

Evolving Ethics — The Investment Fund Industry

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Commission*

Good afternoon. When Professor Brooks asked me to be today's speaker he said that I had been selected because I was controversial. I laughed. But his words were unsettling and I continued to dwell on what he meant and why he would describe me that way.

So when I sat down to think about what I might talk about today, I decided to start by looking in the dictionary to see what the word "controversial" meant. I immediately found that you have to know what the word "controversy" means before you can figure out what the word "controversial" means. And so I continued my search and found that the word "controversy" means "a prolonged argument or dispute, especially when conducted publicly" and that "controversial" means "causing or subject to controversy".

Very interesting, I thought but does this really apply to me?

Before getting too introspective I thought I should continue my search to find the dictionary meaning of another word that Professor Brooks had used in our conversation. And so, I looked up the meaning of the word "ethics". And I found that several meanings were given.

Basically, the word "ethics," in pragmatic terms, refers to a set of principles of right conduct or a theory or system of moral values. It is used to refer to the rules or standards governing the conduct of a person or the conduct of the members of an identifiable group.

Now here's where the discussion of the meaning of "ethics" gets really interesting. Who sets these principles and values? Are they an "art" or a "science"? Does it make any difference? To whom or to what does one ascribe the awareness of right and wrong? Is it to divine will? Is it to some innate sense of right and wrong? Is it to a set of values derived from individual experience? Is there an absolute good to which human activities aspire or are there simply day-to-day categorical imperatives that are independent of any absolute good or theological considerations? Or is the source of ethical criteria simply perhaps the good of the individual or the good of a group?

These are all interesting questions. They are certainly questions which have been the subject of prolonged public arguments and disputes over the centuries that have been conducted by such eminent thinkers as Plato, Aristotle, Rousseau, Locke, Mill, Kant,

Hegel, Dewey, Moore and others. It is clear, even from a cursory reading of the works of these philosophers, that "ethics" and "controversy" have always been closely linked.

And so while I am by no means presumptuous enough to consider myself in the same league as these thinkers, I decided that I was honoured by your association's categorization of me as being "controversial". You have paid me the ultimate compliment for surely, the stimulation of public debate on the development and evolution of the principles of right conduct in the investment funds industry is something to be viewed positively. The "ethics" of an industry - its principles of right conduct - are what is evolving from this "controversy" or public debate.

Such evolution is not only healthy but is essential in a free society. It is very important to recognize this and to view the public discussion and debate that has been underway for the past three years as part of the positive process of constructing the principles of right conduct that will govern the investment fund industry and, indeed, the financial services industry, as it goes forward.

My Report ² highlighted various areas where there is a need to develop these principles of right conduct. It is important to keep in mind that in highlighting these areas, I was reflecting what knowledgeable industry people consistently told me. Their concern (and mine) was to draw attention to areas of industry vulnerability and to suggest ways to address such vulnerability. As Don Phillips, the much-respected publisher of Morningstar Mutual Funds said, "... ultimately, the health of any industry is defined not by the amount of criticism it receives, but by its response to and anticipation of that criticism".³ This is the challenge faced today by the investment fund industry in Canada.

I am now going to comment briefly on some of the identified challenges.

I think that the industry's most fundamental challenge is to ensure that the integrity and trust on which the industry is founded is merited and sustained. There are many dimensions to this challenge and more is required to meet this challenge than simply saying "trust me".

Actions and structure must reflect, support and merit the sustained trust and reliance that the industry has encouraged - and continues to encourage - investors to place in it. The industry, having created in investors the expectation of absolute integrity in relation to the dealings it has with investors, can only expect to provoke controversy if and when it falls back to a "buyer beware" position to justify actions where it appears that industry members' interests have been preferred over those of investors.

Similarly, in this environment that the industry has created, controversy can only be expected if and when advantage is taken of the lack of knowledge, the lack of bargaining power or the alleged apathy of investors. It is in the industry's interest in this environment of trust and integrity that the industry has fostered to ensure that the underlying systems and structures of the industry operate fairly and openly and that the industry rules of

conduct support investors' confidence in and reliance on such trust and integrity. The industry's credibility is at stake as well as the well-being of investors.

We hear a lot these days about the need to manage expectations. While this may be an appropriate activity to make investors aware that it is unlikely that their double digit returns on investment will continue, the managing of expectations becomes controversial when it is used to "dumb down" investors expectations whether in respect of fair dealing, the provision of timely, meaningful and relevant disclosure of material facts or in respect of the industry's adherence to the fundamental standards of conduct expected from persons who have fiduciary obligations.

We hear a lot about conflicts of interest but we are told not to worry about them; they are not real; they are only perceived. We are lulled into accepting that the opportunity that belongs to the client can be appropriated by and to others and that this is somehow necessitated by the practicalities of the Canadian marketplace. Only the bravest (or the most foolhardy) dare suggest

- i. that there is something wrong with this picture;
- ii. that the concept of "conflicts" (at least in relation to measuring acceptable conduct in persons with fiduciary obligations) does not recognize the distinction between the perception and the reality of the conflict; and
- iii. that the standards of conduct expected of a person with fiduciary obligations should not be undermined.

Let me now talk about some of the specifics that have given rise to prolonged public debates about ethics or rules of conduct in the investment funds industry.

Sales Practices

We have all probably heard more about questionable sales practices and what to do about them than we would like. There has been three years of intense industry debate about what is acceptable conduct for fund managers and fund distributors in relation to sales practices. This debate has culminated in a proposed national rule to govern sales incentives.

The rule addresses many of the issues that gave rise to concerns about sales practices and reflects the consensus that The Investment Funds Institute of Canada - IFIC - was able, through the hard work of its members, to achieve. The rule embodies the industry "ethics" - its standards of conduct - in relation to sales practices. It remains to be seen whether these standards of conduct will be adequate to meet the industry's objective of assuring that public trust is merited.

Troublesome issues have already begun to appear and they highlight the concern that a number of people have that the rule will be viewed in the words of Philip K. Howard as "a game of parsing and logical intrigue."⁽⁴⁾ For those of you who might ask why the IFIC Guidelines relating to sales practices were reformulated into a rule in the first place, the

answer is that this was done in response to two major concerns of IFIC about its ability to require compliance with the Guidelines. The first concern was that without legislative authority, the IFIC Guidelines might contravene the Competition Act. The second concern was that it would be difficult for an association in which membership was voluntary to enforce compliance with the Guidelines.

It is hoped that the rule-making process will be complete by year end and that the spirit of the rule will govern the activities of fund managers and fund distributors in relation to sales practices and incentives.

Personal Trading

Personal trading by portfolio managers and other "access" persons is another area that has generated a lot of debate. It is probably the issue that has given rise to the most questions about whether confidence and trust in the integrity of the investment fund industry is justified.

Here again, when Canadians were faced with questionable events that had occurred right here in Canada, in real time, involving well-known Canadian portfolio managers, the issues took on a dimension of reality and immediacy that was missing when they were only "theoretical" concerns outlined in a Report or remote events involving foreign fund managers that had taken place in foreign countries, far from the Canadian scene.

IFIC again took the initiative in dealing with this issue of public confidence by seeking to establish an industry consensus on what the standards should be respecting personal trading. IFIC asked Jim Baillie to review its current Guidelines for a Mutual Fund Manager Code of Ethics and to make suggestions. Following receipt late last fall of his report, IFIC formed a committee to review his suggestions and to revise the current IFIC Guidelines to make them more effective and credible.

The committee issued its interim report in August of this year and has invited comments from all interested parties prior to the end of September. The Committee proposes to consider the comments, make appropriate changes and present a proposed final Code to the Board of Directors of IFIC prior to the end of the calendar year.

The draft Code closely follows the recommendations of the Investment Company Institute Report of the Advisory Group on Personal Investing issued in May of 1994. This coincides with the recommendation that I made in 1994 in my Report.

So once again we see the benefit of "controversy" at work in the form of creating a public process for [prolonged] argument or dispute aimed at adopting rules of professional conduct that will govern personal investing.

I mention that the IFIC Committee has highlighted the need for extending the benefit of the personal trading standards not only to investors in mutual funds but to all investors who participate in pooled funds, pension funds and segregated funds in Canada. I agree

completely with this and I hope that regulators and other industry participants in the affected sectors will make this happen.

In the meantime, many of the people who manage mutual funds also manage pension funds and other pooled or segregated funds. It does not seem unreasonable to expect these managers to extend the benefit of the provisions of the draft code to all of their managed accounts and not just to the mutual funds that they manage. I would think that trustees and others who are responsible for the governance of these other investment vehicles will be giving serious consideration to requiring the benefits of these provisions to apply to their accounts as well.

A related troublesome aspect of IFIC's draft code of ethics relates to the fact that it does not apply to non-member portfolio managers who have been retained by member-fund managers of IFIC to provide investment advisory services in respect of their sponsored funds. This non-applicability includes Canadian money managers as well as to foreign ones. The gap highlights the need for more clearly articulated standards of corporate governance relating to investment funds.

The absence of these standards is an area of concern that has been highlighted in my Report as well as elsewhere. I have been advocating for several years the need to focus on what the minimum standards should be and have highlighted the need for an investment funds statute. A statute of this nature would provide the fundamental constituting basis for investment funds - particularly those that are formed as trusts - and would provide for the fundamental common governance mechanisms that would apply to all investment funds.⁽⁵⁾ For example, principles could be incorporated into this statute that would require the manager of an investment fund, when contracting for services to be provided by third parties to or in respect of the mutual fund, to ensure that the contracting party will adhere to the same rules and standards that the manager would be required to adhere to if it were providing the services directly instead of outsourcing them. In the interim, there are other ways of achieving the same result such as including provisions of this nature as contractual obligations, including such provisions as part of the conditions of registration that apply to fund managers and/or including such provisions in rules relating to the offering of mutual fund securities.

It is interesting to note that the IOSCO Principles for the Management of Collective Investment Schemes reflect this responsibility. Both Canada and the United States as well as the other IOSCO member countries have subscribed to these IOSCO Principles. It is to be hoped that we will build on the commonality of standards reflected both in the IOSCO principles and in the ICI Guidelines and that the IFIC Code on Personal Investing will be changed to support and reflect such standards.

Other industries have accepted the need for "approved international standards". Indeed, many manufacturers and service industry firms will not deal with anyone who does not meet the approved international standards. Why should the investment fund industry be any different particularly in capital markets that for all practical purposes have become borderless.

Here again, co-operation among industry participants, legislators and regulators is essential to achieve desired results.

Self - Regulatory Organization

The need for a single strong, effective self-regulatory organization that will operate on a national basis and in which membership will be mandatory for all who sell securities (including mutual fund securities) is one of the fundamental recommendations that I made. This recommendation was endorsed by the Investment Funds Steering Group. Putting this SRO in place would provide the basic structure for dealing effectively with so many of the areas of concern that were identified in my Report and would provide for:

- the assumption by the SRO of responsibility for the monitoring, compliance and enforcement of the rules of conduct regarding sales;
- the assumption of responsibility for monitoring initial and ongoing proficiency and supervisory standards and procedures;
- the establishment of standards designed to ensure adequate capitalization, insurance and bonding, and contingency fund requirements; and
- the assumption of responsibility for regular compliance and audit checks and for remedial action where necessary.

This SRO would also take on the responsibility for developing, monitoring and ensuring compliance with the rules of fair practice and business conduct including rules relating to performance and other advertising matters. As we have seen from our experience with the sales code rule and as I suspect we will see from the development of the personal trading code rule, the rigidity of the legislative rule-making process does not readily lend itself to the areas that I have just mentioned.

Discussions are underway between IFIC and the IDA (The Investment Dealers Association of Canada) aimed at setting up an SRO for mutual fund dealers with a view to an SRO being in place by July of 1998. It remains to be seen what will result from these discussions and whether the SRO that is created will be capable of fulfilling the expectations that underlie the recommendations in the Report to deal with the areas of vulnerability in the investment fund industry.

I continue to voice concern about the need for a common set of rules and standards regarding the distribution of mutual fund securities that will apply uniformly to all who sell them regardless of which pillar of the financial services industry they belong to. I am afraid that the way we seem to be heading will result in a separate SRO for every type of product that is sold and/or for every pillar that sells products. Apart from any other problems that this may present, it would be a highly inefficient and costly use of resources and would have the potential for regulatory gaps and for uneven standards and enforcement of standards. It would also lag the marketplace given the integration of the provision of financial services that has occurred since the deregulation of the financial services industry was set in motion in 1987. We need to be building a regulatory and a self-regulatory (or self-managed) system in this country that reflects the reality of an

integrated financial services industry while recognizing the need within such structure for functional regulation.

Other Matters

There are many other areas that I would like to talk about in connection with the evolving ethics of or, to use a more colloquial term, the evolving standards of conduct, in the investment fund industry. However, you have to go back to work so I will conclude by observing that as the industry debates the rules that will apply to its conduct, there is a growing awareness on the part of investors of the underlying issues and a growing scrutiny by them of the adequacy of the standards of conduct that are being developed by the industry, particularly as investors begin to understand the impact that these standards can have on their total return. It is to be hoped that a better informed marketplace will exert its own pressures on the evolving standards.

Increasing the knowledge and awareness of investors, industry participants and regulators alike is a core component of the recommendations that I have made. It is essential to the well-being of Canadians, both individually and collectively.

As investors and the media (which often acts as the surrogate of investors) take a closer look at the investment fund industry, we can expect more questions about the adequacy of internal controls, systems, procedures and resources of fund managers, more questions about the adequacy of personal and institutional trading rules, more questions about compensation structures, more questions about related party transactions and more questions about fund governance issues generally.

We can expect more questions about misleading advertising whether it relates to misleading performance information, misleading information about a fund's risk profile, or misleading information about sales charges. The increasing use of the term "no load" is a prime candidate for such questions in relation to funds that are really "level load" funds.

We can expect more demand for timely disclosure of information by investment funds of their portfolio holdings and of the factors contributing to the achievement (or the failure to achieve) their investment objectives.

We can expect more scrutiny of fees and charges whether made to the investor directly or indirectly through charges to the investment funds. We can expect to see a demand for the benefit of operating efficiencies and size to be passed on to investors. We can expect increased demands for assurance of fairness in the allocation of investment opportunities among clients and a closer scrutiny of whether valuations are truly reflective of what a security may be disposed of in a free and open market between a willing buyer and seller dealing at arm's length.

We can also expect more scrutiny of an area that has received little attention in Canada (and perhaps elsewhere) of the fact that by choosing to pool their investments in a

collective investment vehicle, individuals have given up one of the fundamental rights that flow from the ownership of securities - namely the right to vote such securities.

Individuals have unwittingly conveyed their voting power and by doing so have placed enormous power in the hands of professional money managers, some of whom are not independent of other financial and commercial interests. As concerns about concentration of power, shareholder activism, and the impact of the short-term performance focus of money managers, corporate managers and others grow, this is an area that can be expected to give rise to calls for change. It would be well to be giving some thought now to how to deal with voting rights and the related issues.

It must be obvious from what I have said that if a report card were to be prepared at this point in time, it would show that more work is needed to be done to develop suitable standards for the investment fund industry in order to sustain the trust of the marketplace.

I hope that the recommendations that I have made and the questions that I persist in asking will continue to stimulate discussion and generate solutions to meet the needs of investors. For what is good for the investor is good for the industry and will foster fair, efficient and effective capital markets.

Let the rules of fair conduct evolve!

Notes:

¹ The views expressed in these remarks are the personal views of Glorianne Stromberg. They do not necessarily reflect the views of the Ontario Securities Commission, any of the other Canadian Securities Administrators, staff of any of the Canadian Securities Administrators or of other Commissioners of any of the Canadian Securities Administrators.

² Regulatory Strategies for the Mid-90s - Recommendations for Regulating Investment Funds in Canada prepared by Glorianne Stromberg for the Canadian Securities Administrators and issued in January 1995. A copy of this Report and of the Briefing Notes issued in conjunction with the Report may be obtained from the Corporate Relations Branch of the Ontario Securities Commission, 20 Queen Street West, Toronto ON Canada M5H 3S8 - Telephone: (416) 593-8120; Fax: (416) 593-8122.

³ *A Trust Retained*, Don Phillips, Morningstar Mutual Funds, September 2, 1994.

⁴ *The Death of Common Sense* by Philip K. Howard, Warner Books 1994 at page 44.

⁵ Remarks of Glorianne Stromberg - The Canadian Institute - OSC Reformulation Conference - The Mutual Fund Project Panel Discussion, King Edward Hotel, Toronto Canada, January 20th, 1997.