High Closing:

An Alternative Interpretation

Revisiting the RT Capital high closing case.

BY JOEL FRIED

One issue facing all pension plans is that of properly valuing assets in their portfolio. It is important that the issue be properly addressed for three reasons—first, it serves as a means of monitoring suppliers, second, it provides information to sponsors, and third it is necessary to meet regulatory requirements. For defined contribution plans and fund managers, at both the institutional and retail levels, it is also critical to ensure that no unintended transfers occur among unit holders. Thus, when the principal regulator of financial markets in Canada—the Ontario Securities Commission (OSC)—prosecutes a case that, at its core, deals with the issue of asset valuation, it is of special interest to these groups. The RT Capital "high close" case, settled in July 2000, represents an issue in which valuation methods take centre stage. It therefore provides guidance on how pension plans and funds should structure the valuation process for their own portfolios.

In the charges brought against RT Capital (RTC), members of that firm admitted their actions were against the public interest.[1] Those actions apparently consisted of 53 cases of causing the price of a security to end the day on an up tick—a high close. Yet nowhere in the settlement is there an operational definition of high close that might distinguish those from other end of day purchases, thereby providing guidance to other market participants as to what actions, precisely, are now proscribed. Certainly it cannot be simply making a purchase that is the last trade of the day. If it were, then the Toronto Stock Exchange (TSX) becomes the setting for a giant game of musical chairs, with the purchaser in the last trades on any day being fined or drummed out of the industry. If for no other reason than to view trading on the TSX as something other than a child's game, it is important to determine what aspect of end of day trading is proscribed. In this essay I will explore the question of harm caused the public in an attempt to assess more precisely what methods of asset valuation are unacceptable to the financial regulator.

Victims of High Closing

The first group the OSC indicated had been harmed were RTC's clients:[2] RTC was prosecuted for manipulating price against the interests of those to whom it had a fiduciary duty. There are two postulated mechanisms by which this manipulation could hurt RTC's clients. First, the high closes meant that RTC's reported returns would be higher than otherwise, thereby inducing clients to remain with RTC and/or inducing others to become clients. But this makes no sense. The client base for RTC were institutions, particularly pension funds with long horizons. If the "high closes" did cause a price above fair value, then the price would quickly return to its true value unless RTC persisted in continuously buying the security. As soon as it stopped doing so, the return on the RTC portfolio would be less than it otherwise would have been, and any institution that made its investment decisions on the basis of immediate short-run returns would take their money out of RTC. Attracting clients through high closing is self-defeating even if it could induce some institutions to think short term.

The second suggested method by which RTC defrauded their clients was that the increased asset value

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generated by the high closes would increase the management fees charged. This, too, seems unlikely to have hurt RTC's clients. First, in the two relevant RTC Canadian equity funds, the alleged increase in management fees amounted to less than $9000 over a six-month period or, on an annual basis, less than one and one-half dollars per million dollars under management, likely less than rounding errors in calculating unit values. It also does not suggest a sufficient reward for the members of RTC to undertake such actions. Furthermore, more than half of the 53 high closes had no bearing on the calculation of management expenses charged to their clients.[3]

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The OSC also argued that harm was done to other market participants. Again, the logic of such an assertion is tenuous at best. First, those selling the securities involved in the high closes actually benefited. If RTC was buying "above the market," then on balance, other market participants were able to sell these securities above their "true value." Second, if RTC was attempting "trade-based" price manipulation by inducing momentum players to buy at still higher prices, at which RTC would unload their shares, they were notably unsuccessful in doing so.[4] Not only is there no evidence that RTC ever attempted to reverse the positions taken, the median price of the high close securities one month after the purchase was less than at the high close purchase price.[5]

The OSC also suggested that the high closes somehow diminished the integrity of the market. One such possibility might be that the high closes were undertaken as a game among members of the RTC staff and RTC management was lax in suppressing such behaviour—in effect, a governance failure. I suppose the OSC might argue that, by not treating the market seriously, the role of the market as an instrument for allocating capital is compromised. In effect, even if no individuals were directly harmed by the high closes, the market itself was somehow diminished as an institution. However, to determine that this was the case, the OSC would need to show that the high closes they had identified were somehow different from those trades made by RTC at other times, and moved prices away from their intrinsic values. However, it seems these trades differed only in that they were made at the end of the day. For instance, RTC made a six-month return of 13.68 per cent on the asset purchases the OSC identified as high closes versus the alternative six-month return of 8.18 per cent they would have made had they purchased the benchmark TSE300 Composite Index.[6] In effect, the alleged high close purchases made by RTC earned their clients a net excess return of more than 5 per cent over the subsequent six months, an excess return not out of line with their normal performance over the last decade.

The above discussion suggests that no identifiable group was hurt in any material way, or that the high close trades moved asset prices away from their intrinsic values. To be in violation of the high close regulation it appears that there does not need to be a victim, or that actions must differ from normal price discovery. Nonetheless, it is the case that the high close trades did alter prices. Further, some members of RTC apparently have admitted that their actions, in some cases, were undertaken to "move prices." The OSC might then argue that moving price through an end of day purchase must clearly be price manipulation, and, for whatever purpose, must represent an attack on the integrity of the market.

But this brings us back to the issue of musical chairs because, except for the most liquid of securities traded on the Exchange, any trade has the potential to alter price, if only within the bid/ask spread provided by the market maker![7] If price can always change from a given trade, and traders cannot determine what behaviour the OSC regards as proscribed, then they will cut back on all actions that might be regarded as inappropriate, suppressing some legitimate price discovery and making markets less liquid.

An Alternative Interpretation

What, then, caused RTC to be singled out for prosecution? Finding a motive for RT Capital's actions might provide a clue. I suspect that most, if not all, of the claimed high closes were simply misidentified by the OSC and represented normal price discovery. As for the remaining trades, one possibility is that RTC had the hubris to believe it was performing its fiduciary duty to all of its clients by "moving" the prices of these securities closer to what the RTC managers believed were their "intrinsic values." As a manager for a large number of clients, some of whom are adding to their positions while

others are decreasing theirs, his or her fiduciary duty is to value portfolios so that everyone is treated as equitably as possible. If the value is too high, it harms those who are increasing their position, while if it is too low, it hurts those who are selling. Under this interpretation, some of the high closes were meant to increase prices to levels the manager believed represented fair value.[8] To explore this possibility one must consider the nature of the market for less liquid securities traded on the TSX.

I would argue that the ease of obtaining an up to date valuation of an illiquid stock on the TSX occupies a position somewhere between that of a very liquid equity traded on the Exchange and that of a private security. For the most liquid securities, up to date valuations are easily obtained from the most recent trades. Given the large number of traders with an interest in the security, and their willingness to trade it, one can feel confident that all available information is incorporated in its price. In effect, an independent, up to date "external appraisal" of the value of the liquid asset is readily available at zero cost to the manager. On the other hand, for a private security, obtaining an up to date valuation is much more difficult. Trades in it, or similar assets, are intermittent at best, and available information is unlikely to have been incorporated in its most recently posted trade. A manager interested in a valuation of the asset for his clients will, in this case, generally provide an internal appraisal based on his own assessment of the current information. However, periodically an independent, external appraisal will be used to assure clients that the manager's assessments have been reasonably accurate. The reason external appraisals are not used in all cases is that they are costly to obtain, and therefore are not in the clients' best interest.

Illiquid assets listed on the Exchange share precisely the same valuation difficulties as private securities because there can be long periods where the asset does not trade and the last posted trade will not generally reflect current information. Nonetheless, there is always at least one independent assessment of the value of the security that is available, and at much lower cost than is available for private securities. This external appraisal is that provided by the designated registered trader (DRT) in the security. In fact, with illiquid securities, the manager is generally confronted with two external appraisals of the asset, the bid and the offer prices in the market.[9] The Exchange, in other words, provides both a means and a discipline for valuing securities. The manager has a range—established by an independent source—in which to choose to "report." The only "internal appraisal" that is required is to choose, at a minimal fee to record the purchase or sale, which of these two prices he regards as the most consistent with his expectations. The high close regulation appears to say that choosing the offer for valuation purposes is "against the public interest" and is effectively saying that the regulator knows better than either the manager or the DRT what the "true" value of the asset is.

At least some of the end of day trades made by RTC managers were attempts to compensate for this illiquidity problem and obtain fair values for all their clients. This is most evident in the case of Multibank, a derivative security, whose six purchases constituted more than 40 per cent of the increase in portfolio value the OSC linked to the high closes.[10] It was also a very illiquid security. Over the period October 1, 1998 through December 30, 1999 the transaction volume of Multibank was approximately one trade every two weeks and, as a result, its price rarely reflected the current information that was incorporated into the more liquid underlying securities. RTC's portfolio manager, Peter Larkin, was quite open in indicating that his purchases moved the security price closer to the intrinsic value as determined by the trading in the more liquid markets of the underlying securities. If anything, RTC's "high closes" in this security were meant to replicate the more adequate price discovery process in the liquid markets of the major Canadian banks. This was also true with Veritas, a security that traded roughly once a month in Canada but could be exchanged at any time with shares of its U.S. acquirer. The trade and cross in that security was declared a high close by the OSC, and in fact kept the share price in line with the more liquid shares of the U.S. owner. Furthermore, it was also the case that, in the month preceding and the month following the high close in Veritas, RTC's end of month actions actually decreased the value of that security rather than increased it.[11]

Implications

This interpretation of which end of day purchases violate regulations should be viewed with some concern by the industry. There are at least two reasons for this concern. First, attempts by managers of mutual or pooled funds for institutions to use their judgment in reconciling conflicts between purchasers and sellers of their funds will be viewed negatively by the OSC. In particular, the regulations regarding high closing appear to indicate that there should be a bias in favor of those adding to their holdings and against

those who are selling. Given this bias, managers will find themselves torn between their fiduciary duty to treat all clients equitably and satisfying the regulation. Second, it will decrease price discovery and reduce the liquidity in the markets for already illiquid stocks. To assist their clients, managers will attempt to second-guess the OSC and cut back on some transactions in illiquid securities, decreasing price discovery and liquidity, or over-document any transaction that might be viewed as ambiguous by the OSC. The latter will increase costs and lower return to their clients and will decrease legitimate price discovery.

Another way of making this point is to ask what would the consequence be of imposing regulations of the sort implied by the RTC case on private security purchases and sales? Suppose, as might soon be the case, the OSC becomes involved in the regulation of pension funds and it applies similar regulations to pooled funds for real estate, venture capital or other private securities?[12] With the full approval of the clients, external appraisers do not now perform all valuations because it is too expensive to do so. Applying the methods implied by the RTC case would mean that all valuations would always require two external appraisals, of which the lower valued appraisal must be the one used. The consequences of changing to such a system would therefore increase the costs of holding such portfolios. This, in turn, would mean decreased demands for such assets, making private security markets even thinner than they are now. Pension plan members and sponsors would lose, and markets would be less efficient.

In the end, then, could it be that RT Capital's actions were against the public interest because it provided regulators the opportunity to promulgate rules where the marginal costs far exceed the marginal benefits? Under these circumstances, it is difficult to provide guidance to portfolio managers who wish to both act in their clients' best interest and not run afoul of the regulators when valuing assets in their portfolios. ▮

We invited the Ontario Securities Commission to respond to this paper. They provided us with the following statement: "Staff of the Ontario Securities Commission feel that it would be inappropriate for a member of Staff to comment specifically on this matter beyond what is provided for in the settlement agreement between the parties and approved by the Commission in its Decision and Reasons of July 20, 2000."

Acknowledgments:

I would like to thank Ron Wirick, David Burgess, and David Laidler for helpful suggestions on earlier drafts of this paper. I am solely responsible for any errors that remain.

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Endnotes

1. See Ontario Securities Commission (2000a).
2. See Ontario Securities Commission (2000b).
3. It is also the case that, for those high closes that did not affect management expenses, the increase in portfolio value per dollar spent in the high close was greater than in those cases where the purchase did affect management charges. If one were indeed out to "overcharge" one's clients, that seems an illogical way to proceed. Furthermore, seven of the high close charges represented crosses that were at trades between the closing bid/offer spread. To maximize the charges to their clients, RTC would have profited more if the trades had taken place at the ask. See Fried (2002)
4. See Allen and Gale (1992) on trade-based price manipulation.
5. End of day high closes would be an especially strange way to influence momentum players because it is the one trade of the day that provides a period of time for (sober) evaluation of the price prior to the next trade. Given the trading "pause" it is difficult to argue along the lines of the OSC (OSC (2000b), par. 4) that other investors "overpaid as a result of the high closings."
6. See Fried (2002).
7. Surely stating the truth about the nature of the market could hardly be the "crime".
8. Given RTC's past performance, and its willingness to put down money to support their beliefs, they, more than most, would have a good idea what that fair value would be.
9. The Exchange itself negotiates the maximum spread permitted the DRT.
10. Multibank was wound down by March 2000.
11. This information was available to the OSC but they did not report it.
12. There are currently efforts to merge the Financial Services Commission of Ontario (FSCO) and the OSC, and the Joint Forum on Capital Accumulation Plans apparently sees a major role for regulations along the lines of those applied to mutual funds by the OSC. FSCO currently regulates pension plans in Ontario. The bulk of the assets, and members, in the capital accumulation plans examined are in defined contribution pension plans and group RRSPs. For one interpretation why securities regulators attempt to increase their coverage to other financial institutions, see Macey (1994).