

Leading By Example: Corporate Governance at Socially Responsible Mutual Funds

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ABSTRACT

Socially responsible mutual funds incorporate social, environmental and governance criteria in making their investment decisions. These funds have also been lobbying their portfolio firms to improve their corporate governance structures by becoming more transparent. Do these socially responsible funds ‘walk the talk’ by being candid in their disclosures? Using a sample of 45 Canadian mutual fund managers that manage 1,650 individual funds, and a new instrument for providing a cross-sectional ranking of corporate governance disclosure levels, this study finds that disclosure transparency increases when mutual fund managers have a greater commitment to providing socially responsible mutual funds.

Key words: corporate governance; mutual funds; socially responsible investing

INTRODUCTION

Recently there has been an increased interest by academics in the structure (Davis et al., 2007) and performance of mutual funds in general (Berkowitz & Qui, 2003) and socially responsible mutual funds in particular (Bauer et al., 2006; Renneboog et al., 2008). In part, this is because mutual funds own a sizable portion of the investment market.

Members of the Investment Company Institute, the national association of US investment companies, manage \$11.2 trillion of assets and have nearly 93 million shareholders (ICI, 2009). In the UK, members of the Investment Management Association oversee £3,000 billion of assets (IMA, 2009), while the Investment Funds Institute of Canada reports that

there are about 1,800 mutual funds in Canada that have over 50 million unit holders accounts and about \$507 billion of assets under administration (IFIC, 2009).

Because of their size, mutual funds wield considerable power, especially with respect to proxy voting. They have become quite active in lobbying their portfolio firms to improve their governance structures and increase their transparency (Monks et al., 2004). Socially responsible mutual funds have been in the forefront (O'Neill & Cook, 2009). However, there has been scant research on the governance structures and disclosure policies of mutual funds in general, and socially responsible funds in particular. This is the first study we know of to examine whether there are qualitative differences in the governance disclosures of conventional mutual funds and socially responsible mutual funds.

Socially responsible (SR) investing means that investment funds include social, environmental and ethical considerations in the selection of their portfolio investments. They use either positive or negative screens. Negative screens eschew investing in firms that engage in certain unethical activities (such as alcohol, armaments, gambling, and tobacco), while positive screens encourage investing in firms that are actively involved in addressing social problems (such as helping the local community, the environment, and stopping human rights abuses). Although they are called 'ethical', their screens may simply reflect the social, religious or political attitudes of the manager of the fund and the people who want to invest in those sorts of funds and firms (Schwartz, 2003).

Previously, mutual funds avoided taking an active role in addressing potential portfolio risks associated with their investments. They were reluctant to comment on the governance structures of their portfolio firms. However, that attitude is changing, in part,

because the laws in the US, the UK and Canada concerning fiduciary duties have been evolving (Yaron, 2005). Now many investment funds are becoming active owners by submitting shareholder proposals on a variety of governance and social matters. A survey by Monks et al. (2004) of shareholder activism from 2000 to 2003 revealed that over 74 percent of the shareholder proposals concerned corporate governance issues (such as executive compensation, stock options, and board of director characteristics and activities), while the remaining 26 percent addressed corporate social responsibility (CSR) activities (such as equal employment, pollution, health care, and the environment). Most of the submissions by pension funds and general investment funds concerned governance issues, while most of the submissions by SR funds included both governance and CSR issues. O'Neill and Cook (2009) investigated the voting record of 21 mutual fund families over the three-year period 2006 to 2008. They found that generally mutual funds are strong supporters of management decisions, with the exception of SR funds that tend to oppose management resolutions and support shareholder resolutions concerning CSR activities, reporting transparency, executive compensation, and governance.

This raises an interesting research question. If socially responsible mutual funds are strong advocates of, among other things, information transparency, do these same mutual funds have candid disclosures about their corporate governance structures? Do these SR funds 'walk the talk' by being more transparent than all the other mutual funds? Or, is this a case of do as I say, but not as I do?

The next section of the paper develops two testable hypotheses using institutional theory. The third section describes the mutual fund industry in Canada and some unique features concerning corporate governance. A new disclosure instrument is described in

section four. The instrument is designed to capture cross-sectional variations in the quality of the corporate governance disclosures made by Canadian mutual funds. The final three sections outline the methodology of the study, the empirical results, and some concluding remarks.

INSTITUTIONAL THEORY

Institutional theory adopts a sociological perspective to explain organizational structures and behaviour. It draws attention to the social and cultural factors that influence organizational decision-making (Scott, 2001), and in particular how rationalized meanings or myths are adopted by organizations (Meyer & Rowan, 1977). These myths become taken for granted and so are followed in a rule-like fashion when making decisions. They become the institutionalized logic that guides organizational behaviour.

SR funds develop a rationalized logic that uses environmental, social and governance factors in selecting and managing their investments. These social criteria become the technical means for choosing their investments. They are the rationalized investment-making perceptions of the SR fund. This is consistent with Meyer and Rowan's (1977: 343-344) definition of rationalized myths: "they are rationalized and impersonal prescriptions that identify various social purposes as technical ones and specify in a rulelike [sic] way the appropriate means to pursue these technical purposes rationally." For these mutual funds, socially responsible factors are taken for granted as being legitimate criteria, and they become part of the normal evaluation process for identifying potential investments.

Information Transparency

A major goal of accounting is to provide accurate information about a firm's financial position in order to reduce information asymmetry thereby lowering the firm's cost of capital (Botosan, 1997; Verrecchia, 1990). Information transparency helps to ameliorate this problem (Akerlof, 1970). Without candid and forthright disclosures, consumers and investor cannot distinguish between good and bad assets, between high quality and low quality firms. Consumers and investors may make sub-optimal decisions if they lack this information (Healy & Palepu, 2001). This principle also applies to corporate governance disclosures (Mallin, 2002) since transparency and accountability are key elements in good corporate governance (OECD, 1998). SR mutual funds are following this principle when they actively lobby for increased reporting transparency.

Part of the embedded logic of SR mutual funds is that they will screen potential investments based on environmental, social and governance variables. Furthermore, SR mutual funds advocate that their investees strengthen their corporate governance by increasing their transparency. In a study of proxy voting by Canadian mutual funds from 2006 to 2008, O'Neill and Cook (2009) find that mutual funds tend to vote in a management-friendly manner, with the exception of SR funds that show strong support for shareholder resolutions requiring more disclosure concerning executive compensation, board of director voting, and firm behaviour, especially with respect to human rights. If there are these differences in the voting patterns of mutual funds with respect to governance and disclosures, are these differences also manifest in the disclosure patterns of these mutual funds? Do SR mutual funds walk the talk? Are they more candid and transparent? If information transparency is an essential aspect of the logic of SR mutual funds, then it should also be manifest in their disclosure patterns.

H1. Mutual fund managers that have a greater commitment to providing socially responsible funds are more likely to demonstrate more corporate governance transparency than mutual fund managers with a lesser commitment to providing socially responsible funds.

Professional Networks

DiMaggio and Powell (1983) argue that firms facing similar environmental forces will adopt similar organizational structures. Becoming isomorphic with a firm's environment increases the perceived legitimacy of the firm, and so the firm's behaviour is less likely to be challenged and questioned. They contend that isomorphism occurs as a result of coercive, mimetic, and normative pressures. These three powerful institutional forces diffuse organizational templates that cause firms to adopt common organizational structures, procedures, and decision-making routines. (See Heugens & Lander [2009] for a meta-analysis of how these institutional forces give rise to isomorphism.)

However, this traditional approach to isomorphism tends to view the diffusion of organizational norms and standards as a two-stage process, "whereby early adopters are motivated by technical considerations and later adopters engage in mindless imitation fueled by anxiety-driven pressures to conform." (Lounsbury, 2008: 350). For example, researchers find a convergence of homogenous structures as a result of board interlocks (Chau & Petty, 1999), CEO networks (Geletkanycz & Hambrick, 1997), and professional organizations (DiMaggio, 1991). The underlying assumption is that the firms that are members of these professional networks passively accept the norms provided by the network. The impetus is from the network and the firm then accepts it.

Lounsbury (2002, 2008) argues against this overly deterministic paradigm of institutional theory. He suggests that the approach could be based on the institutional rationality thesis proposed by Meyer and Rowan (1977). This perspective would argue that a firm adopts a rationalized logic that becomes part of its DNA; it is the means by which the social purpose of the firm is actualized in the decision-making routines of the firm. Such a firm would not mindlessly adopt the values of a network, but would actively seek to join a professional network that has a set of norms and values that are similar to those of the firm. The network would have to have a social purpose that is simpatico with the goals of the firm. In other words, the norms are not first established by the network and then transfused into a passively receptive firm. Instead, firms that have similar institutionalized logics would join the same professional network, as long as the professional network has a compatible logic. This suggests that institutional values may not be spread by professional networks, but rather that professional networks are the symbolic representation of firms have similar institutionalized logics.

SR mutual funds have a similar rationalized logic that guides decision-making based on principles of socially responsible investing. They use environmental, social and governance factors in determining their investments. As such, these funds, through their managers, should probably be members of a professional network that promotes socially responsible investing.

H2. Mutual fund managers that have a greater commitment to providing socially responsible funds are more likely to be members of a professional network that promotes socially responsible investing than mutual fund managers with a lesser commitment to providing socially responsible funds.

MUTUAL FUNDS IN CANADA

Mutual funds are very popular investment vehicles for Canadians. The first mutual fund was established in 1932 but they did not become extensively used until the 1990's when millions of Canadians began to put their savings into mutual funds. They are currently the fastest growing segment in the financial services sector in Canada. This growth has been spurred by low interest rates, a growing deficit in the Canada Pension Plan matched with increased savings by an aging baby-boom generation, and the entrance of banks and trust companies into the mutual fund sector combined with an increased marketing effort by mutual funds (CICA 1997). At the end of 2001, mutual funds managed \$426 billion of assets. By August 2007 this had risen to \$696 billion, although, with the global economic downturn, the assets under management at the end of 2008 had retreated back to \$507 billion (IFAC, 2009).

Mutual funds are very attractive to people who want a diversified investment portfolio but do not want to make their own investment decisions. Professional investment managers run the funds on behalf of the unit holders and so each unit holder does not have to acquire a high level of investment acumen. Funds pool all the money allowing people to make even small investments into the fund. With a large amount of pooled cash, the fund can become well diversified investing in a variety of stocks, bonds, real estate, money market instruments, and other financial securities in accordance with the fund's investment policies and objectives. As such, mutual funds are a cost-effective way of holding a diversified portfolio that reflects the investor's investment objectives.

The Management of Mutual Funds

A mutual fund requires a variety of services, including portfolio management, the recording of the sale and redemption of units, custodianship, general administration, and record keeping. However, mutual funds rarely have any employees. Instead, the fund has a Manager, an incorporated business that may or may not be publicly traded. The operational duties and responsibilities of the Manager to the fund are laid out in a management agreement. If the Manager's organization does not have the in-house expertise, then the Manager will contract for those services from third parties. Whether or not any services are sub-contracted, the Manager remains responsible for the provision of all services to the fund.

Normally, the Manager sponsors the fund, provides the initial seed capital, markets the fund to investors, and oversees the daily operations of the fund. In return, the Manager receives a fixed percentage of the average net assets held by the fund during the year. If services are sub-contracted, then the Manager will either pay for those services directly or share the management fee with those third-parties. Because the Manager receives a percentage of the net asset value of the fund, there is a strong motivation for the Manager to increase the size of the fund. Well managed, highly publicized and well performing funds encourage large investments by unit holders (Sirri & Tufano, 1998), which, in turn, generates large fees for the management company and the management company's shareholders.

The Manager can be responsible for a family of funds. A family might include, for example, a Canadian growth fund, a Canadian index fund, an international fund, and a socially responsible fund. Families can vary greatly in size. For example, Mackenzie Financial Corporation manages 170 funds, of which only one is considered a socially

responsible fund, whereas TD Asset Management manages 111 funds of which none is deemed to be a socially responsible fund. Meritas Financial Inc., on the other hand, manages seven funds all of which are classified as socially responsible.

Mutual funds are established with a trust agreement that outlines the purpose of the fund. A social responsible fund specifies in its trust agreement that it will follow financial, social, environmental, and ethical guidelines in making its investment decisions. So, a SR mutual fund is one that has self-designated itself as socially responsible and can market itself as such.

Independent Review Committee

The Manager has a fiduciary responsibility to act in the best interests of the unit holders. This means that the Manager is expected to identify and manage any conflicts of interests. In order to reduce conflicts of interest, effective November 1, 2007, all mutual funds must have an Independent Review Committee (IRC). The role and functions of this committee are specified in National Instrument (NI) 81-107. The IRC has no power, authority or responsibility neither for the operations of the fund nor for overseeing the Manager of the fund. Its only responsibility is to reviewing conflicts of interests that are referred to it by the Manager.

NI 81-107 requires the Manager to bring any conflicts to the attention of the IRC, and the IRC will then review, assess and provide a recommendation. Conflicts can be either legal in nature or business related. Legal conflicts of interests involve such matters as cross-trading with other funds managed by the Manager, and purchasing securities issued by the Manager's parent. Legal conflicts of interest must be approved by the IRC. Business conflicts are not clearly defined in NI 81-107, but would include such things as

soft dollar arrangements (whereby the Manager receives investment research support from organizations to whom the fund is paying brokerage fees), personal trading in securities owned by the fund, hiring and paying related parties, and allocating costs between the Manager and the family of funds (Pratt, 2008). Business conflicts only receive a recommendation by the IRC, a recommendation that the Manager need not follow. However, in its annual report to the unit holders, the IRC is required to make known any differences between its recommendations and the Manager's actions.

An example of how conflicts of interest are disclosed in the report of the Independent Review Committee of the AGF Group of Funds is included in Appendix 1.

DISCLOSURE INSTRUMENT

The focus of this study is on corporate governance, and, in particular, on the transparency of the governance disclosures of mutual funds. So, a new instrument was created to assess the quality of the disclosures provided by the IRC. The purpose of this instrument is to provide a cross-sectional ranking of the disclosure levels provided by the IRCs based on the amount of required and voluntary information disclosed in their annual reports. The minimum content of the report is detailed in NI 81-107. This became the basis for the disclosure score, called SCORE. It was augmented with additional voluntary disclosures made by the IRC in its annual report¹.

Five items are included in SCORE: accessibility of the report, details about the committee members, the structure of the committee, details about the compensation paid to the committee, and the content of the report. (See Appendix 2 for a summary.)

¹ This approach follows that of Botosan (1997) who developed a corporate disclosure quality score based on the disclosures of 122 manufacturing firms in their 1990 annual reports.

SCORE is the arithmetic total of the points awarded in the five categories, to a maximum of 34 points.

Report Accessibility. For information to be useful, it must be timely and readily available. One point was awarded for each of the following: the report was dated; the report date was the same as the date of the annual report of the mutual fund; and a contact address was provided for anyone needing more information. Finally three points were awarded if the report was linked to the main web page of the mutual fund; two points if the link was indirect; and one point if it required the use of a search engine to find the report.

Committee Membership. Background information about the members of the committee, their qualifications and their ownership interest is useful to unit holders because it describes the capabilities of the individuals who are monitoring the Manager. One point was awarded for naming the members, an additional point if their address (city name) was provided, and one point for disclosing the date of their appointments to the IRC. A brief explanation of their qualifications received one point; a detailed explanation received two points. A brief explanation would be “we bring to bear extensive experience in the field of business and investing”, whereas a detailed explanation would provide the principal occupation of each committee member. Another point was awarded if the members were identified as being independent². Finally, one point was awarded for disclosing their ownership interest by range, and two points if the ownership interest was precise.

² Independence is defined in NI 81-107 (Section 1.4) as have no material relationship with the Manager, the investment fund, or an entity related to the Manager that could reasonably be perceived to interfere with the committee member’s judgment.

Committee Structure. The structure of the committee provides a context for assessing the means by which the IRC is discharging its responsibilities. One point was awarded if there was a brief explanation of the committee's mandate and two points if it was a detailed explanation. A single point was awarded for each of the following disclosures: the identity of the chair of the committee; any changes in the committee membership; and the terms of office. Two points were awarded if the specific number of meetings was disclosed; one point if the number was vague. A vague disclosure, for example, would be an assertion that several meetings were held during the year. An additional point was awarded if the terms of the members are staggered. Finally, one point was awarded for providing a list of the funds for which the IRC is responsible.

Compensation. SR funds have been lobbying their portfolio firms to provide additional information about the amount and methodology used to calculate executive compensation (see Monks et al., 2004; O'Neill & Cook, 2009). Disclosing the aggregate amount paid to the IRC committee received one point, and an additional point if the amounts per committee members were disclosed. A brief explanation of the compensation process received one point, whereas a detailed explanation received two points. Disclosure of the Manager's recommendation also received one point.

Report Content. The purpose of the IRC is to provide standing instructions to the Manager and report on any conflicts of interest. One point was awarded for a brief explanation of any conflicts and two points for a detailed explanation. Similarly one point was awarded for a brief explanation of any standing instructions and two for a detailed explanation. The IRC is also to conduct a self-assessment review; one point for

saying that such a review was conducted, two points for providing a description of the review.

METHODOLOGY

Sample

Although there are thousands of mutual funds in Canada, managed through hundreds of MF managers, there is no one mutual fund database that contains a comprehensive list of all the Canadian funds. So, the MF managers in this sample are identified through two sources, and the data for this study is collected by hand. The unit of analysis is the Independent Review Committee of the MF manager.

The Investment Funds Institute of Canada (IFIC) is a voluntary member-based organization that provides trade association services for investment funds and their managers. As at December 31, 2008, it had 41 MF managers as members. In a recent study of voting behaviour by Canadian mutual funds, O'Neill and Cook (2009) identified 21 MF managers that collectively managed 85 percent of mutual fund assets under management in Canada. These two lists were combined. There were 14 MF managers on both lists. Two MF managers in the O'Neill and Cook (2009) study have the same Independent Review Committee and IRC reports could not be found for two other MF managers. So, the final sample is 45 MF managers that manage 1,650 mutual funds with assets under administration of \$576.4 billion as at December 31, 2008. Of these funds, 67 are SR funds³ that manage \$5.171 billion of assets (see Table 1). The SR funds are identified by reading the description of each fund that is disclosed on the mutual fund manager's website.

³ This low number of socially responsible funds is similar to the UK where there were, as at December 31, 2008, only 53 ethical mutual funds (IMA, 2009).

– Insert Table 1 here –

Variables

Disclosure Score. All mutual funds must have an Independent Review Committee and the IRC must publish an annual report that is available to the mutual fund unit holders. It is also to be filed with the Ontario Securities Commission and is available on the OSC website at www.sedar.com. NI 81-107 became effective on November 1, 2007. The first full reporting year ended in 2008, and because this was the first reporting period, there was no mimetic effect whereby late-coming mutual funds were ‘mindlessly imitating’ the disclosure policies of the early adopters of NI 81-107.

The disclosure score was calculated by reading the 2008 IRC reports for the 45 MF managers in the sample. SCORE is the arithmetic total of the points awarded in the five categories noted above to a maximum of 34 points.

Number of SR funds. A list of the specific funds included within the mutual fund family is provided in the IRC report. As was previously mentioned, the nature of each fund, whether or not it is an SR fund, was determined by reading the mandate of the fund as disclosed on the fund manager’s website. The continuous variable, NUMBER, is the number of funds within the family of mutual funds that are described as being a socially responsible fund.

Ratio of SR funds. The continuous variable, RATIO, is the number of SR funds in the family scaled by the total number of individual funds that are managed by the MF manager.

Social Investment Organization. The Social Investment Organization (SIO) is a national member-based organization that promotes the integration of environmental,

social, and governance factors into investment decisions. It includes financial institutions, investment firms, financial advisors, and various organizations and individuals interested in socially responsible investing. It provides information to individual investors about socially responsible investing, as well as lists of mutual funds, labour sponsored funds, SR financial advisors, and other SR organizations in Canada and around the world. The organization is also active in shareholder advocacy. The dichotomous variable, SIO, is coded 1 if a MF manager is listed on the SIO website as being a member of the SIO and 0 otherwise.

Controls. Three control variables are added. The first controls for size. Large MF managers have the financial resources to ensure that their disclosures are thorough and complete. Some MF managers have a large number of funds and so, in order to prevent skewing, SIZE is calculated as the log of the number of funds that are listed in the IRC report. The model also controls for the level of compensation paid to the IRC committee members. Compensation is often used as a proxy for effort (see Scott, 2009 Chapter 10). A greater effort by the committee should result in better disclosures. Compensation is also a function of the number of funds that the committee has to report on and oversee. Compensation was calculated as the total compensation paid to the committee divided by the number of committee members and then scaled by the number of funds. To control for skewing, the variable, COMP, is the log of the compensation value. The final control variable is whether or not the mutual fund is owned by a financial institution. Banks and insurance companies have enormous influence in the Canadian economy. Their financial statement disclosures are comprehensive and detailed. Therefore, the dichotomous

variable, FINANCE, is coded 1 if the MF manager is owned by a bank or insurance company and 0 otherwise.

EMPIRICAL RESULTS

Hypothesis two says that MF managers that provide SR funds are more likely to be members of a professional network that promotes SR values. The SIO promotes such values. A univariate analysis for differences between the SIO members and the non-SIO members reveals that MF managers that are members of the SIO have an average of 6.3 SR funds, whereas the MF managers that are not members of the SIO have an average of only 0.029 SR funds. SIO members also have a greater ratio of SR funds than non-SIO members. Both of these differences are statistically significant at $p > 0.0001$ (Table 2). This provides support for the second hypothesis. SIO members provide more socially responsible funds and a greater proportion of the funds within the family are socially responsible funds. Or, MF managers that have a greater commitment to providing SR funds (as proxied by the number and percentage of SR funds within the family of funds) are more likely to be members of the SIO than MF managers that have a lesser commitment to providing SR funds. These managers also have statistically higher disclosure scores ($p > 0.0317$) than the managers that are not members of the SIO (Table 2).

– Insert Table 2 here –

A regression was run in which the dependent variable, SCORE, is a function of the ratio of SR funds within the mutual fund family and three control variables. The results are in Table 3. None of the three control variables – SIZE, COMP, and FINANCE – is statistically significant. However, the coefficient of the RATIO variable

is positive and statistically significant ($p > 0.0070$). In other words, the greater the ratio of SR funds provided by the MF manager, the higher the disclosure score. This provides support for hypothesis one. MF managers that have a greater commitment to providing SR funds (as proxied by the ratio of SR funds within the family of funds) have better disclosure scores than MF managers that have a lower commitment to providing SR funds.

– Insert Table 3 here –

Sensitivity Analyses

Several other regressions were run (results not provided) whose results are consistent with those reported. Instead of the ratio of SR funds, the number of SR funds was used. None of the control variables became significant, and the coefficient of the number variable was statistically significant to within $p < 0.01$. Another regression was run in which the log of the number of funds within the family was used as a control instead of the log of the assets under administration. Once again the results were similar to those reported; the coefficient of the ratio variable remained statistically significant and the coefficient of the new size variable remained statistically insignificant. Finally, a model was run in which the ratio of the assets under administration the SR funds to the assets under administration of all the funds was substituted for the ratio of the number of SR funds, and the log of the total assets under administration for all the funds was used to control for size. The results remain consistent. The coefficient of the size variable remains statistically insignificant and the coefficient of the new ratio variable is statistically significant, at $p < 0.01$.

The disclosure score is composed on 22 items that total 34 points (see the Appendix). Some items have one point for minimal disclosure and additional points for more precise (e.g., item e in Section II) or elaborate (the three items in Section V) information. To test the sensitivity of the SCORE variable, the disclosure scores were recalculated on the basis of one point for all items to a total of 22 points. In other words, no additional points were awarded for more candid disclosures. The results (not provided) were that the new mean disclosure score for the MF managers that are members of the SIO was 16.4 points, while the mean score for the non-SIO families was 15.3 points. This is not a statistically significant difference. Furthermore, the regression was re-run using the new disclosure scores as the dependent variable. The coefficient of the RATIO variable (the variable of interest) was not statistically significant in the new regression, nor was any of the control variables. These results contrast with the original results where the differences were statistically significant. In other words, the two groups of MF managers only differ when the disclosure score incorporates more precise and elaborate information (i.e., when the original disclosure scores are used in the analysis). This provides further support for the hypothesis that MF managers that have a greater commitment to providing SR funds are more candid in their corporate governance disclosures.

Discussion

The Social Investment Organization (SIO) advocates for socially responsible investing and encourages its members to lobby for strong corporate governance. For this sample of mutual funds, MF managers who are members of the SIO tend to have a greater commitment to socially responsible investing. These MF managers have developed a

rationalized logic that uses social, environmental, and governance criteria to identify potential investments for their SR funds. It would appear that they have internalized these values and so are willing to join a professional organization that has a similar set of values. Rather than being influenced by the values of the professional organization and mindlessly adopting its values in an a-rational manner, these MF managers have joined a professional organization that has kindred values and a congruent rationalized logic.

Not only do SR funds use corporate governance criteria to assess the suitability of investments, many actively lobby for governance improvements in their portfolio firms. This sample of mutual funds seems to be walking the talk. Relative to their peer group (MF managers that are less committed to providing SR mutual funds) these MF managers have strong corporate governance as revealed in the disclosures of the annual Independent Review Committee (IRC) report. They are more transparent and forthright in revealing the structure, operations and activities of the IRCs. This indicates a commitment to good corporate governance.

Institutional theory draws attention to the fact that, over time, firms tend to adopt similar organizational structures and behaviours (DiMaggio & Powell, 1983; Scott, 2001), including similar disclosure patterns (Gibbins et al., 1990). The disclosure requirements of the IRC became effective in 2007 and the first reporting year was 2008, the year of this study. Although there are differences in the quality of the disclosures of these MF managers, institutional theory would suggest that, over time, these differences should disappear as MF managers adopt similar disclosure patterns. It would be interesting to track these patterns over the next few years to see if this homogeneity in

reporting actually occurs, and whether it tends towards more or less transparent disclosures.

Another observation of institutional theory is that some firms will adopt a organizational structure, not to improve its efficiency and effectiveness, but rather to convey the impression to its stakeholders that the firm is behaving in a responsible and legitimate fashion (Meyer & Rowan, 1977; Scott, 2001). These firms will then de-couple the organizational structure from having any impact on the firm's operations. An example of this would include a MF manager that joins a socially responsible organization, such as the SIO, in order to appear to be socially responsible and then offers no SR funds. However, in this sample there is no instance of this form of de-coupling. All of the MF managers that are members of the SIO offer at least one SR fund, although not all MF managers that offer SR funds are members of the SIO. More importantly, there are no MF managers that are members of the SIO that did not offer a SR fund. So, MF managers do not appear to be using the SIO as window dressing, to mislead investors into thinking that they are socially responsible when they are not.

There are a number of limitations to this study. First, only a sample of mutual fund families was selected. Although they constitute a large percentage of the total assets under administration of all mutual funds, a large percent of the number of mutual fund families in Canada, as well as a large percentage of funds that are available to investors, this is not a complete list. Second, the identity of SR funds was determined by reading the description of the purpose of the fund as provided on the mutual fund's website. Some funds may not reveal that they use SR criteria in their investment decision-making, and so there may be some miscalculations. The level of the IRC's governance was

determined on the basis of the information revealed in the IRC Report. Some mutual funds may have strong corporate governance but may opt not to reveal that in the Report. As such, the corporate governance score is simply a measure of revealed information, and not of actual performance by the IRC. Finally, the quality of the disclosures of the IRC was determined using subjective criteria that have not previously been used. As such it would be helpful to replicate the instrument in subsequent years. Because the terms of the Independent Review Committee, as per NI 81-107, are unique to Canada it would be impossible to replicate the study using mutual funds from other countries. Although this instrument cannot be used to assess, in part, of the quality of their governance, nevertheless, it in the context of the US and the UK, whether there are difference in the governance structures of SR funds and non-SR funds in those two countries.

CONCLUSION

An Independent Review Committee is a new and limited governance structure. The committee is only to examine and report on conflicts of interest. However, the means by which a mutual fund communicates information about the committee may indicate the attitude of the fund towards corporate governance and transparency. The results of this study reveal that funds that have a greater commitment to providing socially responsible investment opportunities have stronger governance and are more candid in their disclosures about the activities and composition of their IRCs than mutual funds that are less committed to providing socially responsible investment vehicles.

Mutual funds constitute a large section of the investment community in Canada. They can have a great influence on the firms in which they invest the money of their unit holders. Because of their economic clout, they can be active participants in improving

the governance of their investee, and in return contribute to a stronger financial market.

The mutual fund families that are providing socially responsible funds are leading by example. They are members of a network that lobbies for improvements in the governance structure of firms whose stock trades in the marketplace. They are also demonstrating good governance through the structure and operations of their Independent Review Committees.

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Appendix 1
Extract from the Report of Independent Review Committee of
the AGF Group of Funds to Securityholders

Conflict of Interest Matters

National Instrument 81-107 requires the IRC to review all conflicts of interest matters identified and referred to the IRC by the Manager and to give its approval or recommendation, depending on the nature of the conflict of interest matter. In certain cases, the IRC may also issue standing instructions to the Manager in conjunction with the approval or recommendation that allow the Manager to act in the particular conflict of interest matter on a continuing basis. Where standing instructions have been issued, the Manager must request the IRC to review and renew the standing instructions on an annual basis.

Below is a brief summary of the approvals, recommendations and standing instructions relied on by the Manager during the period beginning November 1, 2007 to September 30, 2008 (the “Period”).

Approvals

During the Period, the Manager requested the approval of the IRC to allow certain Funds to purchase securities from or sell securities to another Fund managed by the Manager (referred to as inter-fund trades). The approval granted requires the Manager to comply with the inter-fund trade provisions of National Instrument 81-107 and to report on a specified basis to the IRC.

Recommendations with Standing Instructions

During the Period, the Manager followed the recommendations and standing instructions made by the IRC with respect to conflict of interest matters addressed by the following policies and procedures of the Manager:

- a) Proxy Voting Policy
- b) Benchmark Selection Policy
- c) Soft Dollar Policy
- d) Short Term Trading Policy
- e) Net Asset Value Error Correction Policy
- f) Fund Expense Allocation Policy
- g) Fund Valuation and Accounting Policy

In each of the above cases, the recommendations and standing instructions made by the IRC require the Manager to comply with the related policies and procedures and report to the IRC.

Recommendations without Standing Instructions

During the Period, the Manager sought a review and followed the recommendation of the IRC with respect to the Manager’s proposal to engage Hightstreet Asset Management Inc., an affiliate of the Manager, to replace the Manager as the portfolio manager on the Canadian small capitalization portion of Harmony Canadian Equity Pool in so far as it relates to a potential conflict of interest.

During the Period, the Manager sought a review and followed the recommendation of the IRC with respect to the mergers and reorganization of certain Funds where, among other things, the investment objectives, fee structures and valuation

procedures of the merging funds were substantially the same. The IRC reviewed the proposed mergers and reorganization and the process to be followed in connection with the proposed mergers and reorganization, and advised the Manager, that in the IRC's opinion, having reviewed the proposed mergers and reorganization as potential conflicts of interest, that, following the process proposed, the proposed mergers and reorganization achieve a fair and reasonable result for each of the Funds.

The IRC is not aware of any instance in which the Manager acted in a conflict of interest matter referred to the IRC during the period for which the IRC did not give a positive recommendation. The Manager has an obligation to notify the IRC of any such instance.

Compliance

The IRC is not aware of any instance in which the Manager sought a review of the IRC with respect to a conflict of interest matter but did not meet a condition imposed by the IRC in its approval, recommendation and/or standing instructions. The Manager has an obligation to notify the IRC of any such instance.

Appendix 2
Summary of the Elements in SCORE

- I. Report Accessibility (maximum 7 points)
 - a. Report dated
 - b. Filed on or after annual report (up to 2 points)
 - c. Contact address is provided for more information
 - d. Accessibility on mutual fund family website (up to 3 points)

- II. Committee Membership (maximum 8 points)
 - a. Name and address of each committee member (up to 2 points)
 - b. Date of appointment
 - c. Description of qualifications (up to 2 points)
 - d. Members are identified as being independent
 - e. Ownership interest (up to 2 points)

- III. Committee Structure (maximum 7 points)
 - a. Mandate is described (up to 2 points)
 - b. Committee chair is identified
 - c. Changes in the committee are disclosed
 - d. Terms of appointments
 - e. Number of meetings held
 - f. List of funds for which IRC is responsible

- IV. Compensation (maximum 5 points)
 - a. Aggregate amount
 - b. Payment per committee member
 - c. Description of process for determining amount (up to 2 points)
 - d. Disclosure of management's recommendation

- V. Report Content (maximum 6 points)
 - a. Conflicts of interest (up to 2 points)
 - b. Standing instructions (up to 2 points)
 - c. Self-assessment review (up to 2 points)

Table 1
Descriptive Data

	<u>Managers</u>	<u>Total Funds</u>		<u>SR Funds</u>	
	No.	No.	\$ billion	No.	\$ billion
MF families with at least one SR fund	11	499	194.1	64	5.2
MF families without a SR fund	<u>34</u>	<u>1,151</u>	<u>382.3</u>	<u>0</u>	<u>0</u>
Total, as at December 31, 2008	<u>45</u>	<u>1,650</u>	<u>576.4</u>	<u>64</u>	<u>5.2</u>

Table 2
**Univariate Analysis for Differences Between
the SIO Members and the Non-SIO Members**

	Mean	Std Dev	Min	Max	F-value	Pr > t
Number of SR Funds						
Member of SIO	6.300	5.697	1.00	17.00	44.88	0.0001
Not a member of SIO	0.029	0.169	0.00	1.00		
Ratio of SR Funds						
Member of SIO	0.371	0.440	0.01	1.00	26.31	0.0001
Not a member of SIO	0.001	0.004	0.00	0.02		
Corporate Governance Score						
Member of SIO	21.500	2.224	18.00	26.00	4.93	0.0317
Not a member of SIO	19.043	3.277	13.50	27.00		

Table 3
Multivariate Analysis of Corporate Governance Score

	Intercept	RATIO	SIZE	COMP	FINANCE
Coefficient	11.935	5.566	0.753	0.681	1.663
t-statistic	3.15	2.84	1.46	1.02	1.53
p-value	0.0031	0.0070	0.1521	0.3132	0.1327
F value	3.02				
Prob. > F	0.0287				
Adj. R ²	15.52				

Variable definitions: RATIO is the percentage of SR funds within the mutual fund family; SIZE is the log of the total assets under administration of the mutual fund family; COMP is the log of the total compensation paid to the committee members divided by the number of members on the committee and scaled by the number of funds within the mutual fund family; FINANCE is whether or not the mutual fund manager is controlled by a financial institution.