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Final Report: Conflicts of Interest, Compliance and Governance in Financial Services

PRESENTED TO:

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BY:

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Conflicts of Interest, Compliance and

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Executive Summary

Following the detection of inappropriate trading transactions by staff of Transamerica Life Insurance Company of Canada in respect of its NN Information Technology Segregated Fund and the company s remedial action to indemnify policy holders and to discipline staff based on violation of the company s Code of Conduct, the Financial Services Commission of Ontario (hereinafter FSCO) sent a questionnaire to all 34 insurance companies registered in Ontario which offer Segregated Funds. FSCO is responsible for market conduct regulation of all life insurance companies doing business in Ontario.

In addition to surveying policies and procedures specifically regarding Individual Variable Insurance Contracts where the pricing was dependent on underlying time zones, the majority of questions dealt with the existence of policies and procedures regarding Codes of Employee Conduct. The questionnaire surveyed the policies and procedures of each company, with an emphasis on governance.

FSCO engaged Richard Leblanc, University Centre for Management Studies Inc., to provide advice on the best practices he has encountered in the area of Codes of Conduct in Canadian corporations. Mr. Leblanc (hereinafter the researcher) is a lecturer at York University who is an academic specialist on boards of directors and has made extensive study of corporate governance and compliance in a wide range of major corporations.

The initiating reason for the development of this report arose from a particular occurrence in the insurance industry. It rapidly became apparent, however, that the principles of sound corporate governance in the area of conflicts of interest and codes of conduct identified in the report are not industry specific, but have wider application to all companies operating in the financial services sector. The recommendations in this report, except where specifically referenced to the insurance industry, may be considered applicable to all financial services corporations regulated by the Financial Services Commission of Ontario.

Section 7 of this report contains regulatory recommendations for the Province of Ontario, together with general commentary in section 8 on likely internal costs for improved compliance systems by life insurance companies doing business in Ontario.

1. Introduction and Objective of this Report

The successful implementation of high standards of corporate compliance and governance are important objectives that will contribute to the continued success of, and public confidence in, life insurance companies doing business in Ontario. The establishment and implementation of an effective compliance program, overseen effectively by a board of directors, will determine in part how such companies are perceived by their various stakeholder groups, including prospective and current shareholders, policy- or unit-holders, employees, suppliers, regulators and the public at large. These stakeholders are aware that higher standards of corporate governance are increasingly being expected of both private and public Canadian companies.

The objective of this report therefore is to promote compliance and governance excellence at life insurance and other financial sector companies doing business in Ontario through: (i) high standards of competence, accountability and disclosure; (ii) compliance with legal regulations; and (iii) consistency with best corporate governance practices.

In general terms, there are several objectives to be served by an insurance company in instituting high standards of corporate compliance and governance. They include:

(a) To satisfy shareholders, directors, policy-holders, regulators, the public and other stakeholders that the compliance and governance practices of the company are sound and possess integrity and transparency of process;

(b) To demonstrate to the company s stakeholders that the organization is trustworthy, effective and ethical;

(c) To promote high levels of individual and organizational performance and accountability;

(d) To establish diligence in addressing governance issues; governance failure can be very costly and can result in negative publicity, loss of shareholder and organizational support, costly litigation and other penalties; and

(e) To communicate corporate compliance and governance practices in as relevant and a user- friendly framework as possible, consistent with best practices in the field.

2. Methodology

This report was completed by Richard Leblanc, President of University Centre for Management Studies Inc. (UCMS), in consultation with other compliance experts, whilst maintaining confidentiality.

The methodology for this report was qualitative in nature. Specifically, the data collection, analysis and drafting phases consisted of:

- document review and analysis;
- internet and database synthesis and assessment; and
- in-person and telephonic consultations with FSCO personnel and compliance experts.

This mode of engagement by UCMS involves action research and focuses on providing clients with expertise that is tailored to their specific needs. It is against this backdrop that any recommendations are made (*e.g.* section 8). This contextual inquiry and analysis unfortunately does not readily lend itself to a generic summary or template, publishable in an academic format.

As a qualification of this report, within the time limits and scope of the engagement, its contents do not constitute legal advice, opinion, recommendations or otherwise, and should not be relied upon as such by FSCO or any third party companies or individuals who may subsequently view this report. Third parties in particular are advised to obtain legal and other professional services to suit their particular circumstances, or contact the researcher directly.

3. Conflicts of Interest and Codes of Conduct

In a letter to life insurance companies doing business in Ontario of 4 August 2000, FSCO wrote that [a]s reported in the media on August 1, 2000, Transamerica Life Company of Canada announced that it had taken action to stop inappropriate employee trading activity in their NN Information Technology Fund.

Such inappropriate trading activity, according to one press report (*National Post*, 9 September 2000 at D9), included the following:

> The scheme capitalized on the fund s faulty pricing mechanism by using the time lag between market closings in Europe and North America to accurately predict [sic] daily closing prices. The improper gains meant the employees involved saw their share of the fund increase at the expense of other unitholders.

Transamerica s specific action to provide full restitution to affected policy holders is beyond the scope of this report. However, the role of the company s Code of Conduct was central to Transamerica s approach to dealing with the employees involved and is central to the main theme of this report.

When an employee engages in self-serving conduct, which may be legal (and in this case, to the best of the researcher s knowledge, information and belief, such conduct alleged to have occurred by Transamerica employees was not illegal in that it appeared not to have breached a statute or regulation), and such self-serving conduct occurs at the expense of the company or one of its stakeholders (*e.g.* unitholders in this case), then this activity is characterized as a conflict of interest. Codes of Conduct have a pivotal role in dealing with such conflicts.

What follows below is a description of what constitutes a conflict of interest, then followed by a description of what best practices are for dealing with conflicts of interest in the workplace.

Conflicts of interest

A conflict of interest exists or a perceived conflict can exist if one has a direct or indirect pecuniary or personal interest in a decision being made, a decision that should, and needs to, be made objectively, free from bias and in the best interests of only the company in a corporate setting or the client in a professional setting. By operating under a conflict, one s independent judgment is compromised, and, more importantly, the objective assumption of independent judgment on the part of the decision-maker is seen to be compromised.

In the context of corporate conflicts of interest, employees are required to act in the best interests of the company at all times. A conflict of interest arises when an employee must choose between the company s best interests or his or her own. Employees judgments must be, and must be seen to be, independent of any personal or pecuniary interests arising from business dealings, social ties, or other personal or financial considerations. A company s employees should therefore be responsible for disclosing and, where appropriate, taking action to remedy the conflict of interest. In most instances, such disclosures should be made to the employee s immediate supervisor or an officer of the company. A designated senior officer, with authority and resources, should be responsible for overseeing the management of conflicts of interests and reporting to the company s board of directors on a regular basis, with adequate documentation provided to the board to support that senior officer s opinion that conflicts are being managed in an appropriate fashion.

The Code of Business Conduct

Statements on detecting, disclosing and managing conflicts of interest are often included within a company s Code of Business Conduct (Code). The Code forms the centre-piece of any compliance program. Properly drafted Codes reflect the legal, strategic and operating environment of the company.

An effective Code should have several key objectives:

- To demonstrate to the public, regulators, employees, customers, suppliers and competitors that the company s ethics are soundly managed and that the company is trustworthy;
- To communicate with employees about potentially difficult situations and conflicts of interest, and to provide guidance for resolving such issues;
- To educate employees about the company s principles and values and what the company considers appropriate business practices and behaviours; and
- To promote the guiding principles of respect and fairness in employees treatment of each other and in dealings with other stakeholders.

A commitment to legal and ethical conduct

All Canadian companies operate within a complex framework of federal, provincial and municipal laws and regulations. At all times, a company s employees must comply with the letter and the spirit of applicable laws and regulations in Canada and any other jurisdiction in which the company carries on business.

Accordingly, companies should require employees, within the Code, to conduct the business affairs of the company with honesty, integrity and fairness. At all times, they should be required to be truthful and transparent in communications and relationships with stakeholders in a way that will withstand the highest degree of public scrutiny. Employees should be required to treat each other with respect and dignity and their working relationships should be based on candour and openness.

Application of the Code

A Code should apply to the entire company, including its directors, officers, managers and employees, and to any subsidiaries, related companies or joint interests controlled by the company, including the directors, officers, managers and employees of these associated entities. Suppliers and contractors who provide goods and services to the company should also be expected to conduct themselves in accordance with the Code in their activities relating to the company.

All company employees and key suppliers should receive individual copies of the Code and should be responsible for knowing its content and complying with its provisions at all times. In addition, the Code should be made available to other corporate stakeholders as appropriate and upon request.

Monitoring and enforcement of the Code

Compliance with the letter and the spirit of the provisions within this Code should be a condition of employment for all employees of the company, as well as a condition of contracting for suppliers. Contravention of the Code must result in disciplinary action including dismissal or termination of the employment or contractual relationship, including possible legal action.

Compliance certificates should be completed at least once each year by all employees. Employees should be required to certify on an annual basis that (i) they have read and understood the Code and are in compliance with it; (ii) those employees for whom they are responsible are in compliance, to the best of their knowledge, information and belief; and (iii) they have no knowledge of others who is not, or may not be, in compliance with the Code.

A senior officer of the company should be assigned responsibility to enforce the Code as part of the overall corporate compliance program and to ensure, so far as possible, employees and suppliers are aware of and comply with the Code s provisions. This at a minimum includes the following: (i) distributing copies of the Code to employees, key suppliers and contractors; (ii) overseeing the administration of on-going communication, training and education; and (iii) monitoring compliance with the Code, including reporting on the results and effectiveness of the compliance program at least annually, in conjunction with the CEO, to the board of directors.

Code inquiry mechanism

An important element of an effectively implemented Code as the basis of a sound compliance program is a mechanism to obtain clarification and guidance on complying with the Code s provisions, especially in the area of conflicts of interest.

If any employee in any jurisdiction in which the company operates is unsure about the ethical aspect of any company decision or transaction including for example specific issues of interpretation or clarification, advice, ethical queries or potential breaches of the Code the employee should be required to discuss the matter before acting with his or her immediate supervisor. If that is not feasible, then there should exist a known procedure for the employee to pursue the matter with an officer of the company, such as a compliance officer for example, and the employee should be required to do so under these circumstances.

The procedure for Code inquiry, as will be discussed in the next section, should offer protection to employees for coming forward with compliance-related concerns. For example, information provided should be maintained in confidence to the fullest extent possible, but without impairing the procedural rights of those employees whose conduct may have been alleged to have been inappropriate. A proper investigation should also occur. And no retaliatory action should be taken against any person for refusing to participate in a breach or an apparent breach of the Code, or for disclosing ethical problems to an appropriate company officer or other employee.

Suggested content for Codes within the financial services sector

Lastly, to conclude this section on conflicts of interest and codes of conduct, given the researcher s experience in Code development, including assisting companies in the financial services sector, the content of a Code of Conduct for the financial services sector will be addressed.

In the opinion of the researcher, a well-drafted Code of Conduct for a financial services company (including a life insurance company) would contain the following sections:

<u>Part 1: Introduction and Application</u>

- Introductory letter of support of the Code by the CEO;
- Purpose and objectives of the Code;
- Abiding by the letter and spirit of the law;
- A commitment to ethical conduct;
- Application of the Code;

<u>Part 2: Content of the Code</u>

- Employee relations and an harassment and discrimination free workplace;
- Workplace safety and security;
- Company assets and intellectual property;
- Integrity of books, records and payments;
- Avoiding conflicts of interest;
- Confidential information;
- Securities law and insider trading prohibitions;
- Marketplace relations and competitive business practices (including customer, supplier and competitor relations);
- Media, public, community and government relations;
- Political activity and contributions;
- Shareholder relations;
- Protection of the environment;
- International business activities and facilitating payments ;

<u>Part 3: Administration and Enforcement of the Code</u>

- Code inquiry and protection mechanism for coming forward;
- Compliance sign-off statement and confirmation of adherence to the Code; and
- Conclusion and guidelines for ethical decision-making.

Some of these sections were addressed earlier. Addressing all or even some of these sections from a detailed content and drafting point of view is beyond the scope of this report. For those readers interested in Code content issues, they are encouraged to consult a previous publication co-authored by the researcher: Clarkson, M.B.E., Deck, M. & Leblanc, R. *Codes of Ethics, Conduct and Practice* (The Society for Management Accountants of Canada: 1997).

That said, however, some general remarks will be offered concerning the content of Codes for the financial services sector.

Perhaps the most important sections of a Code for a financial services company are: integrity of books, records and payments; conflicts of interest; confidentiality of information; and insider trading prohibitions. Some financial companies have separate policies for some of these areas but such policies should at least be incorporated by reference to the overall Code of Conduct, and in most cases they are.

Second, in drafting the above sections, it is especially important that they be as detailed and comprehensive in nature as possible, given the company s internal and external environments, supported by examples and rationales, and written in an inviting type of tone. For example, some sample language for the integrity of books, records and payments section of a financial services Code might include the following:

Every transaction between the company and its stakeholders must be evidenced by the appropriate accounting and supporting documents and reflected in the company s books promptly, accurately and completely. No asset, liability or transaction is ever to be concealed from management, internal or external auditors or other persons, including governmental, regulatory and tax authorities. Any deception or other improper circumvention of generally accepted accounting standards is also prohibited. All employees are encouraged to question and report transactions which appear to be contrary to established policies.

As a second example, conflicts of interest defined above within effectively-drafted Codes in the financial services sector will outline examples of how conflicts of interest might arise when employees deal with or advise customers or clients. Examples of conflicts might include the following: outside business activities and associations, including employment, directorships, and passive ownership, meals, entertainment, gifts, favours, cash payments, or any other type of self-dealing that might cause or be seen to cause an employee to render anything other than objective advice or recommendations in the best interests of the customer and the company. The drafting of the Code should include why and how such activities could or would constitute a conflict of interest and provide helpful guidance to the employee in recognizing a conflict, disclosing it to management, and receiving guidance/direction on how to manage that conflict.

Third, examples and rationales for prohibitive rules assist employees in recognition, education and compliance, especially in the financial services sector, where rules are often under-pinned by technical and complex (at least from the point of view of a typical employee) corporate and securities legislation. For example, in the area of confidentiality of information, the Code drafting should define what constitutes confidential information (with guiding principles, numerous examples and as exhaustive of a list as possible), should provide rules for proper access and use, and should restrict such access and use of confidential information only for legitimate internal business purposes, as opposed to self-gain by the employee at the expense of the company or its customers or clients.

Lastly, the better-drafted financial services sector Codes also are effective at defining terms and doing so in a way that employees understand. In the technical area of insider trading prohibitions and personal trading by employees for instance, many of the following sampling of terms and phrases are commonly defined and explained thoroughly in the more effective financial sector Codes: access person, annual certificate of compliance, black-out period, company securities and products, compliance review procedures, confidential information, employee, exempt securities, family, home, independent, independent review of trading decision, insider, investment personnel, material information, person in a special relationship, personal trading reporting process, related person, reporting procedures, requiring prior approval for personal trades, spouse, tipping and trading. Examples should also accompany the preceding definitions as much as possible to enhance employee understanding. Defining such types of terms within a Code is especially important for Codes within the financial services sector and assists in application, interpretation and enforcement purposes.

4. Best Practices of an Effective Corporate Compliance Program

Although a compliance program varies according to the size, scope of business activities and complexity of operation of the company, there do exist best practices for all compliance programs given the researcher s experience. A ten point check-list of sorts is presented below, accompanied by key bullet points and a brief description of each of the ten elements of a best-practice compliance program.

A Ten Point Check-list of Best Practices for an Effective Compliance Program

(1) Board leadership

- compliance oversight as part of its mandate;
- regular reporting to the board and questions of management;
- setting the ethical tone for the corporation;

Responsibility for devising and implementing an effective corporate compliance program rests squarely with senior management. It is the role of the board of directors in turn to ensure that this happens and to hold management accountable if it does not, or if the compliance program is faulty in any way. Best practice boards take compliance very seriously. In many cases a committee of the board has responsibility for ensuring effectiveness of the compliance program and reports to the full board. At a minimum, however, the full board should oversee compliance as part of its overall mandate. This means that regular reporting, by management to the board, must occur, and at least once a year. In addition, positive assurance should be given by management to the board and this assurance should be accompanied by adequate documentation to support management s opinion and enable the board to ask informed questions about the compliance program. The board should also ensure that appropriate resources, technology and controls are in place to enable the compliance program to function effectively. Lastly, the actions of the board in respect of compliance send an important signal not only to senior management but also to external and internal corporate stakeholders about how the board is setting the ethical tone for the corporation.

(2) Senior management support

- walking the talk ;
- inferences made by employees;
- resources, personnel and budget;

When it comes to compliance, actions by management speak much louder than words. What management does is just as important as what it says it will do, and often more important. More specifically, employees will make inferences about the importance of the organizational compliance program based on the amount and type of resources that are dedicated to it by senior management and the support from the CEO. These resources include internal resources, what individuals are involved, the number of them, and whether money is being spent on the program. These factors send important signals to employees and other managers about how serious senior management is about compliance.

(3) A Code of Conduct and decision-making framework as the basis of the program

- comprehensive, effectively drafted, with supporting examples, rationales;
- decision-making assistance and guidance within the Code
- a sign-off procedure and a condition of initial and continued employment;

As mentioned in the previous section, the foundation of any effective compliance program is the Code. The Code is a necessary condition for an effective program but certainly not a sufficient one. Effective Codes deal adequately and comprehensively with issues of risk to the company, both in legal terms and in ethical ones. Properly drafted Codes will have a balanced approach to compliance related issues, containing both rules and guiding ethical principles. In addition, best practice Codes have within their four corners some type of decision-making framework that provides guidance to employees in resolving ethical dilemmas for which the Code may not have accounted. Also, Code compliance should be verified annually by a signed statement by all employees, including senior management, that they have read the Code, understand it, and are in compliance with it. Often times the board of directors at best practice companies will also subject itself to the Code to signal its support throughout the organization. This compliance statement would function as a condition of employment with the company for all employees and would form part of the orientation program for incoming employees.

(4) A protected mechanism for coming forward

- where to go for advice
- coming forward is desirable;
- not investigating, conducting a faulty investigation, or retaliating;

It is critical, as part of every compliance program, that employees know how to obtain assistance in applying the Code and to whom to turn for advice and guidance when they may be unsure, or think that a breach of the Code may be occurring or may have occurred. From the company s point of view, seeking ethical assistance early on is more desirable than an employee not coming forward and acting on his or her own, without the input or direction from management. The reality however is that many employees are reluctant to come forward and the fault of this rests squarely with management. Management should have a mechanism in place to promote the fair treatment of employees when they do come forward. This may include assuring confidentiality to the extent possible, an internal ombudsperson from whom employees can seek advice, and, most importantly, acting promptly, fairly and effectively on the inquiry or the complaint once it is made. The greatest mistake management can make is not investigating an ethical inquiry or complaint made by an employee, doing so in an inappropriate or biased manner, or, worse yet, retaliating in some way against the employee for making the complaint. These types of actions breed cynicism on the part of employees and they learn quickly not to bring ethical concerns forward in the future.

(5) Dedicated officer with resources and decision-making authority

- a senior officer with authority and resources to administer the compliance program;
- direct links, accountability to the CEO and the board;
- officer should have high internal credibility and expertise;

As part of any compliance program, overall responsibility for it should rest with a senior officer who is vested with authority and resources to execute and maintain the program. This means that, in the event of a conflict, the officer possesses the degrees of freedom necessary to override other officers and managers in the best interests of corporate compliance, and will be backed by the CEO and the board if necessary for doing so. The compliance officer should be accountable directly to the CEO and should make presentations to the board on the compliance program periodically. As well as formal authority, the compliance officer should be a trusted, credible, collegial and knowledgeable internal individual, to whom employees can turn directly. He or she should have a reputation for fairness and decisiveness.

(6) Documentation, reporting and information flow

- documentary sign-off procedures and degrees of assurance;
- a cascading reporting process upward to the compliance officer;
- problems, exceptions and remedies;

Internal controls form the heart of any compliance program. The Code of Business Conduct should be a condition of employment for all employees and a contractual condition for outside suppliers. Annual sign-off statements must occur, in documentary form, warranting that employees are in compliance with the Code. Best practice companies have a cascading sign-off process whereby managers warrant program compliance for their direct reports, and warrant that they know of no-one who is or may be in non-compliance with the Code. These reports are fed upwards throughout the organization, level-by-level, eventually leading directly to the compliance officer and the CEO. Along the way, non-compliance with the Code and exceptions must be reported, together with the details and report of the decision taken, by whom, and on what basis. This information then goes to the board, in summary form. Such reporting and information flow is typically supported by the use of compliance technology.

(7) Consistency in enforcement and feedback

- informational feedback and sharing of knowledge is vital;
- avoiding spotty enforcement or perceived favoritism;
- setting the example and signalling how Code breaches will be dealt with;

The use of compliance technology, tailored to the individual company, ensures that feedback on compliance-related issues and questions that employees may have is readily available to employees when needed. To support monitoring and enforcement, compliance tasks may be tracked electronically with automated emails to prompt employees when needed of compliance-related tasks and reporting requirements. When it comes to enforcement, however, management must be able to demonstrate that the sanctioning individuals for Code breaches occurs fairly and evenly. There should not exist the perception that compliance breaches are treated differently depending on who you are, or that the rules for senior management are different from the rules for the rest of the employees. In the area of enforcement in particular, senior management has a special responsibility to be impartial, and to be perceived by employees to be impartial in enforcing the Code s provisions.

(8) Continuing education , training, and developing the right culture

- tangible support for the Code and the compliance program;
- a regular education and training program that establishes diligence;
- linking compliance to company s mission and values;

As mentioned earlier, tangible support, including the endorsement of the board of directors and leadership from the CEO, is essential for any compliance program to be effective. A key form of support includes ongoing training and continued education for every employee on the Code, its provisions, and the overall compliance program. Such support is invaluable and must be taken seriously by management, with resources devoted to it. Best practice companies typically link such training efforts to corporate values and the mission of the company. Training may be done face-to-face, in groups, in half-day or full day sessions, accompanied by senior managers, and with ample opportunity for questions and answers. All employees receive training and on-going education on the company s compliance program on a regular basis.

(9) Follow-up and program adjustment, improvement

- on-going and periodic compliance program reviews;
- instruments to collect and analyze compliance data;
- identifying weaknesses, areas of risk and recommendations for improvement;

The Code of Business Conduct should be updated on a periodic basis, ranging from every three to five years at most. The compliance program as a whole should be reviewed annually. To facilitate such reviews, best practice companies use instruments for data gathering and analysis (*e.g.* surveys, questionnaires, focus groups *etc.*), headed up by a cross-functional internal compliance team. Weaknesses and areas of risk in the program are then identified, recommendations for improvement are made, and then the program is adjusted accordingly.

(10) Independent review and use of external experts

- independent review (independent auditors or external experts) gives board a comfort level;
- provides objectivity and credibility to the program and management;
- access to best practices, standards available;

The final element of a best practice compliance program is an independent review of the program and use of external experts. An independent verification to support management s assurance opinion to the board, either via the internal audit function if it exists, or through the use of external experts, assists the board in its oversight role and provides credibility to both the compliance program and management. In addition, from a practical point of view, management s use of professional advisors who specialize in compliance, and who have knowledge of leading-edge standards and practices, can only assist in maximizing the effectiveness of the compliance program.

Compliance programs within the financial services sector

All of the above best practices are important to an effective compliance program. In addition to effective corporate governance (number (1) above and expanded upon in section 5 to follow), the following best practices are especially vital for a compliance program of a financial service company given the researcher s experience: (3) a Code of Conduct and decision-making framework as the basis of the program; (6) documentation, reporting and information flow; (8) continuing education and training; and (10) an independent review. These are key activities of any compliance program within the financial services sector.

Next, personal trading is a key area of compliance both for the financial services sector and for regulators. Compliance practices within the area of personal trading have varied widely given the researcher s experience and the results of the self-assessment questionnaires that were assessed. The practices tend to fall into three broad categories.

First, for poorly-performing companies in this compliance area, they have inadequately drafted and implemented Codes, inferior compliance programs and poor governance practices in order to detect, report and enforce in an effective manner personal trading by employees that may take advantage of non-public information in a self-dealing manner. These companies are in a very small minority.

Secondly, in the middle ground, for compliance-effective companies, such companies restrict within their Code the transactions and internal and external reporting requirements of trades of company shares by employees primarily if not exclusively to those employees who are in a special relationship to the company (such as insiders or access persons for example), as the legislation and regulations require. The compliance and governance practices of these companies are effective, but focus primarily on this group of individuals who are in a special relationship to the company and regularly are in possession of material, non-public information. In the view of the researcher, given the data, most financial services companies reside in this category.

Thirdly, ideally, the most comprehensive way of dealing with personal trading by employees would be to compel within the Code <u>all</u> employees to report <u>all</u> trades of <u>all</u> company shares, products and services and at <u>all</u> times, and to have a comprehensive, effective reporting and monitoring procedure to detect wrong-doing. To the best of the researcher s knowledge, information and belief, no Canadian financial services company complies strictly with such ideal compliance conditions, which may be perceived at the present time by companies in the second category as being overly-onerous, costly to implement, and perhaps difficult to enforce.

Nevertheless, a regular management review of the activities of all employees purchasing or trading in company products is considered by the researcher to be a basic component of a sound compliance program for the financial services sector. Given advanced technology and global integration, it is arguably possible for an employee to take advantage of confidential information and use this information to his or her advantage when buying and selling company products and services (*e.g.* beyond company shares). Nonetheless such a person may not technically be considered to be in a special relationship or an insider to the company and so may not be required to file insider trading reports and be captured in the net of the existing insider trading regime under provincial securities legislation.

The challenge therefore, in the view of the researcher, is for financial services companies to move from the second compliance category above toward the third category, albeit ideal at present, and have compliance practices aligned such that self-dealing by employees in all company products and shares is detected through effective controls, reporting and enforcement mechanisms.

5. The Board of Directors and its Role in Oversight of the Compliance Program

The mandate of a board of directors

Effective corporate governance is crucial to the long-term continued success of a corporation. Under the law, a board of directors is charged with managing or supervising the management of the business and affairs of the company. Each director and officer, in exercising his or her powers and discharging his or her duties, is required to (i) act honestly and in good faith with a view to the best interests of the corporation, and (ii) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

Responsibilities of a board of directors

A board of directors assumes responsibility for the stewardship of the corporation as articulated in the above mandate. As part of this mandate of overall stewardship, a board has responsibility in five major areas:

Fiduciary responsibilities, including (i) ensuring that the company operates in accordance with all applicable legal and regulatory requirements; (ii) approving and monitoring compliance with the company s Code of Business Conduct and all other significant policies and procedures by which the company is operated; (iii) ensuring the integrity of the company s internal control and management systems; and (iv) providing ethical leadership.

Strategic responsibilities, including (i) adopting a strategic planning process; (ii) approving major management initiatives; and (iii) identifying the principal risks of the company s business and ensuring the implementation of appropriate systems to manage these risks;

Management oversight responsibilities, including: (i) selecting, evaluating and compensating the CEO and other senior officers; and (ii) ensuring proper management succession;

External responsibilities, including: (i) abiding by all disclosure and reporting requirements; (ii) ensuring that the financial performance of the company is reported to shareholders fairly, accurately, on a timely and regular basis and in accordance with generally accepted accounting standards; (iii) reporting in a timely fashion any other developments that have a significant and material impact on the value of shareholders assets; and (iv) having a communications policy for the company to enable it to communicate with all shareholders, other stakeholders and the public generally when necessary; and

Internal responsibilities, including: (i) the board managing its own affairs, including planning board and committee structure, composition and mandates and selecting board and committee chairs and members; (ii) assessing the performance of the board as a whole and its committees; (iii) selecting, evaluating and compensating directors; and (iv) orienting new directors and having a continuing education process for current directors.

The board of director s oversight of the corporate compliance program

On at least an annual basis, either a committee of the board (*e.g.* conduct or risk review, compliance, audit *etc.*) or the full board, depending on the circumstances, should approve and review management s compliance program, including compliance with the Code and conflict of interest guidelines if they are separate. The committee or the full board should also assess the integrity of the company s internal control and management systems and the extent to which such systems effectively identify and manage the risks to which the company is exposed.

As mentioned in the earlier section, an officer (*e.g.* the compliance officer, general counsel, CFO *etc.*) should be responsible for overseeing company-wide compliance with the Code and all other significant policies and procedures, and for ensuring that the company operates in accordance with all applicable legal and regulatory requirements. These compliance opinions, with supporting documentation, should be reported to a committee of the board and/or the full board on a regular basis.

Compliance information and opinions provided by management

Management must be required to keep the board fully informed of the progress that has been made in achieving its established goals, objectives and policies. Any and all material deviation therefrom must be brought to the board s attention promptly and candidly, including the area of corporate compliance.

In order to be objective in its deliberations, knowledgeable in its decision-making, informed in its questioning of management, and independent in its voting, the board of directors needs information from management that is: (i) high in quality (relevant to the decision that needs to be made); (ii) appropriate in quantity (concentrated and useful); (iii) timely (in advance); and (iv) in a suitable format.

This informational requirement is especially important in the area of corporate compliance and forms the basis of the board s questioning of management on its compliance opinion and program. A compliance opinion to the board should summarize at a minimum: (i) any current issues/breaches/risks that have arisen and enforcement actions taken under the Code during the reporting period; (ii) any proposed amendments to the Code and the compliance program; and (iii) the educational, training and reinforcement sessions held on the Code and the compliance program; (iv) a summary of the compliance statements submitted by all employees and the current state of compliance; and (v) the basis for management s compliance opinion, accompanied by documentary support provided to the board.

Independent assessment of the compliance program and retaining professional advisors

Lastly, the chair of the board, in his or her discretion, should be able to retain a professional advisor to provide services to the board of directors or a committee of the board at the expense of the company. If an individual director wishes to engage an outside advisor at the expense of the company, for advisory purposes, the engagement of such outside advisor should be approved by the chair, depending on the circumstances and reason for requesting independent professional advice.

A corporate compliance program should be independently assessed from time to time. Professional advisory firms (law, accounting, consulting, *e.g.*), retained by management, are not necessarily independent, or viewed so by regulators when it comes to assessing compliance programs. They may be considered pro-management (see *e.g. New York Times*, 28 Sept. 2000 at A-12).

The implication of this view for the board s role in compliance oversight is that, for independent assessment of the adequacy of management s compliance program, experts should in fact be independent. This may mean that internal experts are retained, such as internal auditors for example, where such a function exists. Independence may mean external experts are retained by the board or a board committee directly rather than being retained by management. It may involve the board insisting that management retain outside assistance by a service provider who does not currently provide other forms of assistance to the company (*e.g.* auditing) and who has the knowledge and skills necessary to undertake the compliance review.

6. Implications for FSCO and Life Insurance Companies Doing Business in Ontario

Going back to our original discussion of conflicts of interest and compliance programs, it is not possible for a regulator to detect or monitor the myriad of possible corporate conflicts of interest within a workplace. It is also arguably not the regulator s role to do so. Practically, no amount of regulation will ever be adequate to dissuade the agency cost borne by professional managers engaging in self-serving conduct. The direct responsibility of detecting, monitoring and prohibiting conflicts of interest within life insurance companies doing business in Ontario is that of senior management. The responsibility in turn to ensure that senior management has an effective compliance program in place in order to do so rests clearly, and squarely, with the board of directors of such companies.

Inadequate or ineffective compliance, ultimately, is the fault of the board of directors, and therefore that is where compliance efforts by regulators are beginning to be, and should be, directed. Regulatory compliance efforts should be targeted at the boards of directors of life insurance companies doing business in Ontario.

Regulatory efforts in the field of market conduct should, if they do not already, embrace overall compliance programs of life insurance companies doing business in Ontario.

The implications for life insurance companies doing business in Ontario therefore is that resources and efforts should be directed to ensure that their compliance programs are in line with the best practices and suggestions in Section 4 of this report. Reforms to compliance systems would need to occur, as would oversight mechanisms by the board of directors.

7. Conclusions and Recommendations for Action by the Superintendent of the Financial Services Commission of Ontario

The recommendations below target the boards of directors of life insurance companies doing business in Ontario in particular in ensuring that management s compliance program is effective. Reference is made both to FSCO and to regulators more generally in the event that this report is circulated to regulators outside of Ontario.

Lastly, the conclusions and recommendations that follow are not intended, nor should they be interpreted, to constrain, limit or pre-judge in any way FSCO s ongoing responsibility for market conduct regulation of life insurance companies doing business in Ontario. Commenting, directly or indirectly, on FSCO s market conduct regulation of life insurance companies doing business in Ontario was beyond the scope of this report.

The conclusions and recommendations are as follows:

(1) Regulatory efforts in the area of market conduct should, if they do not already, embrace the overall compliance programs of such companies. The focus of regulatory efforts should be on the responsibility of the board of directors to ensure high standards of conduct and compliance, and on the processes and practices through which the board of directors obtain assurance that these standards are being met by management of life insurance companies.

(2) It is not the role of a regulator such as FSCO to monitor or detect all potential conflicts of interest at life insurance companies doing business in Ontario, nor is it practical for a regulator to do so. It is the role of each life insurance company, and particularly its board of directors, to ensure an effective compliance program is in place that will detect and monitor the possible conflicts of interest within the organization. It is the direct responsibility of management of the company to detect, monitor and manage (including prohibit) conflicts of interest. Recommendations on the content of an effective Code for financial services sector companies are included in the last sub-section of section 5 above, at page 9.

(3) A compliance program varies according to the size, scope of business activities and complexity of operation of the company. Thus, the costs to devise and implement an effective compliance program will vary. While the cost of an effective compliance program is not insignificant, it is much less than the loss which may be experienced through a compliance failure in conduct, both from a monetary perspective and in terms of public confidence.

(4) In addition to continuing to review and examine compliance programs of life insurance companies doing business in Ontario, as a member of the Canadian Counsel of Insurance Regulators, FSCO may wish to consider communicating and co-ordinating resources and expertise with other provincial regulators on a national basis in order to promote education and communication about corporate compliance, including articulating expectations as to what constitutes an effective compliance management

program.

(5) Regulators should encourage the Canadian Life and Health Insurance Association to develop, in guideline format, a compliance management program based on the Code of Conduct content, compliance and governance standards and processes contained in this report.

(6) This guideline should be amplified in a more broadly detailed plain language compliance template to assist life insurance companies to understand and comply with their compliance obligations. This document should be available on regulators websites to ensure that it is available to both life insurance companies and to the general public to document the regulators expectations in this area against which companies compliance performance may be measured.

(7) Compliance best practices should be included as components of an effective compliance management program and would be similar to those articulated in section 4 above.

(8) Regulators should consider, if they do not already do so, including in their market conduct regulatory activities an assessment and review of the conflict of interest guidelines, Code of Conduct, compliance program and governance processes of life insurance companies doing business in their jurisdictions.

(9) Regulators should appoint internal personnel whose responsibility would be to oversee the development of the compliance expectations and convey to life insurance companies doing business in their jurisdictions the regulator s expectations regarding compliance.

(10) Regulators should adopt and implement these recommendations and then propose a time frame within which life insurance companies doing business in their jurisdictions would be expected to have implemented their compliance programs in conformance with the above recommendations.

8. Cost Implications of the Recommendations to Life Insurance Companies Doing Business in Ontario

The cost to devise and implement an effective compliance program will vary according to the circumstances of the individual insurance company. The cost to life insurance companies doing business in Ontario was an important criterion in developing the above recommendations.

In respect of the cost for upgrading compliance systems for life insurance companies doing business in Ontario, the researcher recommends the promotion by regulators of education and communication initiatives to such companies that include not only the elements of an effective compliance program, but also the indirect cost advantages associated with effective compliance. These cost advantages include: (i) leading management and business practices, (ii) improved consumer relations, (iii) marketing and sales advantages, (iv) effective regulatory relations, and (v) investor and public confidence. There is no question that, relative to the potentially enormous financial and reputational costs of faulty compliance systems, Best practice compliance costs are modest.

9. About the Researcher

Richard Leblanc is a lawyer, certified management consultant, experienced teacher and academic specialist on boards of directors, organizational compliance and corporate governance.

As an educator, Mr. Leblanc has taught courses in boards of directors, business strategy and business law at two Ontario universities over the last five years, at the undergraduate, graduate and executive levels. He was the 1998 recipient of what is believed to be the largest teaching award in North America from York University s Schulich School of Business, as selected by his students.

As President of University Centre for Management Studies Inc., Mr. Leblanc has been actively involved in providing applied business practice research and consulting assistance to a variety of organizations over the last ten years. More specifically, he has, *inter alia*, provided compliance assistance in the drafting, assessment and implementation of Codes of Ethics, Practice and Conduct to a number of large Canadian corporations in a variety of industries (*e.g.* financial services, manufacturing, consumer products and resource-based sectors), as well as to professional bodies. Other clients include not-for-profit associations, government and Crown corporations.

Educated in both the United States and Canada, Mr. Leblanc holds a CMC, BSc, MBA, Canadian and US law degrees (LLB, JD), a graduate law degree (LLM), and is currently completing his doctorate in corporate policy at York University s Schulich School of Business, where he is specializing in the effectiveness of boards of directors. He may be reached directly at rleblanc@schulich.yorku.ca or tel. no. (416) 944-2884.