AUTORITÉ DES MARCHÉS FINANCIERS

GOVERNANCE GUIDELINE

April 2009

Table of Contents

Preamble

The *Autorité des marchés financiers* ("AMF") establishes guidelines setting out its expectations with respect to financial institutions' legal requirement to follow sound and prudent management practices. These guidelines therefore cover the execution, interpretation and application of this requirement.

The AMF favours a principles-based approach rather than a specific rules-based approach. As such, the guidelines provide financial institutions with the necessary latitude to determine the requisite strategies, policies and procedures for implementation of such management principles and to apply sound practices based on their nature, size and complexity of their activities.

There is a major correlation between governance, integrated risk management and compliance (GRC). The AMF considers these three elements as the foundation stones for sound and prudent management of financial institutions and, consequently, as the basis for the prudential framework provided by the AMF.

Introduction

Given the vital role financial institutions play in the economy, the AMF considers it essential to inform them of its expectations with regard to governance. Sound governance, which constitutes the cornerstone of sound and prudent management, is crucial for any industry, but especially so for the financial services industry, which, moreover, fundamentally depends on the confidence of consumers of financial products and services.

In issuing this guideline, the AMF wishes to ensure that financial institutions adopt sound governance practices, particularly through accountability for boards of directors and senior management.

The core principles and guidance published by the Basel Committee on Banking Supervision[1] and the International Association of Insurance Supervisors[2] clearly explain the need for financial institutions to implement sound governance practices. Moreover, regulators are encouraged to provide financial institutions with the frameworks to do so.

The AMF adheres to the principles and guidance published by international bodies that foster sound and prudent management practices. Pursuant to the authority[3] conferred upon it under various sector-based statutes, the AMF is issuing this guideline to explicitly inform financial institutions of its expectations regarding governance.

---

[1] Basel Committee on Banking Supervision, Bank for International Settlements, Core Principles for Effective Banking Supervision and Core Principles Methodology, October 2006.

Basel Committee on Banking Supervision, Bank for International Settlements, *Enhancing corporate governance for banking organisations*, February 2006.

[2] International Association of Insurance Supervisors, Insurance Core Principles and Methodology, October 2003.

International Association of Insurance Supervisors, Insurance Core Principles on Corporate Governance, January 2004.

[3] *An Act respecting insurance*, R.S.Q., c. A-32, ss. 325.0.1 and 325.0.2.
An Act respecting financial services cooperatives, R.S.Q., c. C-67.3, s. 565.
An Act respecting trust companies and savings companies, R.S.Q., c. S-29.01, s. 314.1.

Scope

This governance guideline is intended for insurers of persons (life and health), damage insurers, portfolio management companies controlled by an insurer, guarantee funds, mutual insurance associations, financial services cooperatives as well as trust and savings companies, which are governed by the following Acts:

- *Act respecting insurance,* R.S.Q., c. A-32;
- *Act respecting financial services cooperatives,* R.S.Q., c. 67.3;
- *Act respecting trust companies and savings companies,* R.S.Q., c. S-29.01.

This guideline applies to financial institutions operating independently as well as to financial institutions operating as members of a financial group[4]. As regards financial services cooperatives and mutual insurance associations that are members of a federation, the standards or policies adopted by the federation should be consistent with - and even converge on - the principles of sound and prudent management prescribed by law and detailed in this guideline.

The generic terms “financial institution” and “institution” refer to all financial entities covered by the scope of this guideline.

[4] For purposes of this guideline, “financial group” refers to any group of legal persons composed of a parent company (financial institution or holding company) and legal persons affiliated therewith.

Coming into effect and updating

This governance guideline will come into effect as of April 1st, 2009.

With respect to the legal requirement of institutions to follow sound and prudent management practices, the AMF expects each institution to develop strategies, policies and procedures based on its nature, size, complexity and risk profile, to ensure the adoption of the principles underlying this guideline by April 1st,2011. Where an institution has already implemented such a framework, the AMF may verify whether it enables the institution to satisfy the requirements prescribed by law.

This guideline will be updated based on developments in governance and in light of the AMF's observations in the course of its supervision of financial institutions.

Governance

In general terms, governance describes the administrative organization of an institution for the purpose of achieving its objectives, guiding it and managing its risks. As such, governance involves, notably, outlining the roles and responsibilities assigned to each member of the board of directors and senior management with regard to the management of the financial institution.

Governance also involves implementing monitoring and accountability structures through control policies and procedures and developing information systems that help organize the management of the financial institution.

Efficient and effective governance is vital to the sound operations of a financial institution. A governance program is the starting point for building the governance structure. The next section outlines the AMF's expectations in this regard.

1. Governance program

The AMF expects financial institutions to develop and implement governance programs based on their nature, size, complexity, and risk profile.

The governance program enables a financial institution to co-ordinate the initiatives intended to improve its governance. This program defines the institution's governance philosophy and values. It must therefore consider various factors such as its activities, nature and complexity of operations, resources, organizational structure and ownership, and risk appetite.

The governance program establishes and formalizes the strategies, policies and procedures required to define and organize the various mechanisms necessary to achieve sound governance.

An effective governance program generally includes the following:

- integrated risk management;
- internal controls;
- independent oversight of activities; and
- audit functions.

In addition, depending on the mechanisms the institution puts in place, it is important for the governance program to clearly define roles and responsibilities. An effective governance program usually consists of:

- the composition of the board and its committees, if applicable;
- a clear definition of the roles and responsibilities of senior management, the board and its committees, if applicable;
- the independence criteria used for key functions;
- the components of accountability systems;
- the criteria used for board self-assessment programs;
- conflict of interest and ethics policies.

Drawing up a governance program must take into consideration the specific characteristics of certain entities, such as co-operatives, mutual organizations and companies, or whether they are members of a financial group, as well as the activities carried out through subsidiaries across their operating territory.

A financial institution's governance program should reflect changes made over time. The quality of governance practices is important for maintaining market confidence. Guidance and related practices are considerable and evolving rapidly in a number of areas, including board and audit committee independence, accountability for risk management and strategic planning, and assessment of board performance.

Through the governance program, the board of directors demonstrates its determination to apply the most rigorous governance principles within the financial institution.

2. Roles and responsibilities of board of directors and senior management

The AMF expects the members of the board of directors and senior management to be qualified and have the necessary experience and competencies to assume their roles and responsibilities adequately.

The very nature of a financial institution, its role in the economy, and the type of risks related to its operations are areas where officers must have a high level of expertise, specialized qualifications and a good sense of judgment. In addition to these aptitudes necessary for the sound management of a financial institution, directors and senior management must also perform their functions with integrity and diligence.

The AMF also expects a majority of board members to be independent. Where directors are not independent, the institution should document the procedures used to foster open discussion and unbiased judgment.

The stability and effectiveness of a financial institution is contingent on the accountability of directors and senior management. Particular attention should therefore be paid to the quality of the monitoring and control carried out by senior management and the board of directors when policies are developed and strategic decisions made. Managing a financial institution requires an in-depth understanding of the entity, the environment in which it operates, its sectors of activity and its risk profile. This knowledge may also encompass areas such as the nature of risk, regulation, lines of business, products, and accounting and/or actuarial principles. From this perspective, it would seem essential for financial institutions to introduce a human resources management policy in particular with respect to succession planning for key management positions.

2.1 Roles and responsibilities of board of directors[5]

The board of directors supervises the tasks carried out by senior management. As such, it must ensure that effective governance mechanisms are implemented. The board of directors must also take into consideration the relevant reports resulting from the application of these mechanisms.

The board of directors must be composed of members whose qualifications and competencies meet the requirements of their mandate. The board's mandate must be provided in writing and notably cover the roles and responsibilities assigned to board members. Under sound governance practices, the members of the board are also urged to conduct a regular assessment of the work carried out by the board and its committees as well as a self-assessment. This type of exercise maintains and strengthens the effectiveness of the board of directors.

The customary roles and responsibilities of the board of directors are to:

- review the financial institution's performance in terms of its objectives, strategies and programs;
- review and approve the organizational structure and controls;
- ensure that the members of senior management are qualified, competent and compensated in a manner that is consistent with appropriate prudential incentives;
- review and approve policies developed for major initiatives and significant activities[6];

5 A reference to the board of directors can also include a board committee, such as a board committee established to examine specific issues.

6 An activity is considered significant where it contributes to the achievement of the institution's objectives and strategies.

- obtain reasonable assurance on a regular basis that the financial institution maintains control over its environment;

- actively participate in the choice, review and assessment of strategies, objectives and business plans;

- undertake succession planning for senior management positions.

2.2 Roles and responsibilities of senior management

Senior management of a financial institution play a key role in the governance structure. Senior management are the architect of the systems and processes essential for sound governance. They ensure that the various mechanisms adequately fulfill their mandates.

The main roles and responsibilities of senior management are to:

- plan, conduct and control the financial institution’s activities;

- develop operational objectives, strategies, plans, organizational structure and controls;

- develop policies for approval by the board of directors;

- develop and promote sound internal governance practices;

- monitor the achievement of operational objectives, strategies and plans approved by the board of directors;

- ensure the implementation of a “culture of governance” and the adoption of an organizational behaviour based on ethics and professional conduct;

- ensure the effectiveness of the organizational structure and controls and inform the board of directors accordingly on a regular basis.

The decision-making bodies of the financial institution, namely, the board of directors and senior management, are the pillars on which the governance program stands. However, as mentioned, certain mechanisms, such as integrated risk management, are an integral part of sound governance.

3. Integrated risk management[7]

> The AMF expects financial institutions to establish an integrated risk management mechanism that is supported by reliable governance involving the board of directors and senior management. This will enable material risks to be identified and operational plans to be developed according to the risk appetite and risk tolerance levels determined by the institution.

Effective and integrated management of risks is a crucial component of sound governance. An appropriate risk management process allows for identifying, assessing, quantifying, controlling, mitigating and closely monitoring major risks.

To do so, the financial institution should have a solid internal governance system, effective strategic management as well as a proactive and integrated method of assessing the risks to which it is exposed. It is important to mention that in the case of the members of a group, the risk management mechanism could already be present within the group and may not require the creation of an additional mechanism.

The main purpose of effective and efficient risk management procedures is to:

- identify existing and new risks;
- set risk appetite and risk tolerance levels and supervise the financial institution's position with respect to approved variables;
- monitor compliance with legislative, regulatory and normative requirements;
- put in place reliable internal controls.

It is therefore essential that the financial institution be able to identify all material risks to which it is exposed, evaluate the potential impact from these risks and implement measures to effectively manage them. To accomplish this, risk management may be supported by internal controls.

[7] The AMF "Integrated Risk Management Guideline" effective as of April 1st, 2009 provides more details with regard to the integrated risk management mechanism and outlines the roles and responsibilities of the board and senior management.

4. Internal control

The AMF expects financial institutions to implement internal control mechanisms that meet targeted objectives and support the achievement of those objectives.

Internal control is a set of mechanisms designed to give a financial institution’s decision-making bodies reasonable assurance that the institution's objectives will be met, in particular with respect to the efficiency and effectiveness of operations, the reliability of generated and published reports, and compliance with policies or practices in place and applicable codes of ethics.

Internal control is an essential component of an effective governance structure, since it helps to detect functional weaknesses, which could be major sources of risks for a financial institution.

Since internal control involves all levels of the financial institution, staff involved must be aware of the importance of internal control mechanisms and receive, for that purpose, clear communications from senior management. It is therefore essential that the pertinent information be identified, gathered and communicated in a form and timeframe that enables the individuals concerned to adequately assume their responsibilities.

The board of directors generally has a specific role with respect to internal control, namely, a periodic comprehensive assessment of internal control, the assessment of its mandate and organizational structure and, consequently, the approval of significant changes made to it. This assessment ensures that the function is adequately meeting the financial institution's objectives.

As part of the review of internal control, the board of directors could, for example, base its assessment on the following:

- reports from senior management on the operations and financial condition of the financial institution, risk management system or other control systems, any significant departure from controls and non-compliance with codes of ethics, laws, regulations or standards;

- internal and external audit opinions on the adequacy of the financial institution's controls, as well as any recommendations to improve deficiencies;

- the audit report on the audited financial statements and all other reports of the external auditor, including any communications with senior management;

- opinions solicited by the board of directors from legal counsel;

- for insurers, the actuary's report on provisions and reserves and the Dynamic Capital Adequacy Test (DCAT);

- the recommendations, observations or opinions of the financial institution’s regulator.

In addition, it is the board's responsibility to ensure that senior management take prompt action to correct any material control problems identified in connection with the assessment and ensure that they are adequately monitored.

As mentioned, the implementation of sound governance at a financial institution is contingent on the contribution of various mechanisms, which include, in addition to risk management and internal control, the independent oversight function.

5. Independent oversight of activities

> The AMF expects financial institutions to ensure effective, ongoing and independent oversight of activities. Such oversight should support the board of directors in validating the effective functioning of control mechanisms and the reliability of the institution's reporting and results.

The board of directors delegates responsibility to senior management for ensuring that the various mechanisms adequately fulfill their mandates. However, depending on the financial institution's size and complexity, this responsibility may be assigned to independent oversight functions, such as internal audit, compliance, or, in the case of insurers, the appointed actuary, and, where such a function exists separately, risk management.

Consequently, the board of directors relies on the advice and opinions from the independent oversight functions within the financial institution, but also from those of the audit function.

To ensure that these functions are able to provide it with the necessary support, the board of directors should notably:

- take an active interest in the selection of candidates for independent oversight positions;

- recommend to shareholders or members, as applicable, the appointment of a suitable candidate as external auditor;

- ensure that the persons responsible for the various functions are independent from the operations they oversee and are free of influences that may affect their ability to perform their responsibilities objectively;

- ensure that the persons performing these functions have the necessary authority and resources and the support of senior management;

- understand the key findings of the reports produced by independent oversight functions and ensure follow up on any concerns raised.

6. Audit of activities

The AMF expects the financial institution's audit committee to be satisfied that the institution's audit plan is risk-based and covers all relevant activities over a measurable cycle, and that the work of the internal and external auditors is co-ordinated.

Legislation[8] requires financial institutions to set up an audit committee within the board of directors. The main functions of this committee may consist in reviewing the financial statements and the internal control and risk management mechanisms implemented by senior management to ensure that principal risks are correctly managed and reported to the persons responsible.

The internal audit function enables the institution to obtain an independent and objective overview of the effectiveness of its risk management, control and governance processes. This includes the effectiveness of and compliance with operational and management controls, compliance and risk management policies and practices, as well as the effectiveness of independent oversight functions.

Where institutions are members of a group, the internal audit function could act on behalf of the entire group so that an additional function need not be created. However, if some or all of internal audit is outsourced - for example, where it is not practical to have an internal function due to the size or operational complexity of the financial institution - the board of directors is nonetheless responsible for overseeing the performance of the audit function as a whole.

As regards external audits, the audit committee should, in general terms, be responsible for the following:

- scope of the audit plan;

- skills and resources of the external auditor;

- recommendations concerning the appointment of the external auditor;

- periodic review of the external auditor's effectiveness;

[8] *An Act respecting insurance*, R.S.Q., c. A-32, s. 298.1.
An Act respecting financial services cooperatives, R.S.Q., c. C-67.3, s. 253.1.
An Act respecting trust companies and savings companies, R.S.Q., c. S-29.01, s. 282.

- independence of the auditor as well as of the auditor's internal quality control practices and policy;

- compliance with accounting and actuarial practices as well as assurance that they are conservative and appropriate;

- ensuring receipt of all material correspondence between the external auditor and senior management regarding audit findings, in accordance with current Canadian generally accepted accounting principles;

- quality of the financial statements, including a fair presentation of the institution's financial position.

One criterion is essential for all functions involved in the governance structure: the transparency of information and its dissemination among the appropriate persons. The following section discusses financial institutions' disclosure requirements.

7. Disclosure

The AMF expects financial institutions to disclose the main aspects of their governance programs in consideration of the nature of their activities.

This disclosure should enable market participants to understand the financial institution's governance structure. Regardless of the vehicle used to achieve this, transparency remains the key to satisfactory disclosure. The institution may use its annual report, website or any other support to provide adequate disclosure.

To achieve transparency, the following could be disclosed: independence criteria used and applied to key positions of responsibility, rules of conflict of interest, risk management systems, internal control, and reference to events during the reporting period.

8. Assessment of governance effectiveness

The AMF expects financial institutions to introduce a governance program tailored to their nature, size, complexity of their activities and risk profile and to ensure the effectiveness of this program.

8.1 Role of financial institutions

Governance practices are evolving rapidly. The AMF expects the decision-making bodies of financial institutions to be aware of governance best practices and tailor them to their needs. As such, the governance program should be regularly updated.

8.2 Role of the AMF

In seeking to promote sound and prudent management of financial institutions, the AMF may review observance of the sound and prudent principles contained in this guideline and the effectiveness of the governance programs set up by institutions.

Since this guideline sets out the AMF's expectations through a principles-based approach rather than a rules-based approach, its provisions should be considered guidance to assist institutions in introducing adequate, effective and efficient governance programs. Consequently, the AMF will take into consideration the specific profile of each financial institution when determining effective implementation of sound governance, in particular by assessing policies and procedures, their relevance to the institution as well as the quality of the supervision and control carried out by the board of directors and senior management.

The AMF also intends to examine the governance programs of institutions based on the extent to which industry governance best practices have been considered and integrated into an institution's own practices.