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WHEN INVESTMENT PROFESSIONALS LOSE THEIR WAY:

THE 'HIGH CLOSING' CASE AT RT CAPITAL:

*"Clients who entrust their investment funds to an advisor
have the right to assume that trades will be made only*

From Disbelief to a Search for Answers

No sooner had Canadian pension fund managers settled in for their summer holidays at the cottage, than the Ontario Securities Commission announced a startling development. The OSC charged blue chip RT Capital, the institutional investment arm of the Royal Bank of Canada, with 'high closing' activity. Our first reaction was disbelief. This had to be a mistake. However, it soon became clear there was no mistake. RT Capital admitted that two of its senior portfolio managers and two equity traders had coerced 12 sell-side traders to bump up the closing quarter-end and year-end prices of 26 stocks in RT Capital client portfolios.

These facts led to a series of cascading consequences. The 'high closings' meant that other market participants likely made purchases in the 26 stocks at too high a price. RT client portfolio values and performance were overstated, though not by much. Clients were overcharged, though not by much. Nevertheless, restitution had to be made. Fines had to be paid. Careers were ruined. A major national financial institution received a reputational black eye, and the general public now wonders how safe its pension investments are in the hands of greedy money managers.

In reflecting on these events, it is the gross asymmetry between the potential gain from undetected 'high closing' actions, and the actual consequences which followed from their discovery, that our thoughts keep turning to. Clearly, there was a major 'disconnect' at play here. Quite apart from ethical considerations, no investment professional of sound mind would engage in 'high closing' actions with very limited potential for financial gains, if they thought through the terrible consequences of discovery of these actions. In the RT Capital case, either no thought was given to this gross asymmetry of outcomes, or if there was, the discovery outcome was assigned a probability of zero.

The next two pages of this *Letter* take the apparent 'disconnect' between the potential gain and pain of the actions taken as the starting point of a search for the lessons to be learned from this sad, but true story. Specifically, what can investment organizations do to ensure its people stay connected to the mission of the organization, and to achieving it in an ethical manner? And what should be the role of the clients in all this? The back page summarizes recent research findings on 'high closing', and related questionable money manager activities.