Forget this TSE obsession and fix the capital markets

By Roger Martin

Lately there has been much talk in the Canadian investment and finance community about the future of the Toronto Stock Exchange. The TSE has almost become an obsession with pundits debating the relevance of a local stock market in a global financial environment. Since the TSE is so often equated with the Canadian capital market, most fear the takeover or end of the TSE would sound the death knell of the Canadian capital market, hobbling our economy.

Although the TSE's future is important, it needn't be an obsession. The Toronto Stock Exchange does not define the Canadian capital market; it is merely one component. Certainly, the economic future of Canada depends on a lot more than the presence or absence of a local stock market in Toronto.

Capital markets consist of a complex and intersecting array of mechanisms and institutions, which together create the conditions in which capital flows efficiently to the highest and best investment uses. These mechanisms and institutions include not only stock markets, but also investment banking firms; legal and regulatory frameworks and bodies; the presence of securities lawyers, venture capitalists, incubators and angel investors; ready access to financial databases and publications; and taxation structures.

In aggregate, the quality of these mechanisms and institutions determines whether a jurisdiction does or does not have a robust capital market – and with it a thriving, competitive local economy full of firms that can compete globally.

We tend to look longingly at California's San Francisco Bay Area as the most vibrant local economy in the world. In Silicon Valley, the raising and apportioning of capital is the most efficient on the planet, and the rate of new business formation is off the charts. Dot-coms, application service providers, network infrastructure suppliers and biotech firms pop up every day, well funded by the robust and indigenous capital market. It is often said that to win in the high-tech, new economy sectors, Toronto needs a capital market akin to Silicon Valley's.

But where is the valley's stock market? Certainly not in the Bay Area – not even close. Silicon Valley's stock market, the New York-based Nasdaq, is on the other side of the country – four times closer to Toronto than to Silicon Valley.

Why do we think the Bay Area's capital market is so great? It doesn't have a stock market. Nor does it headquarter the key players in traditional capital market institutions. The global investment banks – Goldman Sachs, Morgan Stanley Dean Witter, Merrill Lynch and Salomon Smith Barney – are all headquartered in New York. So are the world's leading securities law firms: Wachtel Lipton, Cravath, Swain & Moore, Sullivan & Cromwell, to name a few.

The truth is: Silicon Valley has grown an array of mechanisms and institutions that make it the most powerful capital market in the world, without the presence or even proximity of an indigenous stock market.

In Silicon Valley, the capital market epicentre is Sand Hill Road, home of a whole new breed of venture capital. Firms such as Kleiner Perkins, Benchmark, Sequoia and scores of others have taken the financing of startups to a level of sophistication not yet seen anywhere else in the world. Wilson Sonsini Goodrich & Rosati rivals any New York law practice as one of the most important commercial law firms in America. A new class of "angel investors" has taken form, and become a key institution. The law schools and business schools of UC Berkeley and Stanford attract high-quality human capital from around the world, most of whom stay in the area after graduation. Accounting companies, communications specialists and consulting firms specializing in issues affecting high-tech firms have come on stream to support the capital market activity. Now, major global investment banks and law firms are setting up shop in Silicon Valley, in part to learn how this special capital market works.

The Bay Area has the most vibrant capital market in the world not because it has an indigenous stock market but because it built a new set of capital market institutions and mechanisms that serve its businesses in a unique and powerful way. If everyone in the community had obsessed about the lack of a local stock market, or worried that all the important investment banks and law firms were 2,000 miles away on the opposite coast, Silicon Valley wouldn't have developed such a vibrant capital market.

I AM OPTIMISTIC THAT AN ENVIRONMENT CONDUCIVE TO WINNING IN THE NEW ECONOMY IS TAKING SHAPE HERE

Here at home, Canadians need to stop fixating on the TSE. Instead, we need to ask what capital market institutions and mechanisms we need to incubate a world-class capital-raising environment for Canadian firms. If we don't have them now, what can be done to encourage their creation? What role can and should the TSE play in the overall aggregate of required institutions and mechanisms?

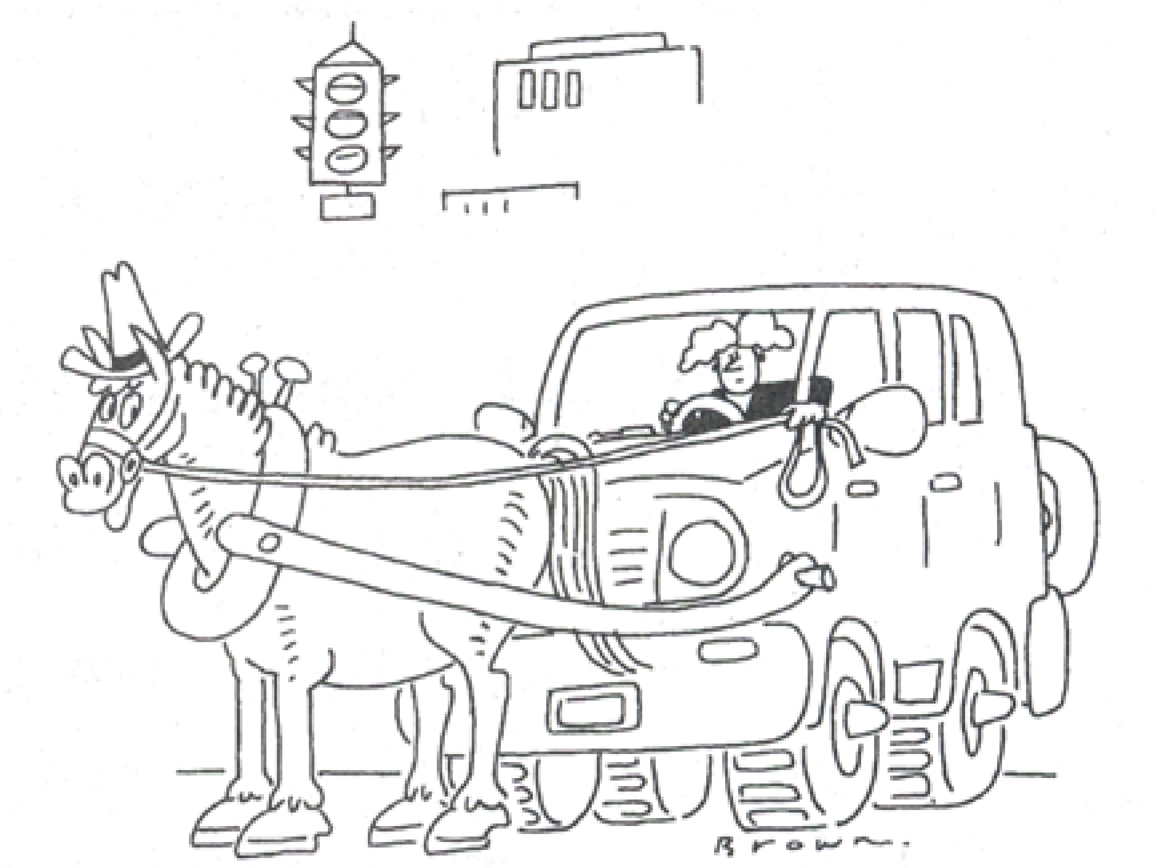
I, for one, am cautiously optimistic that a capital market environment conducive to Canada winning in the new economy is starting to take shape here. One indicator is the recent proliferation of venture capital firms aimed at flowing capital to new economy startups and supporting them. Entrepreneurs who just a few years ago had only the traditional financing sources to tap, now have Brightspark, Itemus, Mosaic Venture Partners, NRG Group, Watson Wyatt, XDL Intervest, and many more venture capital firms willing and eager to listen to their innovative ideas. Our law firms, accounting firms and investment banks are becoming more sophisticated supporters of this new capital market as well.

We are fortunate that the TSE had the foresight to fund the University of Toronto Capital Markets Institute in 1998, a joint initiative of the University of Toronto's faculty of law and the Joseph L. Rotman School of Management. The institute has undertaken, as a central thrust of its mandate, to answer the question: What capital market mechanisms and institutions must Canada develop in order to create a world-class capital market that can support a globally competitive business sector?

Two or three come to mind immediately. For example, while we now have a growing number of venture capital funding sources, we need them to generate a level of competition that matches the intensity in Silicon Valley, to ensure that entrepreneurs have sufficient choice and bargaining power. Currently, they're obliged to give up too much in the early rounds of financing, which leaves too little room for investors in later rounds when startups are close to going public. Additionally, we need to develop a more robust pool of angel investors to provide the most speculative early financing. However, these are just isolated examples. We need a much more comprehensive understanding of the workings of capital markets to ensure progress in Canada. Later this year, the Capital Markets Institute will bring together leading academics, practitioners and regulators to address this very matter and identify the research necessary to answer this and other complex questions.

If Canada is to succeed in the new economy, we need to rise above narrow, parochial questions surrounding the TSE and focus instead on the big view. The question that counts is: How do we develop broader capital markets and create a nurturing environment for engines of economic growth to develop in centres across the country? This is the way for Canadian firms to win, not only in their local markets, but within the new global economy as well.

Roger Martin is dean of the Rotman School of Management at the University of Toronto.



WHEN OIL HITS $50 A BARREL.