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Ontario Securities Commission
Alberta Securities Commission
Manitoba Securities Commission
Registrar of Securities, Government of Yukon
Registrar of Securities, Department of Justice,
Government of the Northwest Territories
Securities Commission of Newfoundland and Labrador
Nova Scotia Securities Commission
Commission des valeurs mobilières du Québec
Saskatchewan Financial Services Commission
Office of the Attorney General, Prince Edward Island
Registrar of Securities, Legal Registries Division,
Department of Justice, Government of Nunavut
Department of Justice, Securities Administration Branch, New Brunswick

Dear Sirs/Mesdames:

Proposed Multilateral Instrument 52-110 Request For Comment

We are writing in response to the Canadian Securities Administrators' Request for Comment in respect of proposed multilateral instrument 52-110 Audit Committees published June 27, 2003 (the "Proposed Instrument").

1. Definition of Independence – Our comments on the definition of "independence" are intended to ensure greater balance between the need to attract and retain directors with the experience and skill appropriate to the organization and the need to avoid any real or perceived relationship with management. We think that the definition as proposed will eliminate too many good directors from service on audit committees where the risk of those directors being influenced by management as a result of a current or past relationship is *de minimis* or remote.

   (a) Including "immediate family members" in the bright line test on the basis that they are, for example, employees of the issuer, its parent or any of its subsidiary entities or affiliated entities casts too wide a net. This test would disqualify a director from sitting on the audit committee if a family member was employed

anywhere in the issuer's consolidated organization, regardless of the level of employment of that individual or their connection with the organization's financial reporting. A director would cease to be independent if a son or daughter living in the director's home had a part time clerical job while attending university. We would suggest that the bright line test be restricted to immediate family members who are senior level employees. It will still be open to the board to find that a director's independence is compromised by an immediate family member occupying a more junior level position. The governance policy currently being prepared by the Ontario Securities Commission could recommend a higher standard or specifically recommend that boards take into account that employment relationships at all levels between members of a director's family and the corporation involve some potential for compromising the director's independence and that the board should take this potential into account in assessing independence for the purpose of service on the audit committee.

(b) The three year cooling off period is too long. We suggest a 12 month period.

Directors who understand the corporation and the factors that drive its success have a significant contribution to make on the audit committee. In most cases, an individual who has had no formal relationship with the organization for a full year will have had no input into the decisions made during that year. This will create sufficient distance from management in most cases. Again, it remains open to the board to determine that a relationship not caught by a 12 month cooling off period continues to create sufficient potential for conflict, real or perceived, that the individual should not be invited to re-establish his or her relationship with the organization as a director, or at least as a member of the audit committee.

(c) The exclusion of individuals who have accepted fees from the organization should be subject to a materiality threshold. To exclude a person who has done an insignificant amount of consulting or professional work from service on the audit committee for a period of three years is overly cautious.

2. Controlling Shareholders – The definition of independence precludes controlling shareholders and their employees from sitting on the audit committee. We note the exception that a member of the controlling shareholder's board who is independent of the controlling shareholder and the public company subsidiary may sit on the subsidiary's audit committee.

We understand that the purpose of the independence requirements is to ensure that the audit committee is independent of management. While controlling shareholders are often involved in the management of the corporation, there are many examples where they are not, especially where they are institutional investors. There are a number of examples in Canada of controlled companies having a professional management team which does not include anyone who would be considered related to the controlling shareholder. In that

case, it is not clear why the controlling shareholder should not be entitled to sit on the audit committee. In fact, with the largest stake in the corporation, the controlling shareholder will have a clear interest in the integrity of the corporation's financial reporting. We recognize that it is possible for there to be situations in which the controlling shareholder may prefer an accounting treatment that members of the audit committee not related to the controlling shareholder believe is not in the best interests of the corporation. This type of conflict is likely to arise infrequently, but could be handled through the conflict of interest procedures otherwise applicable to decisions made by the board in which the controlling shareholder has an interest. To be effective, this would require an amendment to the Proposed Instrument to require that a majority of the members of the audit committee be unrelated to the controlling shareholder.

3. Audit Committee Financial Expert – Our concern with identifying one or more members of the audit committee as "audit committee financial experts" relates to liability. We note that the proposed companion policy records the intention not to impose additional liability on directors as a result of being named as an audit committee financial expert. Whether a court would honour this intention remains to be seen. Until there has been some legal determination of the issue, members of audit committees are understandably nervous. The current environment and the leadership being shown by securities regulators in the area of governance presents an excellent opportunity for their respective provincial governments to reflect the intentions of the regulators in an amendment to the various business corporations acts confirming that directors are not subject to greater liability because they serve on the audit committee (or other committees), including where they so serve because they possess a particular skill set.

4. Audit Committee Responsibilities – The thrust of governance reform has been to require the audit committee to stand in for the shareholders in the corporation's relationship with its external auditor because it is impractical for shareholders to have a direct relationship with the external auditor, notwithstanding that the external auditor reports directly to the shareholder. We are concerned that the Proposed Instrument (as well as governance regulation in the United States) has, perhaps inadvertently, gone well beyond this objective by making the audit committee responsible for "overseeing the work of the external auditor".

One of the most important roles of an audit committee is to support the independence of the auditor from management. This objective can be addressed by requiring the audit committee to approve engagement letters, the scope of the audit and audit fees (in addition to recommending the hiring and firing of the auditor to the shareholders), and any exceptions to a prohibition on the auditor or any of its affiliates providing non-audit services to the corporation or its subsidiaries, and by requiring the audit committee to hold *in camera* meetings that exclude management, at which the audit committee assesses any issues that could affect the independence of the auditor.

However, the audit committee is not in a position to "oversee" the work of the external auditor in the sense of determining whether the external auditor is performing its function appropriately (as it does with management). This is a matter for the standards established and maintained by the accounting profession and their various oversight bodies. Moreover, there are two streams of accountability to the shareholders – the board of directors on the one hand and the external auditor on the other. It is important that the shareholders have the benefit of both of these checks on the financial reports prepared by management. The concept of "oversight" suggests that the auditor should not have the authority to give its view directly to the shareholders if it disagrees with the approach being taken by the audit committee. This suggestion is reinforced by the proposed requirement that the audit committee should be responsible for the "resolution of disagreements of management and the external auditor regarding financial reporting".

General requirements about the audit committee having oversight responsibility with respect to the external auditor or the external auditor being accountable or responsible to the audit committee compromise the checks and balances built into the corporate model and go well beyond what an audit committee is equipped to do.

Please do not hesitate to contact Carol Hansell (416) 863.5592, Rosemary Newman (416) 367.6970 or Maryse Bertrand (514) 841.6460 to discuss our comments further.

Yours very truly,

Carol Hansell

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