BRITISH COLUMBIA SECURITIES COMMISSION

THE Registrant

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In this issue

eth-ics/ˈɛθ ɪks/

What is ethics? Webster's Online Dictionary provides the following definition:

1. Motivation based on ideas of right and wrong.
2. The philosophical study of moral values and rules.
3. The science of human duty; the body of rules of duty drawn from this science; a particular system of principles and rules concerting duty, whether true or false; rules of practice in respect to a single class of human actions; as, political or social ethics; medical ethics.

Simply put, ethics is about dealing with what is good and bad with a moral duty and obligation.

Most firms have a code of ethics in place in their policies and procedures manual and many reference the CFA Institute's code of ethics, as a practical matter. However, how does your firm deal with ethics in your everyday operations? Is there a tone set from the top by the firm's management that the firm will act ethically and expect all staff to adhere to the code? Is there a way for staff to bring ethical issues to senior management without fear of repercussion?

In this issue, we will explore ethics in a number of articles that we hope will spur discussion at your firm about ethical behavior and that good ethics also equals good business.

Some of the ethics articles and figures cited in this issue have been adapted (with his permission) from a keynote presentation by Robert Rudloff, Vice President, Internal Audit for the MGM Mirage Group, to the Association of Certified Fraud Examiners 2010 conference in Vancouver.

(Un)ethical and ironic quotes

"Relativity applies to physics, not ethics." Albert Einstein

"I am not denying anything I did not say." Brian Mulroney

"Go after the men who go after prostitutes." Eliot Spitzer

"F@#k my victims. I carried them for 20 years, and now I'm doing 150 years." Bernie Madoff

"I am absolutely not guilty of the charges. There was no criminal intent here. Nothing was hidden. There were no shredded documents. All the information the prosecutors got was directly off the books and records of the company." Dennis Kozlowski

"It's fair to say that Kozlowski and Swartz abused many corporate prerogatives and that they invented new ones just so they could abuse them. They acted like pigs, as a lot of CEOs act like pigs." Forbes Magazine on Dennis Kozlowski and Mark Swartz

"I don't think I'm a criminal, number one." Ken Lay

"There are no accounting issues, no trading issues, no reserve issues, no previously unknown problem issues." Ken Lay

"We don't break the law." Ken Lay

"We need someone who is a strong representative of our value system." Ken Lay

"I know what I don't know. To this day, I don't know technology, and I don't know finance or accounting." Bernie Ebbers

"I just want you to know you aren't going to church with a crook." Bernie Ebbers

"No one will find me to have knowingly committed fraud." Bernie Ebbers

Some ethical lapses from the investment world

A quick look at some notorious frauds

Charles Ponzi gave the world a name for a fraudulent scheme that lives on to this day.

Ponzi concocted an arbitrage scheme in Boston, where people would invest in discounted postal reply coupons from overseas, which would be redeemed at face value in the USA. However, there were not enough postal reply coupons to fund the returns promised by Ponzi and ultimately, new investor money was paid out to old investors in order to keep the scheme running.

Ponzi had exposure to the basics of this fraud from his time in Montreal working at a bank started by Luigi Zarossi. Zarossi invested in bad real estate loans and paid the interest with the deposits of new accounts.

Ponzi spent three years in a Canadian prison for forging a cheque of a former Zarossi customer, before returning to Boston where he engineered his infamous fraud. Another (tenuous) Canadian connection is that Ponzi first arrived in the USA via the *SS Vancouver*.

Finally, would it surprise you that Ponzi was also involved in selling real estate in Florida, which turned out to be under water, i.e., swampland?

Bernie Madoff, the perpetrator of the largest investment fraud in the United States (using the Ponzi scheme) is now serving a 150-year prison sentence. The total of the fraud, including fabricated gains is estimated at $65 billion, but the actual losses are expected to be $18 billion.

Norburg Financial Group, the largest investment fraud in Quebec, where Vincent Lacroix diverted $130 million of investors' capital for his personal use.

Earl Jones ran a $50 million Ponzi scheme in Quebec and defrauded even his own family members.

Ian Thow used off-book investments to defraud Victoria-area residents, an estimated $30 million.

Bre-X Minerals Ltd. was a Canadian penny stock that eventually reached $6 billion in market value after reports of a massive gold find in Indonesia. Unfortunately, the gold find turned out to be a massive fraud when technical core samples were found to be salted. Bre-X became the largest mining fraud in history.

The next generation: what's coming?

From a 2008 study by the Josephson Institute:

- 60% of high school students cheated on an exam in 2007
- 62% of high school students lied to a teacher in 2007
- 82% of high school students lied to their parents in 2007
- 33% copied something from the internet
- 28% stole from a store in 2007
- 23% stole from a parent of relative

- 11% of college students reported cheating in 1960
- 49% of college students reported cheating in 1993
- 75% of college students reported cheating in 2003 and 2005-2007
- 50% of graduate students reported cheating in 2006

Chances are, you are going to hire these people in your business to service your clients. How will this affect you and your business?

People who cheated on exams in high school are:

- 3X more likely to lie to a customer
- 3X more likely to inflate an insurance claim
- 2x more likely to inflate an expense claim
- 2x more likely to lie to or deceive a boss
- 1.5X more likely to cheat on taxes

The fraud triangle

Donald Cressey coined the "fraud triangle" and it describes three factors that are present in every fraud:

1. Motive or pressure – the need to commit fraud, such as the need for money or the pressure to meet targets and deadlines

2. Rationalization – the justification to commit the fraud: the means justify the end; I need the money; the company/client will never miss it

3. Opportunity – the situation that enables the fraud to occur, such as poor compliance and weak internal controls

Firms can break the fraud triangle by removing one of the three factors that make up the fraud triangle. The removal of opportunity by instituting a strong compliance system of internal controls is probably the most direct way to reduce and prevent fraud. However, you should still be aware of unusual circumstances, such as an employee suddenly enjoying a lavish lifestyle that is beyond their means.

Costs of ethical lapses

Unethical behavior can have severe financial consequences, as seen in these high profile examples from the first decade of the 21st Century:

- 2000 Prudential pays $2.8 billion to clients after its agents are caught collecting hefty commissions on insurance policies that turn out to be far more expensive than the agents had led customers to believe
- 2002 Arthur Andersen LLP surrenders it license to practice as Certified Public Accountants in the USA after the Enron accounting scandal destroyed its reputation – the effect is the demise of a big five accounting firm and the loss of 85,000 employees around the world
- 2003 WorldCom agrees to pay $750 million to investors after perpetrating an $11 billion accounting fraud
- 2005 KPMG pays a settlement of $465 million for promoting what the US government considers to be illegal tax shelters
- 2006 Fannie Mae fined $400 million after its senior executives are accused of manipulating the company's accounting in order to collect undeserved bonuses
- 2006 AIG pays a $1.5 billion settlement after admitting to fraudulent insurance transactions that bolstered the quality and quantity of its earnings
- 2008 Siemens pays a $1.6 billion fine to settle bribery allegations by US and European authorities
- 2010 Goldman Sachs pays $550 million to settle an SEC allegation that the firm defrauded investors in a mortgage-backed collateralized debt obligation by failing to tell them that hedge fund Paulson & Co., which was planning to bet against the deal, had helped to design it

While these very high-cost examples involve very large companies, many with a global reach, what they all have in common is damage to the companies' reputation, which many consider to be a priceless commodity.

What is your reputation worth?

Understanding unethical behaviour

by Sandy Jakab

Most individuals who find themselves charged with fraud do not simply wake up one day and decide to turn to a life of crime. Each one of us, under the wrong conditions, is vulnerable to unethical behavior. In an easy-to-read and somewhat shocking summary of the psychological research, Professor Robert A. Prentice from the University of Texas explains clearly how it is that we are so vulnerable. (*Ethical Decision Making: More Needed Than Good Intentions, Financial Analysts Journal*, Volume 63, No. 6, 2007, CFA Institute).

We all underestimate how strong our tendency is to obey authority. So, if we work in an environment where there is no ethical code, or where the ethical code contradicts actual behaviour, or where the incentive system does not reward ethical behaviour, we are very vulnerable to behaving badly.

We also underestimate how strongly biased we are towards conformity. This conformity bias makes us conform our judgements to the judgements of our peer group - even if that peer group is composed of strangers.

We are prone to what Professor Prentice calls "incrementalism". Over the course of time, we might incrementally make small changes in our behaviour which, taken by themselves, are almost unnoticeable but collected together add up to significant change.

These are but a few well-known psychological phenomena that make us vulnerable to unethical behaviour, even against our core traits and our intentions. Others include groupthink, overoptimism, overconfidence, self-serving bias, framing, considering or honouring sunk costs, the impact of the tangible, close and near term, and loss aversion.

Professor Prentice completes his paper with suggestions about how each of us can increase the odds of doing the right thing. We strongly encourage you to read and discuss Professor Prentice's paper in your firm, and with your peers. If we can better understand how we are vulnerable to doing wrong things despite our intentions of doing right things, we will be better equipped than if we don't have that knowledge.

Why isn't compliance enough?

Rules and regulations can only go so far, because:
- the law is the floor,
- the law is constantly changing,
- the law is not necessarily representative of universal morale,
- the law is not always right,
- the law does not answer every challenging dilemma, and
- the law is slow to catch up to new dilemmas.

It's up to firms to establish good ethical behaviour with a proper system of internal controls to deter fraud. Employees rarely miss the ethical issues but there is a problem of:
- employees not raising the issue,
- not having the ability for raising the issue, or
- being retaliated against for raising the issue.

What can you do to encourage ethical behaviour in your firm?
- Openness and open lines of communication
- Environment of accountability and personal responsibility
- Freedom for risk-taking within appropriate limits
- Willingness to tolerate and learn from mistakes
- Unquestioned integrity and consistency
- Pursuit of collaboration and integration
- Courage and persistence in the face of difficulty

Ethical reasoning and actions
- Issue: identify the dilemma
- Facts: obtain all unbiased facts
- Alternatives: what choices do you have?
- Stakeholders: who has an interest? What are the motivations? Who holds what power?
- Impact: what is the impact on each stakeholder?
- Guidance: obtain guidance from your organization
- Action: now what? Take Action!
- Monitor Outcomes

What would you do in each case? How would you, as the manager or business owner, want your employee to act?

1. The customer wants a refund. You agree that a refund is called for but company policy says "No." If you go to your supervisor, the supervisor will deny the customer's refund. If you act on your own authority, the customer will be satisfied, but you may get in trouble.
2. Quality is supposed to take precedence over everything else. The job you are finishing is acceptable but you know that you could do a "quality" job if you spent two more hours on it. If you take the extra time, you will miss your deadline.
3. The company procedure is very clear but you know a "better" way to do the job. Your productivity results are a bit low this month. If you use your new approach (and violate the "rules") you can raise your results to an acceptable level.
4. A fellow employee suffers harassment at work and is afraid to say or do anything about it. If you "blow the whistle," the company may retaliate against you. You could even lose your job.
5. You are working to correct a mistake that you boss does not know about. If you tell the boss, you will be blamed for the mistake. If you do not tell the boss, you could be chewed out for taking too long to do the job.

What should you consider and include for your business ethics and code of conduct? Here are 20 questions for you to consider:

1. One Code for all or two for staff that are more equal than others?
2. Does the Code cover newly developing risks?
3. Has the Code kept up with changes in the law?
4. Can employees raise questions about concerns?
5. Do employees certify to the Code?
6. Does the Code include examples?
7. Is the format inviting and effective?
8. Does the Code talk about values?
9. Is the Code's organization useful?
10. Are there finding aids in the Code?
11. Does the Code lead to other information sources?
12. Did the Code get the right input?
13. Is there a communication plan?
14. Has the Code entered the electronic age?
15. Does the Code's message reach third parties?
16. Is the Code global?
17. Is the Code translated if your firm is multilingual or multinational?
18. Does the Code include things that no longer make sense?
19. Does the Code go to all employees?
20. Is the Code ethical and legal?

The ethical connection

Opening remarks by Sandy Jakab at the September 28, 2010 BCSC Chief Compliance Officer Outreach

Yesterday, my husband interviewed an investment dealer representative who is a candidate for my husband's business. The fellow noted that my husband had been paying many unnecessary costs and his money hadn't grown as quickly as it could have over the course of several years and explained to him why that was so. (This part of the conversation, recounted with the enthusiasm of someone who has had a sudden insight, revealed how shockingly little my husband has remembered from our own conversations about investing over the years!)

The candidate explained to my husband what his investment philosophy is. He finished by telling my husband that how concerned he is about the state of ethics in his industry.

Why am I telling you about this encounter? This was an investment dealer and none of you are investment dealers.

I am telling you this because I think the investment industry is under the microscope of public scrutiny in a way it has never been before. It is trite to say that in the wake of the 2008 economic melt down, the investment industry found itself having to rebuild trust with its clients, with government, and with the larger public.

I believe the investment advisory industry is on the cusp of tremendous change. It will partly come from within, and partly be influenced by change in other jurisdictions.

In the United States, the SEC is actively considering how (rather than whether) to impose a fiduciary standard on broker/dealers. In the UK, the FSA is moving toward banning all payments from product manufacturers – including all investment funds – to the sellers of their products. In Australia, a statutory fiduciary standard is in force.

In Canada, watchful investor advocates like the Canadian Foundation for the Advancement of Investor Rights and the Small Investor Protection Association consistently draw investors' and media attention to industry practices, and regulatory frameworks, that allow investment firms to prefer their interests to those of their clients.

In Canada, the securities legal framework includes a duty on all registrants to act fairly, honestly and in good faith in their relationships with clients. This principle is deeply rooted in ethical considerations – in fact, it kind of sounds like the Biblical Golden Rule that implores us to treat others, as we would like to be treated.

Many of you in the room or listening in today are portfolio managers who, in Canadian law, may be viewed by the courts as fiduciaries because of the dependence inherent in a discretionary management relationship. Those of you who are investment fund managers already have a statutory obligation to put the investment fund's interests first.

Ethical dilemmas present themselves to portfolio managers, too, and often underlie the compliance deficiencies we find. In all the following situations, you must ask yourself whose interest you will prefer and why:

- charging exorbitant and unrelated charges to a fund;
- performance reporting that is meant to create an impression not supported by the facts; and
- confusion about how to resolve the conflicts inherent in operating your own fund and selling those fund units into your clients' fully managed accounts.

For those of you who are just starting out as registered exempt market dealers, or registered investment fund managers, you may think that it is "piling on" to ask you to consider ethics on top of the immediate task of just getting yourself registered and operating under the registration framework. There is no time like now to focus clearly on your ethical choices. You will find that sound ethical choices are the foundation for sound compliance and risk management. We believe there is a direct and critical relationship between your ethics and your compliance culture.

In Warren Buffett's famous September 27, 2006 memo on ethics to his more than 200,000 employees, he opened by saying:

"The five most dangerous words in business may be "Everyone else is doing it.""

After setting out his view of the current state of ethics in American business, Buffett finished by saying:

> So, at Berkshire, let's start with what is legal, but always go on to what we would feel comfortable about being printed on the front page of our local paper, and never proceed forward simply on the basis of the fact that other people are doing it.

Whether you are starting out as a registrant, or have been operating for many years, I invite you to critically assess your activity when everyone else is doing it to consider whether, quite apart from that fact, it is ethical.

Sandy Jakab is the Director, Capital Markets Regulation at the BCSC

Q&A on IFRS requirement for all registrants

by Janice Leung

On January 1, 2011, Canada will adopt the International Financial Reporting Standards (IFRS) as the accounting principles for publicly accountable enterprises. The Canadian Securities Administrators (CSA) has concluded on the requirement for registrants to changeover to IFRS. Because of the IFRS changeover, CSA amended several Instruments to reflect the new requirements.

On October 1, 2010, the CSA announced the expected adoption of National Instrument 52-107 *Acceptable Accounting Principles and Auditing Standards*, its Companion Policy 52-107CP, and related amendments to National Instrument 31-103 *Registration Requirements and Exemptions* and its Companion Policy 31-103CP. You can review the advance notices by clicking on the above links.

NI 52-107 sets out the accounting and auditing requirements while NI 31-103 sets out the ongoing financial reporting requirements for registrants. Here are some Q & A to help you understand the transition and the changes in requirements.

Q: When will the revised NI 52-107 and the companion policy be in effect?

> A: NI 52-107 will be effective on January 1, 2011. Related amendments in NI 31-103 will also be effective on January 1, 2011.

Q: As a registrant, what accounting standards should I apply for my firm's financial statements?

> A: Registrants are required to prepare financial statements in accordance with Canadian Generally Acceptable Accounting Principles (GAAP) applicable to publicly accountable enterprises (PAEs).
>
> Canada's Accounting Standards Board (AcSB) will adopt IFRS as Canadian GAAP for PAEs effective January 1, 2011. This means that registrants must prepare financial statements in accordance with IFRS for financial year beginning on or after January 1, 2011.

Q: My firm does not meet the definition of a publicly accountable enterprise set out by the AcSB. Does my firm have to prepare financial statements according to IFRS?

> A: All registrants are required to adopt IFRS, regardless of whether the registrant fits AcSB's definition of publicly accountable enterprise.

Q: My firm owns several subsidiaries. How should I account for them?

> A: NI 52-107 specified that registrants should account for any investments in subsidiaries, jointly controlled entities, and associates as specified for separate financial statements in International Accounting Standards (IAS) 27 *Consolidated and Separate Financial Statements*. This means that you should prepare your firm's financial statements on a non-consolidated basis.

Q: What financial information is required to adopt IFRS?

> A: The requirement to adopt IFRS applies to all financial statements and interim financial information delivered under NI 31-103.

Q: My firm's next year-end will be March 31, 2011. When do I have to begin adopting IFRS?

> A: IFRS applies to financial year beginning on or after January 1, 2011. In this case, you will have to adopt IFRS for the financial year beginning April 1, 2011.

Q: My firm is registered as an investment fund manager and has a December 31 year-end. When do I have to begin reporting using IFRS?

> A: As an investment fund manager, your firm has to deliver quarterly interim financial information to the Commission for the first three quarters. You will have to report your interim financial in accordance with IFRS starting for the quarter ending March 31, 2011.

Q: Will there be filing extension to help registrants to transit to IFRS?

> A: Yes. Sections 12.15(2) and 12.15(3) of NI 31-103 allows dealers and investment fund managers to deliver the first interim financial information, Form 31-103FI *Calculation of Excess Capital*, and net asset value adjustment description of an interim period beginning on or after January 1, 2011 no later than 45 days after the interim period end.

Q: Do I have to restate comparative information for the preceding financial period in IFRS?

> A: Section 12.15(1) of NI 31-103 allows registrants to exclude comparative information in the annual financial statements, interim financial information, and Form 31-103F1 for a financial year beginning in 2011.

Q: Where can I find a copy of IFRS?

> A: The AcSB has already incorporated IFRS to form Part 1 of the Canadian Institute of Chartered Accountant (CICA) Handbook. A copy of the Handbook is available on the CICA's website.

Q: Where can I find IFRS resources?

> A: The CICA provides many free transition resources on its website, especially for small and mid-sized companies.

Janice Leung is a Senior Examiner in the Examinations Branch of the BCSC's Capital Markets Rgulation Division.

Resources for Registrants

- National Instrument 31-103 *Registration Requirements and Exemptions*
- BCSC Compliance Toolkit – a resource for compliance
- CSA Registration Database – registration type and status of individuals and firms
- BCSC Disciplined Persons List – individuals that have been sanctioned by the BCSC
- BCSC Q & A's for Dealers and Advisers – questions and answers for registrants
- BC Securities Act, Regulations and Rules – the securities legislation
- Policies and Instruments – policies and instruments in effect in BC
- Registration Forms – forms specific to dealers and advisers
- BCSC Weekly Report – weekly updates on new policies, news releases and orders
- InvestRight – investor education by the BCSC

Other resources:

- BC Statutes and Federal Statutes
- AIMA Canada – The Alternative Investment Management Association
- Canadian Securities Administrators
- Canadian Securities Institute
- CFA Institute
  - CFA Professional Conduct
  - CFA Standards of Practice Handbook (PDF download)
  - CFA Vancouver
- FINRA Financial Industry Regulatory Authority - Compliance tools
- Managed Funds Association – reports on sound practices
- OSC Compliance resources
- Society for Corporate Compliance and Ethics
- Canadian Centre for Ethics and Corporate Policy
- US Securities and Exchange Commission
  - Information for Newly-Registered Investment Advisers

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Let us know what you think about the Registrant and make suggestions for future articles or Q&As.