted substantially over the course of the company coming into play.

While such laws benefit shareholders, they can discourage directors from resisting foreign takeovers and considering the broad implications of a particular bid. This has clearly been the case in Canada, where there are few, if any, instances where a board has chosen, following a proper review of a takeover bid, to let management continue with its strategy.

[10] Ontario Business Corporations Act, 134 (1) (a); 136 (1) (a) and (4) (b); 161 (1) (b); 207 (1) (a) (iii); 248 (2) (c).

4. Competition Policy

Panel Question #12: *Does Canada's approach to mergers strike the right balance between consumers' interest in vigorous competition and the creation of an environment from which Canadian firms can grow to become global competitors?*

We believe the panel's question is critical to Canada's business regulatory and legislative framework, and for mergers in particular. The panel has identified a key relationship between two critical aspects of the public interest: vigorous competition and the growth of global competitors. We believe a balance can be struck and, in fact, must be struck between these elements, and that they can be mutually beneficial. In answering the question posed by the panel, we will review the issue of consumer protection in the context of the business imperative of scale. We'll then offer our views on the merger review process and the need for bank mergers in Canada.

During this period of unprecedented corporate consolidation, scale is a driving factor of international competitiveness. Whether through organic growth, mergers or acquisitions, Canadian corporations need a policy environment that allows them to gain the scale to be globally competitive.

The need for scale, however, does not run counter to the need to ensure consumer protection through vigorous competition. In fact, the regulatory regime can manage both interests – promoting growth and vigorous competition. Globalization and the Internet have propelled an increase in both scale and cross-border competition. On the one hand, scale and competition have led to advances in research and development, technology, efficiencies, product innovation and pricing. On the other hand, it has provided unprecedented access to markets, consumer choice and convenience, vastly improved consumer information and comparison and, cumulatively, increased the economic power of individual consumers. As the process of global commerce evolves, Canada needs to adapt and succeed on both counts, at the level of the consumer and at the level of the corporation.

In the case of banking, new entrants and new business models have emerged, driven by rising individual consumer awareness and demands at one end of the market and global scale at the other end. It was recently reported that two brothers formed a new privately owned bank in Canada that will conduct its philanthropy through individual consumer choices.[11] Commercial entities, such as Canadian Tire, now operate banks in Canada in select markets where they can apply their scale, and global competitors such as ING compete in Canada using their scale and access to consumers through the Internet.

The process of globalization is transforming banking. The effects are widespread and truly transformational in wholesale markets, and the effects are beginning in retail banking. The process will continue into the foreseeable future. If properly managed, Canadian financial institutions will find opportunities and will grow into global competitors while consumers benefit from the new competition and consumer power.

The consumer interest, of course, needs to be protected, but the key elements of Canada's financial sector policy – competition, transparency and plain language disclosure – should continue to be the principal means of protection.

Only when it is needed should regulation be used, and only when absolutely necessary – when all other means have failed and the threat of harm is real – should activity be prohibited. International competitiveness and the growth of Canadian firms into global competitors should not be set aside as a goal simply because of a perceived threat to competition. The Competition Bureau and other approval processes must be permitted to operate in order for the balance to be struck between global growth and vigorous competition.

[11] John Partridge, *New privately owned bank aims for philanthropy with profit,* (Globe and Mail, December 19, 2007).

As our economy is small, open and trade dependent, the importance of this balance increases as markets integrate and trade and investment grows. Canadians have seen global corporate consolidation sweep through a number of industries over the last few years, including mining, forestry, media and information technology. The trend towards greater scale for large multinational corporations, primarily through mergers and acquisitions, is a dominant one and a long-term reality in international markets.

As a result, the size necessary to effectively compete in international markets must be explicitly recognized in our approach to competition policy. There is no doubt that large domestic firms in Canada are small players on the global stage. The goal of building global competitors needs to be embraced and it needs to translate into policy.

Banking is a case in point. Canadian banks rank as some of the largest companies in Canada and are generally recognized by Canadians as such, but they are small in the context of global banking markets. Even with the size Canadian banks have obtained, they are not large enough to be as efficient and competitive as they could be.

Outgoing Bank of Canada Governor David Dodge has noted that, compared to our foreign counterparts, there are significant unexploited economies of scale for Canadian banks. Scale does matter and the status quo won't cut it as Canada has, over the past decade, fallen behind the consolidation that has taken place in other countries:

> "Unless regulators lift rules preventing mergers among the country's financial institutions, Canada could become increasingly less efficient and be left behind in the global economy."[12]

For the better part of the last two decades, most of our major international competitors have been regulated under regimes where there is no direct review of merger transactions by national legislatures. Most countries, including other small, open economies, such as Switzerland, Belgium and the Netherlands, have regulatory frameworks that allow and, in fact, encourage the formation of large globally competitive banks headquartered there, as well as complementary local and regional banks.

The same approach is needed in Canada, where domestic banks have an opportunity to gain the scale needed to be internationally competitive, while the Canadian market benefits from the competition made possible by international financial institutions with the scale to offer competitive products in Canada through the Internet and various other delivery channels.

We strongly believe that Canada should embrace international competitiveness by immediately moving to allow the process of bank mergers in Canada. An approval process that has been well studied exists for bank mergers, and it balances the interests of vigorous competition and global growth. An extensive set of criteria must be met to protect the consumer interest, in addition to the review by the Competition Bureau to ensure vigorous competition is maintained.

To better ensure that there is a balance between these two factors, there must be a better appreciation of international scale and the necessary size that entails. It needs to be acknowledged as a goal that consolidation will lead to some very large global corporations being headquartered in Canada, but that vigorous competition can nonetheless be enhanced.

[12] David Dodge, quoted by the Canadian Press (December 2006).

5. Trade Policy

Panel Question #4: *Do Canada's economic policies appropriately reflect our increased integration with the North American and global economy? How might these policies be changed to better reflect this new competitive environment?*

Canadian economic policy has recognized open trade and economic integration as an explicit goal and, in the past, Canada has made important advances at the regional and multilateral levels in the pursuit of this goal. More recently, however, Canada has lacked a strategic approach and has fallen behind other nations in its pursuit of trade relationships and its support for Canadian investment abroad in what is now a very competitive environment.

The *Advantage Canada* plan addresses this concern by announcing a new integrated approach to international trade policy that will be part of the federal government's global commerce strategy. We fully support this approach and recommend that the panel emphasize the importance of proceeding along these lines, which means focusing on key sectors and key markets in an integrated approach to trade, investment and international commerce. Investment policies geared toward the promotion of Canadian outbound investment need to be considered as part of the comprehensive support government provides to trade, investment and Canadian business operations abroad.

In this respect, we draw the panel's attention to a strategic approach to Canada's trade priorities. Based on the current status of multilateral trade negotiations, it is difficult to predict positive results soon. In the meantime, the Canadian government's determination to pursue bilateral and regional agreements is the correct one. We need to pursue our economic interests in foreign markets and to make sure that our companies are not left at a disadvantage versus other global players in international markets.

The U.S. is our most important trade partner and it is an obvious focus of Canada's trade, investment and security policy. While there is still much to be done, particularly with respect to the border, we must exploit opportunities in other markets in which Canada has advantages related to geography, history, culture, industrial capabilities and expertise. The difference in perception that exists about Canada and the U.S. in some markets can be a significant advantage for Canada. For a small market economy such as Canada, advantages over larger, more powerful global players cannot be ignored. As a result, the current focus of the Canadian government on the Western Hemisphere is critical. Free trade agreement negotiations with Peru, Colombia, Dominican Republic and the CARICOM are a strong start to what must be a sustained effort.

We also support the government's use of a broad range of trade and investment instruments, and appreciate the opportunity to consult with the government on its trade priorities as well as the agreements it is negotiating. This collaboration is part of a larger dialogue and close working relationship that is essential for Canadian companies competing on an international basis.

Similarly, on a regional level, where economic integration evolves more quickly and can be pursued more aggressively, we appreciate the consultative approach that is taken between the public and private sector. As the panel examines factors affecting the international competitiveness of Canadian firms and the Canadian economy, it is also instructive to examine factors affecting competitiveness at the regional (e.g., NAFTA) level. The creation of the North American Competitiveness Council (NACC) is a positive step in this regard. It facilitates public-private consultation on issues of competitiveness and it allows for a strategic, longer-term approach to improving regional competitiveness.

We believe a key issue for the panel to consider in terms of the increasing integration in the North American and global economies is regulatory convergence. The *Advantage Canada* plan states that action should be taken to make regulation more competitive through the adoption and mutual recognition of international standards. While there is clearly a regional dimension to this convergence that we encourage the Canadian government to pursue, we also point to the increasing number of global standards impacting Canadian firms operating in international markets.

The cumulative effect of small differences can be debilitating, and this includes not only differences in the letter of the law but the judgments that are used to apply the rules by regulators. As an international bank, we are aware that international convergence occurs through common standards, such as Basel II and International Financial Reporting Standards (IFRS). Nevertheless, there are differences in the way in which countries interpret and enforce these standards. Canada's lead regulator, the Office of the Superintendent of Financial Institutions, has stressed the importance of "competitive" rules, which mean:

- Our regulatory regime must not disadvantage Canadian financial institutions. Competitive rules also mean rules that are flexible, up-to-date, and able to change quickly when circumstances warrant.
- The judgments used are reasonable and similar to the judgments that would be applied elsewhere.
- Regulators consider adopting the approaches of others and preserving differences only in the relatively few areas where differences matter most to Canada for policy reasons.[13]

In addition to the work being done through the Security and Prosperity Partnership, the fact that policymakers from different Canadian government agencies have close contact with their counterparts in different countries to discuss issues of common concern is a healthy practice that should continue being fostered, particularly with key strategic markets in the hemisphere. This exchange is particularly useful at early stages of the rulemaking process, because it provides information on what other governments are doing. In this sense, international working groups made up of public and private representatives are useful initiatives that, in addition to bringing a practical perspective to a policy issue, allow for the exchange of best practices among different countries and opportunities for complementary expertise and exploring the possibility of recognizing other parties' standards. We should continue working towards promoting business practices that support regulatory convergence on a regional basis.

It is also time for Canada and its NAFTA partners to turn to longer-term strategic priorities for the region. The NACC is one forum for this discussion to take place. Such a discussion should include stretch goals; for example, a customs union. Convergence on customs would reduce the costs and obstacles of doing business in North America and facilitate further economic integration.

The creation of a customs union would require the negotiation and implementation of a common external tariff on third-country imports. Other key components include harmonized external trade policies, a revenue-sharing agreement for the customs duties collected at the external border, and compatible customs procedures. Ultimately, these measures require sustained and supportive political involvement.

A customs union would bring North American laws and regulations closer to a single economic market. Economic research shows that the benefits of such a union outweigh those of a free trade agreement. Establishing a common tariff and phasing out the rules of origin would result in simpler, uniform border procedures for goods coming into North America and free movement of goods and the necessary service personnel inside North America. A longer-term planning horizon on issues such as regulatory convergence, while difficult to accomplish politically, is nonetheless the approach Canada needs to take to its international competitiveness and its integration into global markets.

[13] Nicholas Le Pan, *A Financial Regulator's Perspective on Evolving North American Markets,* (Financial Services Institute, May 21, 2002), p.2.

Conclusion

In summary, we wish to emphasize that Canada needs to orient a range of policies – market structure, competition, investment, trade – toward strategic sectors and the ability of firms to succeed as global competitors in international markets. At the same time, Canadian businesses need to more aggressively pursue growth opportunities abroad, as too many are focused solely on the domestic market. And the time to act is now. We cannot ignore or shield ourselves from globalization – we need to actively engage in it; otherwise, we risk losing the head offices of large, internationally oriented corporations, and the considerable economic benefits they bring to our economy.

A summary of our recommendations follows. We appreciate the opportunity to provide this input and look forward to additional opportunities to contribute to the panel's work.

Summary of Guiding Principles and Recommendations

- Canada must identify, support and play to its strengths. Our country has a relatively small domestic market without the clout and natural international recognition of much larger economies. Canada must build on its key strategic sectors and focus on its priority markets.
- Given the pace of change in global markets, opportunities must be seized today.
- Flexibility in the regulatory environment that allows corporations to act and react quickly is critical. Open and supportive legislative and regulatory regimes that provide operating flexibility matter more than ever.
- Government must act with a long-term planning horizon so that strategic adjustments can be made with appropriate transition periods for the private sector.
- A global perspective is essential, especially with respect to markets and scale. Policy and legislation must be assessed in terms of global standards and practices to ensure a level playing field for Canadian corporations with our international competitors.

Recommendations:

1. Regardless of how "hollowing out" is defined, Canada must to turn its attention to measures that strengthen our standing in the global economy – specifically, the size of acquisitions and the value head offices bring to cities and national economies. Research on these subjects is needed to inform a proactive public policy on international competitiveness.
2. Policy must be guided by a consistent move toward open competition rather than protectionism. Protectionism is regressive and it hinders companies from effectively competing in globally consolidating markets.
3. Before the banking sector is opened to foreign acquisition, it is critical to allow Canadian banks to restructure and adjust, including the option to merge. Canadians can rest assured that any proposed bank merger will be judged by standards that are significantly higher than the global norm.
4. Eliminate the specific ownership limits in banking and rely on the minister's discretion (fit and proper test) to assess foreign bank investment to ensure control over the Canadian banking system is maintained and that any acquisition is made in the national interest by enhancing domestic competition.
5. Allow direct branching for foreign banks accepting retail deposits in Canada, so long as prudential controls can be maintained through other means. The subsidiary requirement should be lifted for foreign banks from home jurisdictions that are similarly open to direct branching.
6. Differences between Canadian corporate and securities policies and those of other jurisdictions need to be assessed in light of the disadvantages they pose to Canadian competitiveness. Three areas need attention to ensure there is a level playing field in the market for corporate control:
   a. The right to adopt indefinite poison pills,
   b. The flexibility for authorities to extend the M&A review period and to explore (possible) options that may be of greater net benefit to Canada than those bids already on the table, and
   c. The prescribed duties of board members and their resulting legal liability around hostile takeovers.
7. Ensure that consumer protection interests are balanced with considerations of scale for international growth by all parties reviewing the benefits of mergers and acquisitions.
8. Sustain and supplement with other foreign policy measures Canada's pursuit of bilateral and regional agreements in markets in which Canada has a comparative advantage (e.g., related to geography, history, socio-economic policy expertise and industrial capabilities).

9. Expand the government's consideration of economic integration, with long-term goals for convergence within North America and the Western Hemisphere. Examples include:
    a. Consideration of a North American customs union, given the benefits of increased trade flows that would result.
    b. Accelerated and comprehensive "smart" regulation that enhances the international competitiveness of Canadian-based corporations by taking into account regulatory co-operation and convergence in North America and consistency with international standards in all cases.