COALITION

For the protection of investors

To avoid another Norbourg…

….AND LOOK BEYOND

FOR A NATIONAL SAVING AND INVESTMENT POLICY

Summary of a Brief submitted in French to the

Public Finance Parliamentary Commission

Quebec Government

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1- INTRODUCTION : What fiduciary convergence means for investors

This brief is the work of a coalition of industry professionals and university professors. We are concerned with a growing imbalance between the needs of investors and the functioning of the investment industry. Our aim is to alert the government and public opinion on the critical changes affecting pooled savings over the last ten years. These changes will fundamentally affect the life style expectations and security of millions of savers in Quebec and across Canada for generations to come.

"The Norbourg fund case has caused more than a scandal. It was a pandora box revealing a growing state of financial insecurity."

The Norbourg fund case has caused more than a scandal. It was a pandora box revealing a growing state of financial insecurity. Crisis of confidence, high fees and lack of competition, a deep shift in retirement schemes transfering to individuals the fiduciary responsiblity of yesterday, increase volatilily of financial markets, growing complexity of financial instruments and an unwarranted extension of the fiduciary chain. Not surprising that Québécois have problems finding their way through the financial maze. This brief is based on three key ideas :

- Fiduciary convergence : the growing integration of pension funds, mutual funds, insurance segregated funds, etc has shaken our habits and requires a **shift of regulation policy from one of strict rules or of principles to one based on risk control**. This means shifting from a passive security system of prescriptions to an active security system of accountability.
- Fund management : Instead of focusing mainly on products, it it **imperative to pay more attention to those who manufacture them, the investment management companies**. These organizations now occupy the centre stage of the fiduciary industry, which dominates finance across the industrial world. Their behaviour could have profound effects on today's society. The way financial resources are being allocated alongside labour, whether investments should be more or less socially responsible, how inside investors can be controlled or how best to monitor corporate governance, all depend on them. Yet, this is a profession that is poorly represented in Quebec as in the rest of Canada and has no self-regulatory responsiblity.
- Investor responsibility : The urgency of making the investor fully responsible by providing a wide range of tools enabling him to become fully autonomous. This may take as long as half a generation. Until then, this goal will require the active contribution of advisors, brokers and dstributors alike to share the burden. We also need to define fiduciary rights and obligations

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and help investors better define their needs. A groundswell of retirees is expected over the next ten to fifteen years. Their investment requirements will strain the fiduciary system to a point where it may not be able to cope with growing operating risks.

So now is the time to act by adopting a comprehensive saving and investment policy framework.

This brief :

- Answers 13 out of 16 questions raised by the Public Finance Commission;
- Makes 18 recommendations;

by proposing to establish an effective real saving and investment policy in Quebec with a wide range of means to make all parties involved in the market fully accountable for their action.

The coalition is made up of university professors and industry professionals

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- ***The GIREF** is an Interdisciplinary Research Group in Financial Ethics (GIREF), a cooperation programme between professeurs of UQÀM, Université de Paris 13 and business professionals from Quebec and Europe. See www.giref.uqam.ca*
- ***The Centre for Fiduciary Excellence (CEFEX**) is a global initiative aimed at promoting best fiduciary practice within the investment industry. Its main partners are leading standard setters and registrars such as the Canadian Standards Association (Toronto, Cleveland), SAI Global of Sidney, Australie, AFAQ-AFNOR of Paris, The Foundation for Fiduciary Studies/Fi360 of Pittsburg and Rating Capital Partners SA of Luxembourg. See www.cefex.ca*

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2- OBJECTIVES : Are we not all fiduciaries ?

This brief pursues three goals

- comment on the current state of the investment management industry for mutual funds ;
- put into context the growing role of mutual funds in the saving patterns of Quebecois and how it will affect hundreds of pension funds in a vast convergence movement ;
- propose practical means based on a global vision to encourage Québécois to take their savings into their hands

The fundamental principles of this brief is to optimize access to markets and help investors to protect their capital..

If fiduciary rights and obligations of investors must be clearly spelled out, the Legislator must also underline the fiduciary responsibility of all professionals who manage, administer, intermediate and safeguard assets on behalf of third parties. Drawing a **distinction between those who give advice and those who do not no longer reflects today's market reality**. The walls have become simply too thin to set such a borderline. It would be better to focus on functions. With the exception of commercial banks and credit providers (finance, leasing and factoring), finance has become predominantly fiduciary in nature. Instead of arguing over who is fiduciary, it would be more useful to define each function's own specific fiduciary constraints.

Trying to impose standard measures and legislate for all under a universal approach is a daunting task. An alternative and more attractive option could be to adopt specific rules of proximity shielding the most vulnerable segments of the community from various types of risks. As an illustration, under the context of the universal right of access to a security of revenue, an approach based on risk would take into account :

- retirees who have exhausted their retirement savings;
- single and handicaped people who are often easy targets to market conditions ill-suited to their needs ;
- young people at the start of their career who often tend to avoid the discipline of, saving and social security, either by lack of experience, knowledge or simply by negligence;
- single parents or people living under social hardship.

The brief introduces the concept of active and passive security. The approach involves two layers of surveillance. One, more universal, which takes into account the prescriptions made by the world's two largest regulators, the United States and the European Union. In a flat and

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global world of capital markets, it becomes increasingly difficult for small to medium size sovereign regulators, such as those in Canada, to move against major regulatory tides. Passive security is embodied in laws and rules that can be applied through the concept of passports[1]. Alongside the concept of the "most favoured nation clause" used in trade agreements, allowing countries to claim the same treatment as the one provided to a counterparty's best trading partner, we recommend the adoption of the "most favoured investor regulation" in Quebec's regulatory policy.

"Saving practices have become far too central and fungible to narrow the legislator's view to only mutual funds."

By contrast, active security provides a greater sense of proximity. More dynamic, flexible and local, it can be implemented without contrevening best regulatory practice in Canada, America or Europe. For instance, it is recommended that investment management firms under AMF regulation have a board composed of a majority of independent directors or experts, in order to provide stronger check and balance within the organization that manufactures mass market mutual funds. Or more recently, Bill 30 recommends to treat all service providers to pension funds, like actuaries or invetment managers, as full-fledge fiduciary agents with no limit to their legal responsibility.

3- PROBLEMS AND ISSUES

Mutual funds represent the first investment choice of millions of Québécois and Canadians for their retirement, current and future saving needs (education, etc). By focusing on mutual funds (Fonds commun de placement or "FCP"), the Commission has put its finger on the pulse of collective savings in Quebec. Mutual funds are the centre of the savings and investment universe.

[1] The concept of passport boils down to mutually recognized accreditation tools agreed on the basis of reciprocity by various regulatory authorities. The process is already in place in Canada amongst provincial regulators, except the Ontario Securities Commission. An example would be the case of a fiduciary agent accredited by the Securities and Exchange Commission in the United States or the British Columbia Securities Commission, which would be automatically authorized by the Quebec regulator, the Autorité des Marchés Financiers (AMF) to operate on the Quebec market.

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They are the pivot of an increasing number of retirement plans (especially capital accumulation or defined contribution plans), segregated funds of insurance programs and collective RRSPs[2]. This is why this brief warns the Legislator against the temptation of trying to isolate mutual funds from all other forms of pooled savings. The brief proposes specific measures concerning mutual funds but invites the government to conduct a general review of saving and investment modes. By adopting mutual funds as its central theme, this brief often makes references to pension funds to draw parallels and outline converging points in terms of conflicts of interest, fraud, evaluation tools of investment management firms and sharing of public information.

"Expand the supply of fiduciary services by involving a greater number of investment management firms, instill greater confidence in the market by lowering the impact of fraud and foster better practice"

The Quebec government is facing the challenge of fostering market innovation and competition for its citizens, while ensuring the protection of their savings. The latest scandals have exacerbated the problem of competition by pulling away investors from small to medium size investment management firms[3]. However spectacular it may have been through the media, the Norbourg case (four times smaller in value than the Portus case) remains quite minute compared to the size of the industry. In order to increase competition, this brief makes two major recommendations : the **establishment of an Anti-fraud Indemnity Fund** and **the opening the Canadian borders to foreign funds,** under a passport agreement with regulators in the US and Europe.

The fund would help expand the supply of fiduciary services by involving a greater number of investment management firms, instill greater confidence in the market by lowering the impact of fraud and foster better practice. The Fund would be financed mainly by the investors

[2] This convergence can be found in the various bills (Bill 29 modifying the Securities legislation, Bill 30 modifying the legislation on supplementary retirement plans to introduce the notion of fiduciary responsibility for all service providers, including investment managers), regulation projects (81-107 on Independent Review Committees, on the exemption of municipalities and universities from the capitalization solvency ration on pension funds) and consultations (the current one staged by the Public Finance commission)

[3] In December 2005, the 10 largest fund families in Canada handled some 78% of all Canadian mutual fund assets, according to statistics quoted from IFIC by the Parliamentary Commission. The situation is even more critical in Quebec where less than 5% of mutual fund assets are managed locally.

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and the investment management firms overseeing the funds, just like the deposit insurance plan of Canada. A premium would be set on the basis of the fiduciary risk of each investment management firm that would be rated by an independent organization[4]. The annual rating creates level field by falling into the public domain to optimize transparency and help a vast majority of investors, individual as well as small to medium size pension funds that do not use consulting firms, make a better selection of their managers[5].

Opening the borders is also essential to give Québécois access to financial products that are innovative, performing and economic. While Canadian investors can easily buy US securities through US stockbrokers, order cars directly from Detroit or buy clothing from a US department store, they can not buy mutual funds as freely from US suppliers. In short, NAFTA does not apply here and may explain why management fees are much higher in Canada than in neighbouring America[6].

The opening to financial innovation, including the access to hedge fund management, must be secured by **strong control and risk prevention systems.** Quebec should aim for the world's best regulatory practice whether in Ontario, the United States or Europe, where regulators such as the UK Financial Service Authority ("FSA") is well ahead of the internaitonal pack.[7] Each time a regulator improves access to market for investors, the AMF should follow suit

[4] Half of the premium would be paid by the investors on the basis of their subscribed capital while the other half would be paid by the investment management firms themselves on the total asset class under rating.

[5] Various studies confirm that today's heavy reliance of most investors on performance ranking services tend to mislead them by believing that past performance predicts future returns. Furthermore, investors are generally surprised to discover a gap between their own fund's earnings and the those published officially by the organizations managing those same funds. The difference is due mainly to market timing and the "time mis-alignment" between investor's subscriptions and liquidations with the formal 3, 5 and 10-year formal return statistics released by fund families. These studies were conducted by several organizations such as Dalbar Financial Services of Boston, Prof. Charles Trzcinka of Indiana University, McKinsey & Company, Strategic Insight from New York and John Bogle of Valley Forge.

[6] This is probably one of the reasons why mutual funds are so expensive in Canada compared to the US or other European countries, according to two University studies : « Mutual Funds Fees Around the World », May 7, 2006, by Ajay Knorana, College of Management, Georgia Institute of Technology, Atlanta, USA Henri Servaes, London Business School, CEPR and ECGI, London, UK, and Peter Tufano, Harvard Business School et NBER, Boston, USA and « Expense ratios of North American mutual funds", by Karen Ruckman, John Molson School of Business, Concordia University, published in February 2003 by Canadian Economic Review, Vol. 36, No. 1

[7] The Bill amends the Securities legislation in order to add new instruments allowing the Regulator to sign mutual agreements with other regulators in Canada or abroad or to delegate powers in exchange for reciprocity.

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automatically. A lax regulation would only invite more Norbourg, Lancer, Norshield, Mount Real, etc. By contrast, more idiosyncratic measures would only isolate investors, narrow down supply and slow further an already downsized investment management industry.

On the other hand, the proliferation and growing complexity of investment products are forcing saving and investment consumers to pay more attention on what is offered to them and demonstrate their know-how and discrimination. To achieve that, they need education, information and appropriate tools. We can't talk about accountability and « knowing your manager » without giving them the right means. The Quebec government should focus on accompanying savers and investors and sustain as a priority the development of simple tools and indicators improving the selection of financial products. These tools, such as a National Saving and Investment Observatory, a charter of fiduciary rights and obligations, fiduciary certification and rating services, a registry of funds and of professional consultants, would encourage professionals to compare each other and adopt best fiduciary practice.

"As the investor is not ready yet, financial intermediaries must be properly equipped. Potential conflicts of interests liable to hit the client's interest should also be reduced. This long and perilous fiduciary chain can often hide serious risks, as was the case with Portus and Norbourg. From the advisor to the distributor and the fund manager, nobody understood how the manager was operating."

It is because investment management is such a strategic vector in the financial world that the legislator should have a fresh look at the overall industry. Saving practice has become too critical and fungible to restrict the legislator's review to mutual funds only.

The traditional regulatory mode was based on the protection of small savers and investors, on the presumption that the investors' size of portfolio was directly proprotional to their financial knowledge. This is why the notion of « know your client » was built in the legislation. But a sea changed occured since. **Classic features differentiating primary institutional and qualified investors from individual and unqualified investors do not reflect the reality anymore.** The fast growing granularity of pension funds, where individuals, instead of an investment committees, decide on asset allocation, not to speak of direct investments into all

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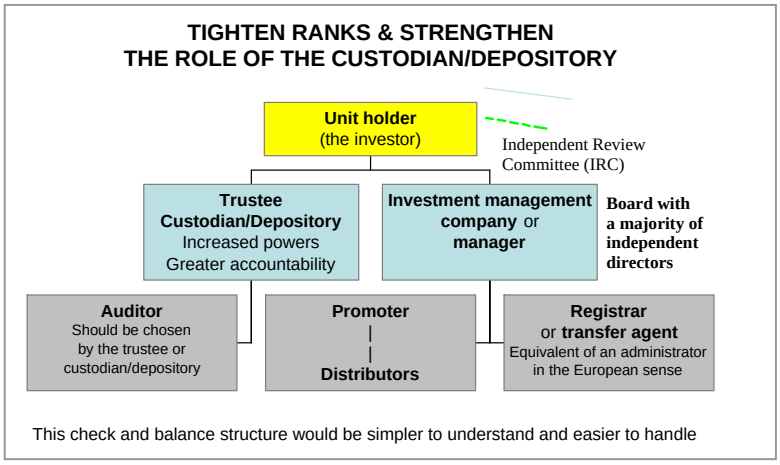
kinds of other pooled funds, is blurring traditional frontiers between what used to be big and small investors.

The challenge of investors is not to analyse securities in which to invest but rather to evaluate the financial product that stands between him and the securities, i.e. the mutual fund and its management alongside fund distributors and even financial planners. For a single individual or even a pension fund, the steady extension of the fiduciary investment chain has become a difficult exercise to deal with. To make his selection, the investor must nowadays evaluate the governance of a fund as much as the reliability and strategies of the investment management firm that handles the fund. The Coalition recommends that the structure of a mutual fund be simplied and introduce a new balance of power between the investment management firm and the trustee/custodian. Aside from the fund itself, which is a legal vehicle with its own prospectus, there are five professionals around the table, with a sixth one to be added with the Independent Review Committee, according to new regulation 81-107. By giving more powers and requiring kore accountability from the trustee/custodian, the legislator may indeed strengthen the investors' representation.



Investors need a whole range of tools, indicators and references in order to compare and assess managers. Comparing past returns through performance ranking tables is simply too misleading to satisfy such exercise. As the investor is not ready yet, financial intermediaries must be properly equipped. Potential conflicts of interests liable to hit the client's interest should also be reduced. This long and perilous fiduciary chain can often hide serious risks, as was the case with Portus and Norbourg. From the advisor to the distributor and the fund manager, nobody understood how the manager was operating. Thus the need to **establish a registry of advisors and mutual funds** to provide greater transparency.

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4- SUMMARY OF RECOMMENDATIONS

Three fiduciary principles drive the general thread of this brief's recommendations:

- Optimize access to financial markets to offer the best fiduciary services ;
- The general convergence of fiduciary structures and the blurring of investors' size;
- The need to have a regulation based on risk and open markets to stimulate competition and innovation.

Problem	A- General policy	B- Mutual funds	C- Pension funds
1- Fiduciary rights and obligations of investors and professionals, including rights of recourse, are generally confusing	Adoption of a Charter of fiduciary rights and obligations, spelling out what investors can expect and are expected to do **Preventive action**	The Charter would provide high level fiduciary principles. Too many investors do not understand the position they have between retirement saving plans and mutual funds in which they are invested either directly, through their RRSPs or via their retirement plans. Likelise, it is important that professionals rely on investors ready to gain better knowledge to make more informed choices. This is why it is recommended that the « know your client » formula be filled by investors rather than by service providers	
2- The overall state of collective saving and investment in Quebec, its conditions, trends and risks are difficult to estimate.	The Finance Department or the Department of Employment and Social Solidarity should establish a « Saving and Investment Observatory », in close relationship with the Institut de la Statistique du Québec, the university network and the private sector. This Observatory would publish an annual diagnosis and become a privileged source of education and reference for both professionals and individuals. **Monitoring action**	The annual diagnosis would establish the annual state of liabilities (total amount of gross and net subscriptions) of mutual funds, insurance segregated funds and other pooled funds, and of assets. This would help provide a better understanding of the current level of savings.	The diagnosis would cover the whole universe of public and private retirement funds, including the whole segment of insurance and social security.

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Problem	A- General policy	B- Mutual funds	C- Pension funds
3- The number one problem is the cost of access to market, either because of very high entry/exit fees or because of low economies of scale for pooled funds and retirement plans. **A few compounded basis points on an estimated CAD 300 billion of pooled savings (mutual funds, retirement plans and segregated funds) over 10 to 20 years in Quebec could make a huge difference for a generation.**	The revision (Bill 30) of the Supplementary retirement fund Legislation should set minimum thresholds to encourage cost reduction, improve economies of scale and reduce conflicts of interest. Regulators should encourage distributors to sell funds with a minimum size. Legislators and regulators should open borders to encourage greater competition on the basis of a « most favoured investor » policy. **Corrective and preventive action**	• Foster the practice of mutual funds of greater size and the consolidation of funds whose size is considered un-economical. • Request from distributors warnings for funds whose size may not be economical, especially for start-up or innovative funds, unless management accepts to cap fees. • Allow investors to exit freely from funds under a change of ownership of the investment management company or following a period of under-performance exceeding 5% of the benchmark	• Foster the emergence of institutional pooled funds (such as pooled trusts or super annuation funds) for small to medium size retirement plans through a delegation of powers. Set a threshold of CAD100 million • Encourage the development of sectoral retirement plans. • Examine closely the Chilian accumulation plan model (that has spread across Latin American and Eastern Europe) for small to medium size firms
4- Conflicts of interest still prevail among consultants and professionals on the asset/liability management of pooled funds. **For mutual funds, it is difficult to breakdown the fiduciary responsibilities of each of the five professionals sitting around the table: the fund manager, the promoter and distributor, the registrar or transfer agent, the administrator, the auditor and, soon to come, the Independent review Committee.** **For retirement plans, it is urgent te clarify the current law on supplementary pension plans to state whether service providers are fiduciary or simply contractual agents.**	Review the overall fiduciary structures of mutual funds **Corrective and preventive action**	Reduce the number of professionals required around the table and and provide greater accountability and powers the trustee and/or custodian.	Limit the activities of an actuary (or the firm that employs the professional) to a single side (liability or asset) of a retirement plan. This would make the actuary in charge of the periodic evaluation of a plan more independent and reduce potential conflicts of interests. Bill 30 amending the Quebec legislation on supplementary retirement plans confirms and clarifies that all service providers (including investment managers), to which powers are delegated by the retirement committee, act as full fledge fiduciaries

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Problem	A- General policy	B- Mutual funds	C- Pension funds
5- The information and evaluation of investment management firms represent a major problem for both institutional and individual investors. **Today, only medium to large retirement plans can take advantage of consultants for the evaluation and selection of managers. Small pension funds and individual investors have no access to those manager profiles and depend solely on past performance to make their choice.**	Fiduciary certification of investment managers should be mandatory while rating should be carried out on a voluntary basis (except for pooled funds). The AMF should encourage the creation of a new self-regulator through an association of investment management professionals. **Control action**	Investment management firms should be assessed independently to provide a level playing field to all investors by sharing the same information and reducing transaction cost for the whole community. A registrar of public domain certification and rating, either paid by inverstment managers or by an Anti-fraud Indemnity Fund would benefit to all.	
6a- Anyone can claim to be a consultant to pension funds, administrator or even fiduciary to mutual funds. **6b- A growing number of un-registered funds are sold in Quebec to institutional investors and family offices**	Establish a public domain central registry with the Régie des rentes du Québec (RRQ) and the AMF. Each fund would be registered with a number, as proposed by the Centre des Fonds d'Investissement du Québec (CFIQ, the Quebec chapter of IFIC), to provide transparency and common information on the market place. **Preventive and control action**	This registry would complement the fiduciary assessment services by allowing both investors and third party fund distributors and financial planners to « know their manager », the professionals that they employ and the universe of funds sold across the province. This would reduce the opacity prevailing on the current state of operators.	Greater transparency will help retirement plans as well as their beneficiaries to know who sits around their plan table.
7- Several sponsors have chosen collective RRSPs as alternative to a formal retiremernt plan to avoid regulatory constraints.	Register all collective RRSPs with the RRQ to standardize their conditions. **Preventive and control action**		Registration of collective RRSPs. Collective RRSPs, which are not supplementary programs to already existing retirement plans, should be subjected to basic regulations.
8- The rights of recourse for most investors are difficult to exercice in case of frauds in pooled funds	Indemnity against fraud should be provided to instill greater trust across the market and foster best fiduciary practice. **Indemnity action**	The establishment of an indemnity fund to protect participants against fraud and fiduciary negligence and speed up the process of compensating investors.	Bill 30 should provide the same advantages against fraud, on top of measures to protect participants against the solvency risk of pension funds.

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