

***Federated Press***  
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**Speaking Notes for  
Keynote Address by  
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Alberta Securities Commission**

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## **Introduction**

Good Morning.

I have been asked to address the broad subject of your conference from the perspective of a securities regulator. I will give you the perspective of this particular securities regulator and you should be cautioned that my views will not likely square perfectly with those of all other securities regulators in Canada. We at the ASC find that we rather often take a different approach to matters of corporate governance than do, in particular, the securities commissions in Ontario and Québec. I am tempted to utter a further disclaimer that my personal views do not necessarily reflect those of the ASC, but in my capacity as Chair and CEO, they should be reflective.

Our explanation at the ASC for our difference in approach is that we have greater regard for the good faith, loyalty, effort and common sense of directors generally that do regulators in central Canada who, in our view, often project that directors will more frequently than is accurate act in their own best interests and without due care, unless forced by regulators or pressured by shareholders to do otherwise.

The explanation offered by the securities regulators in Ontario for the differences in approach is that we in Alberta see corporate governance and other policy matters through the eyes of, and with regard to the interests of, issuers in our capital markets, whereas the OSC has a mandate to protect investors.

In fact, the mandate of the ASC is to protect investors and the integrity of the capital markets. We do have an eye to efficient capital raising as being one of the fundamental purposes of capital markets and appreciate that the manner and degree to which we regulate the conduct of issuers will have a significant impact on the efficiency of capital raising. At the same time, we recognize that if investors are not fairly protected and the capital markets are not seen by investors to have integrity, there may be no capital markets, there may be no public capital raising and issuers will obviously suffer in this result. So I maintain strongly that the ASC has a keen eye for the protection and interests of investors and believe that we will be doing no good for issuers if investors are not fairly protected or lose confidence in the integrity of the markets.

All of that to say, that our differing approaches are based on differing evaluations of the role, responsibilities, intentions and performance of boards of directors. We are less inclined at the ASC to the view that securities regulators know better than directors how their corporations should be managed.

And while I am wandering off on this short tangent from the subject of risk management, I will wander a little further to add that the ability of the ASC to take a different approach, and influence national policy-

making with that different approach, is one of the important benefits to Alberta of our current structure of securities regulation in Canada that would in all likelihood be lost with the substitution for the current provincial commissions of a single federal regulator.

### **Disclosure**

So to get back on topic, we at the ASC accept two basic premises when considering issues of corporate governance: firstly, under our regime of corporate law, directors are to manage the business and affairs of a corporation; and secondly, the cornerstone of regulation of the issuance and trading of securities is disclosure. Fundamentally then, while directors have responsibility for how corporations are managed, securities regulators mandate the manner in which they disclose the intent behind and the steps they take in fulfilling their management responsibilities.

### **Responsibility for Risk Management**

There is little doubt that along with growing the capital base and making an investment return, ensuring the survival of a corporation is a fundamental responsibility of the directors that must be given serious regard in the context of every decision taken. While risk management has become the focus of much attention over the course of the past two years, few would disagree that risk management has always been a fundamental responsibility of the board, or that there has not always been an expectation that the weighing of risk was a fundamental task to be undertaken by the board in the normal course of management, as well as at every turn of strategic direction.

It has also been almost universally assumed that the risk of the loss or downfall of a corporation would be the ultimate motivator in driving prudent conduct. It is difficult to argue logically that the threat of bankruptcy of a corporation, the loss of all the jobs of its employees, the destruction of shareholder value and the personal financial damage done to senior executives would not be a more effective a tool in bringing about prudent risk management than the threat of regulatory proceedings and sanctions that might include monetary penalties, bans from engagement as directors or officers and public embarrassment.

What has been unsettling in one's observations of the events of the last couple of years is that the threat of total collapse of the enterprises for which the directors had responsibility did not, in fact, serve to ensure the avoidance of collapse resulting from the seemingly reckless taking of risk.

### **Role of Regulators**

Having witnessed that the motive of self-preservation was not successful in bringing about fail-safe risk management, the question must be asked whether added oversight of regulators and new legislated requirements of process and conduct will succeed in preventing the future collapses of public entities that may do so much damage to investors, participants, employees and the entirety of the financial system.

In considering the circumstances and consequences of the credit crisis, an appropriate series of questions might be: did the directors forget or wilfully avoid their risk management responsibilities, or did they just not do a very good job? If the former, can regulation ensure that in the future they do not forget or wilfully avoid their responsibilities? If the latter, can regulation ensure that they do a better job?

Personally, I find it hard to be persuaded that boards of directors in the past decade either forgot that risk management was crucial or simply decided to forgo the effort to undertake the task. If any of them did somehow forget or give that responsibility an inappropriately low priority, it is hard for me to believe that they have not had a sufficient reminder of the importance of risk management over the course of the last two years to inspire greater attention now and in the future. So, I would not see it a useful role of regulators to compel boards of directors to address risk and risk management. I am confident they will be doing so without the need for regulatory direction. However, is there a place for regulators to improve through regulatory interventions the quality of risk management undertaken by boards of directors?

### **Impact of Process**

In recent decades, more and more has been demanded of directors and, I would argue, more and more intervention of regulators and shareholders have at the same time made it more and more difficult for directors to fulfill expectations. I believe that attention to the subject of good corporate governance by regulators, advocates, shareholders, and directors themselves have greatly elevated the quality of governance at the board level. As an offset, the improvements in process have come with some challenges to good decision making and, in some instances, unintended consequences. Rigorous attention to process can lead to distraction from management of the business and a loss of enthusiasm on the part of directors to do their jobs.

Accountability can become a disincentive for experienced skilled candidates to serve and risk their hard won reputations. It is questionable whether the constant threat of liability actually keeps the negligent or dishonest director in line and it may be argued that in the face of that threat the diligent and honest director is only discouraged from becoming engaged. If what makes for the best board are the best directors, perhaps policy should be focussed more on the qualities of experience, skill and integrity and less on features of independence and absence of potential conflict of interest.

### **Shareholder Democracy**

To me, shareholders democracy is not an entitlement to hold a plebiscite on every decision made by a board. There are corporate law requirements for shareholder votes, and stock exchanges require shareholder votes in certain circumstances under the terms of the listing agreement. Beyond that, shareholder democracy means that the investor can refuse to invest, the shareholder can sell its shares and the shareholder can replace the board of directors. It is the responsibility of regulators to ensure that in the exercise of their discretion or rights, investors and shareholders have the information before them that will permit an informed investment decision or judgment as to the suitability of a board of directors.

### **Say on Pay**

The recent trend, and now apparent institutionalization, of “say on pay” provides an example of contradicting intentions and possibly consequences. Examples of financial industry compensation excesses and constant repetition of the theory that short term compensation incentives lead to irresponsible risk taking have given strong support for the demands by large investors that shareholders should have a say on the compensation policies and practices of public corporations. At the same time, shareholders are demanding that directors take greater and greater control over management, the flow of information provided by management and the decisions made by management.

One of the most effective tools with which directors can control management and their focus is the setting of compensation. Will the “say on pay” practice lead to more effective control by directors or to an abdication of control and a deference to shareholders’ perceptions and, worse, their pet initiatives?

To date, the “say on pay” practice has come about as a consequence of investor and shareholder persuasion. All the while pressure has been mounting on the regulators to mandate such practices and various proposals in the United States and among countries of the European Union would see the mandating of “say on pay” practices in various forms. That brings us back to the question of the role of securities regulators. Are we to regulate behaviours or only the accurate and understandable disclosure to investors and shareholders of the behaviours selected by issuers and those who manage them? And is the intention behind mandated disclosure to actually influence behaviours? Further, regardless of what the intention of the mandating of disclosure may be, will it actually be successful in causing the pattern of behaviours to change in the desired direction?

The requirements of securities regulators that all features of executive compensation be disclosed had the collateral intention of bringing discipline to executive compensation practices. The discipline that resulted in fact, ensured that every corporation paid their executives within the top two quartiles – leaving

nobody in the bottom two quartiles and, as a further result, turning the top two quartiles into the new bottom two quartiles – and on and on. It had the further consequence of causing boards of directors to ensure that their CEO was not embarrassed to read that he or she was being paid disproportionately less than his or her peer. Just as was the case with professional baseball salaries, all salaries went up.

Is there a broad structure or practice that securities regulators can mandate that will enhance the quality of risk management by boards of directors? I believe that we can ensure that attention is paid to the issue by requiring disclosure about it; however, as I said earlier, it is hard to believe that anyone would be ignoring the issue in the environment we are now working in.

### **Compensation and Risk Management Disclosure**

Interestingly, the focus on risk management following on the reaction to the credit crisis has offered a potentially more effective practice by which downward pressures might be applied to the compensation excesses that are viewed as so offensive. A link has been drawn between excessive compensation incentives and excessive risk taking. If eye-popping bonus incentives are assumed to present the potential for excessive risk taking and issuers are going to be judged and possibly punished for excessive risk taking, the market may be successful in placing downward pressure on that eye-popping compensation not on the basis that it is simply too high but rather on the basis that it is in itself creating an unacceptable level of risk. A combination of mandated compensation disclosure and mandated risk management disclosure may indirectly impact on compensation evaluation and awards. Whereas it has not been seen to be appropriate for regulators to regulate compensation, it would not be seen inappropriate for regulators to mandate a full analysis of the impact of compensation levels on risk and risk management. In struggling to convince investors that their risk management practices can successfully counteract huge bonus incentives, issuers may themselves conclude that the huge bonus incentives must be changed.

### **Risk Management Committees**

One of the proposals on the table in the U.S. is that boards be required to establish a distinct risk management committee. The optics of such a creation may be positive, but I would not argue that the quality of risk management will thereby be enhanced. I do not agree that risk management is a discrete subject that can be more effectively addressed by a sub-set of the board. It is such a fundamental issue that it should be the constant responsibility of every director in respect of every decision made. To suggest that it is too complicated a matter or one that can or should be isolated from broader oversight and management responsibilities seems to me to be inappropriate. Directors should not be lead to believe that any of them has less than a full share of responsibility for risk management.

### **Limits to Board Intervention**

One common feature of organizations that were investing in recent years in products that carried excessive risk was that management at many, if not all, levels didn't really know what they were doing. There are two lessons to be learned here. One is that investors (be they corporate, institutional or individual) should be fully informed and have a full appreciation for the attributes of investments they make for themselves, their organizations or their clients and, two, failing that full understanding, they should not make or recommend the investment - period.

Although the board of directors is ultimately responsible for management of the business and affairs of the corporation, it would seem appropriate that the more specific task of understanding and analyzing investments may properly be delegated to management and their staff. If directors are to be required to know the details of every facet of the corporation's business then they will need to be experts in each area in which the corporation employs people of particular training, skill and experience. That is not a realistic expectation.

Instead, directors must satisfy themselves that the corporation has a properly qualified and motivated executive team, procedures are in place to ensure that there are appropriate lines of review, reporting and accountability, there is a universal appreciation within the corporation of appropriate risk parameters and investments are not being made by employees or executives who cannot explain what it is they are doing and why. So the directors should be satisfied that there is a means available to them by which they can judge that the factors I have just mentioned are features of their corporation. If these features nevertheless fail to prevent the taking of an extravagant and eventually damaging risk, I would not think that liability should rest with the directors.

### **Disclosure Content**

What the securities regulators do, in connection with their responsibility to regulate good disclosure, is ask that all information relevant to an investment decision be provided to investors and shareholders. Today, after all that has transpired in the past two years, it must be considered relevant to an investment decision how a board of directors manages risk. Regulators will differ on the policies that should be implemented to encourage good disclosure, but there will be little disagreement that the disclosure itself is necessary. Appropriate disclosure will be considered that which satisfies an investor or shareholder that a board is justified, without either itself taking on the job or second guessing every task of every employee, in determining that risk is being properly managed by the corporation.

There has been much heard on the subject of “principles-based” regulation in recent years. Principles-based regulation is contrasted to rules-based regulation, and for some, principles-based regulations is held out as the answer to voluminous, costly and overly prescriptive regulation which leads to participants in the capital markets finding imaginative ways to comply with the technical requirements of rules instead of complying in a more meaningful way with the intention behind the broad principle. In the world of vehicle traffic regulation, the requirement to drive with due care and attention would be a principle-based regulation, while a requirement not to exceed the speed limit of 30 kph would be a rules-based regulation.

There would be a hope among regulators as well as readers of the disclosure that when dealing with risk management, issuers might tend to a principles-based approach where one size does not fit all, common sense plays a prominent role and selected procedures are followed because they are effective, and not simply in technical compliance. Similarly, when disclosure is made of risk management practices, the goal should be to fairly explain the regime that is in place to guard against the threat of inordinate risk and the manner in which the board satisfies itself that such a regime is not only in place, but is followed and is in fact effective.

I might say a little more here on the subject of principles-based regulation in the context of corporate governance.

Principles-based regulation has been proposed by many, in many cases without understanding much about it, as a necessary ingredient for vastly improved securities regulation. It is supported on the basis that it will greatly simplify the ever lengthening rule books, rid the regime of conduct that seeks only technical compliance with the specific requirements of rules and reduce costs for participants in the capital markets. The investment industry in Canada has been particularly vocal in pressing regulators to adopt principles-based regulation. The Financial Services Authority, which regulates all financial services in the UK, has been a strong proponent of principles-based regulation and the BC Securities Commission drafted a new securities act some five years ago based on principles-based regulation.

The ASC has not been an advocate for principles-based regulation for the reasons that we viewed the advertised rewards to be highly overstated, saw the changes required to be less than the likely costs and feared that a more junior and inexperienced capital market, as exists to a significant degree in Canada, might lack the time, resources and experience to implement principles-based regulation.

When the CSA proposed a broad look at Canada’s corporate governance regime a few years ago, we at the ASC saw an opportunity to test principles-based regulation in an area (corporate governance) where major players (directors) were relatively sophisticated and experienced business people, where there had

been much written and pronounced on the subject and where large investors exercised considerable influence.

We ended up having a number of concerns about the proposed re-writing of the corporate governance rules, one of them being that the proposal did not go far enough in using and testing principles-based regulation. We felt that the draft rule still contained too many detailed and explicit rules and did not leave enough to the discretion of issuers, their managements, boards and shareholders.

To our surprise, while some of the commentary applauded the degree to which the new proposal utilized the principles-based regulation approach, many more demanded a return to detailed and explicit rules of conduct. We were clearly wrong in our view that this area of regulation was ready for a principles-based approach. It is apparent that many would like the flexibility of principles-based regulation when it is applied to themselves, but do not trust the good judgment and motivation of others to use that flexibility responsibly.

The draft BC act was never proclaimed and the FSA in the UK (along with its much praised principles-based approach) has suffered reputational damage in the past two years as a result of the serious disruptions in the London financial community. In addition, public and government faith in good judgment of boards and management teams has been eroded seriously through the period of the credit crisis.

There will be challenges to those advocating a principles-based regulatory approach in the near term, and while we at the ASC might not have seen this approach to be the cure for all ails that many have, I believe that it is unfortunate that corporate governance rules may not soon benefit from its advantages.

We struggle as regulators to persuade issuers and their professional advisers that we want to see that they have told a relevant and understandable story in their disclosure documents – not just filled in the standard boilerplate or made evaluations based on what they think regulators want to hear. “Just tell it like it is” would be a good motto for most securities regulators. Personally, once the regulators have satisfied themselves that you have indeed told it like it is, I believe that they have done their job. It is not, in my view, for the regulators to pass judgment on your story. That evaluation should be left to investors, shareholders and analysts to undertake.

## **Conclusion**

To conclude then, I would summarize a few of the points I have endeavoured to convey.

Our commission is inclined, without being naïve or wilfully blind, to assume the good faith and good intent of directors. That attitude is not fully aligned with that of regulators in all jurisdictions in Canada, and that is one of the reasons I believe the independence of the ASC under our current structure of securities regulation in Canada is preferable for Alberta participants in our capital markets.

Corporate governance is the subject of corporate law. Securities regulation and regulators, in connection with the regulation of the issuance and trading of securities, is focussed on disclosure. Disclosure enables fully informed decisions by investors and shareholders in the exercise of their discretion and rights.

Events of the past two years have brought the subject of risk management to the fore. Issuers can expect that regulators will demand that extensive disclosure of relevant risks and risk management practices be made in offering and continuous disclosure documentation.

Risk management, in my view, should be the constant responsibility of each and every member of the board and should be factored into every decision made by the board. Other than for optics, I do not see a separate risk management committee as adding value.

In establishing good governance principles, it should be kept in mind that ultimate management responsibility rests with the directors, corporations will be served best by the best available directors rather than the best processes, and regulations should not detract from the ability of a corporation to attract the best available directors or from the ability of those directors to do their jobs.

Disclosure of truly relevant risks, extreme levels of compensation incentives among them, might have the indirect result of limiting excessive compensation.

Finally, in disclosing risk management practices with the goal of satisfying securities regulators, and whether or not principles-based regulation attracts more or less favour in the future, an issuer would be guided best by implemented practices that work for that particular issuer and its board, and in disclosure documents to “tell it like it is”.

Thank you.