September 25, 2003

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

Re: Comments on Proposed Multilateral Instrument 52-110 *Audit Committees*

I. INTRODUCTION

This letter responds to the request of certain members of the Canadian Securities Administrators (the "**CSA**") for comments on proposed Multilateral Instrument 52-110 *Audit Committees* ("**MI 52-110**"), proposed Forms 52-110F1 and 52-110F2 ("**Form 52-110F1**" and "**Form 52-110F2**" and, collectively, the "**Forms**") and proposed Companion Policy 52-110CP ("**Policy 52-110CP**") (MI 52-110, the Forms and Policy 52-110CP being collectively referred to as the "**Instrument**").

Part II – General Comments sets out our general comments on the Instrument. **Part III – Response to Specific Requests for Comments** set out our response to the CSA's request for comments on certain specific aspects of the Instrument.

II. GENERAL COMMENTS

1. **Implementation**. Fasken Martineau fully supports the purpose of MI 52-110 which is to prescribe policies, practices and procedures for audit committees which will "enhance the quality of financial disclosure made by reporting issuers, and ultimately foster increased investor confidence in Canada's capital markets". We agree that a properly constituted audit committee which functions largely independently of management, has direct access to the internal and external auditors and operates under a charter which ensures its independence and authority can be an extremely important tool in promoting better and more

reliable disclosure by reporting issuers and in re-establishing investor confidence in the capital markets.

2. **Uniformity of Legislation**. We support the efforts of those members of the CSA who agreed to the terms of the Instrument as uniformity of regulation is a key to efficient capital markets. We encourage the CSA to continue to work with British Columbia to gain its support for this initiative. We also congratulate the CSA for endeavouring to make the proposed regime for audit committees consistent with the existing and proposed rules in the United States, while recognizing important differences in Canadian regulation, practice and the participants in Canadian capital markets. As much uniformity as is possible consistent with meeting the essential needs of the Canadian markets is to be strongly encouraged.

3. **S.1.1 MI 52-110 - "audit committee financial expert"**. We suggest that paragraph (b) of the definition of "audit committee financial expert" be deleted. If an issuer (for example, an insurance company) has unique or complex accounting issues relating to estimates, accruals and reserves, financial expertise in dealing with these issues would be covered by paragraph (c). Also, it is not clear what the phrase "*in connection with the accounting for estimates, accruals and reserves*" refers to.

4. **S.1.1 MI 52-110 - "Marketplace"/"Venture Issuer"**. The term "marketplace" in National Instrument 21-101 *Marketplace Operation* includes exchanges, quotation and trade reporting systems and alternative trading systems. The TSX, NYSE, ASE and the Pacific Stock Exchange are "exchanges" and the Nasdaq National Market and Nasdaq SmallCap Market are "quotation and trade reporting systems" for purposes of Canadian and U.S. securities laws. An issuer that has securities listed or quoted on any of these exchanges or quotation and trade reporting systems is not a "venture issuer". An issuer that has securities quoted only on an "alternative trading system" in Canada or the U.S. is a "venture issuer". It seems anomalous that an issuer that has securities listed or quoted on any marketplace, including an alternative trading system, outside of Canada or the U.S., is not a "venture issuer". Perhaps "marketplace" is not the appropriate term and some other threshold should be identified.

5. **S.1.1 MI 52-110, S.7 Form 52-110F1 and S.5 Form 52-110F2 - "Non-Audit Services"**. The requirement in s.2.3(4) of MI 52-110 for the audit committee to pre-approve all "non-audit services" inevitably calls into question the issue of what are "non-audit services". The term "non-audit services" as defined in s.1.1 of MI 52-101 is, with respect, not very helpful as it defines these as services "other than those provided to the issuer in connection with an audit or review of the financial statements of the issuer." The Forms may be said to provide some

guidance as they require separate disclosure of billings for "Audit Fees", "Audit-Related Fees", "Tax Fees" and "All Other Fees", however, these categories also create distinctions that may be difficult to draw. For example, in s.7 of Form 52-110F1 and s.5 of Form 52-110F2, it is not clear whether services "normally provided by the external auditor in connection with statutory and regulatory filings or engagements" (called "Audit Fees" in paragraph (a)), or "assurance and related services" that are "reasonably related to the audit or review of the issuer's financial statements" (called "Audit-Related Fees" in paragraph (b)), are audit or non-audit services requiring pre-approval. As a simple example, MD&A does not form part of the financial statements, but it is a statutory and regulatory filing. Is the auditor's review of MD&A an audit service or non-audit service?

We feel that the definition of non-audit services in s.1.1 of MI 52-110 should exclude, in addition to services provided to the issuer in connection with the audit or review of the issuer's financial statements, any other services rendered in connection with the issuer's statutory and regulatory filings. We understand that these services are not of a kind that taint auditor independence. Also, paragraphs (a) and (b) of s.7 of Form 52-110F1 and s.5 9 of Form 52-110F2 should be collapsed into one disclosure item requiring disclosure of "any services other than non-audit services". In particular, "Audit-Related Fees" should not have to be reported separately, with a description of the nature of the services, as currently required by paragraph (b) of s.7 of Form 52-110F1 and s.5 9 of Form 52-110F2.

6. **S.2.4 MI 52-110 - "De Minimis Non-Audit Services"**. We suggest that the *de minimis* exemption for pre-approval of non-audit services be increased from 5% to 10% of total audit fees. The new CICA and U.S. rules preventing chartered accountants from providing many "non-audit services" to audit clients and the divestiture by many audit firms of their "non-audit" lines of service make the provision of non-audit services by external accountants less critical to auditor independence. Also, a 10% "basket" would allow management some scope to engage the auditors for insignificant non-audit services without calling a special meeting of the audit committee or its designate to obtain the required pre-approval. We agree that all such engagements would need to be reported to the next audit committee meeting.

Also, since fees for non-audit services and total audit fees will not be known at the time of the determination, and since fees paid by the issuer's subsidiary entities should be included in the calculation, we suggest that paragraph (a) of s.2.4 be reworded along the following lines:

"(a) the aggregate amount of all the non-audit services that were not pre-approved is reasonably expected to constitute not more than

> ten per cent of the total amount of revenues reasonably expected to be paid by the issuer and its subsidiary entities to its external auditors during the fiscal year in which the services are provided;"

We also do not think that the issuer (and the auditor) should have to recognize the services as non-audit services for the *de minimis* exemption to be available. Accordingly, we recommend that paragraph (b) of s.2.4 be deleted.

Finally, in paragraph (c) of section 2.4, the requirement that non-audit services be "promptly" brought to the attention of the audit committee is impractical and invites liability. It should be acceptable if services are brought to the attention of audit committee at its next scheduled meeting.

7. **S.2.5 MI 52-110 - Delegation**. By expressly allowing pre-approval of *de minimis* non-audit services to be delegated to one or more audit committee members, it may be inferred that no other audit committee functions may be delegated. We submit that boards and audit committees should be free to determine their own functions and procedures and should be free to delegate "any powers of the audit committee within its responsibility and mandate" to one or more audit committee members as they see fit in the context of the issuer, the membership of the audit committee and other unique factors. We agree that any matter that is delegated should be presented to the audit committee at its next scheduled meeting.

   Timeliness of disclosure requires expedited review and decision-making which can be facilitated in appropriate circumstances by delegation. For example, s.2.3(5) of MI 52-110 requires audit committee pre-approval of "the issuer's financial statements, MD&A and earnings press releases". Presumably, "earnings press releases" includes earnings guidance, earnings warnings, corrections, etc., all of which may have timely disclosure implications. Unless boards and audit committees are free to delegate, audit committees may need to establish artificially low quorum requirements to enable valid meetings to be called and held on short notice to review timely disclosure announcements.

8. **S.5.1 and S. 5.2 MI 52-110 - AIF/Management Information Circular**. It seems to us that the Form 52-101F disclosure should be able to be made in the issuer's management information circular rather than its AIF if it chooses to do so.

9. **Drafting Comments**.

   S.1.1 MI 52-110 – Definitions (General). The terms "AIF", "designated foreign issuer", "investment fund", "marketplace" and "MD&A" are defined by cross-

referencing the defined terms in other National Instruments or proposed National Instruments. You may wish to consider taking the same approach with certain other defined terms. See our specific comments on the defined terms below.

S.1.1 MI 52-110 – "accounting principles". The term "Canadian GAAP" is defined in National Instrument 14-101 *Definitions*; the terms "U.S. GAAP" and "International Financial Reporting Standards" are not.

S.1.1 MI 52-110 – "asset-backed security". You may wish to consider defining "asset-backed security" by cross-referencing NI 44-101 *Short Form Prospectus Distributions.* Alternatively, to conform the definition to NI 44-101 *Short Form Prospectus Distributions*, add the word "either" before the phrase "fixed or revolving" and insert a comma after the phrase "finite period.

S.1.1 MI 52-110 – "executive officer". The differences between the definition of "executive officer" in MI 52-110 and the definition of "executive officer" in proposed National Instrument 52-102 *Continuous Disclosure Obligations* do not appear to us to be substantive. To avoid having multiple but similar definitions in the different regulatory provisions, we suggest defining "executive officer" in MI 52-110 by cross-referencing the definition in NI 52-102.

S.1.1 MI 52-110 (new) – "International Financial Reporting Standards". Is a definition required?

S.1.1 MI 52-110 - "US GAAP". We suggest defining this term by cross-referencing proposed National Instrument 52-107 *Acceptable Accounting Principles, Auditing Standards and Reporting Currencies.*

S.1.2(d)(i) MI 52-110 - Application. The words "displayed for trading" should be replaced by the words "listed or quoted". See for example the definition of "venture issuer" in s.1.1 MI 52-110 and National Instrument 21-101 *Marketplace Operation.*

S.1.3(b)(ii) and S.1.4(7)(b) MI 52-110. It is not clear what is meant by "managing member" in s.1.3(b)(ii) and "member" and "non-managing members" in s.1.4(7)(b). The term does not work well with the described businesses (accounting, consulting, legal, investment banking and financial advisory services).

Ss.1.3(4)(a) and 2.4(a) MI 52-110 and S.3.2(a) Policy 52-110CP. We suggest using "not more than ten per cent" rather than "ten percent or less" in each of these sections to conform the wording to other places in the Instrument. Also, in

s.2.4(a), the words should be "not more than" the prescribed percentage (not "no more than…").

S.1.4(3). As set out in this Comment Letter (see Part III, paragraph 1 below), we believe that the provisions of s.1.4(3), which, in effect, deem certain relationships to exclude persons from being "independent", should not be automatic but should be at the discretion of the board. If you do not agree with this view, we recommend that the word "considered" in the lead-in language of s.1.4(3) be replaced by the word "deemed" (i.e., "the following persons are deemed to have a material relationship").

S.1.4(3)(b) MI 52-110. The words "in a professional capacity" should be inserted on the first line after the phrase "a person who is, or has been, an affiliated entity of, a partner of, or employed" to conform the language to paragraph (c) of the same subsection.

S.1.4(3)(d) MI 52-110. The defined term is "executive officers" not "executives".

S.1.4(3)(d) MI 52-110. We suggest that the word "material" be inserted before the phrase "consulting, advisory or other compensatory fee" as we submit that a materiality threshold is appropriate.

S.2.3(5) MI 52-110 - Earnings News Releases. We note that in National Policy 51-201 *Disclosure Standards* and elsewhere, the term used is "news release" not "press release".

S.2.3(8) MI 52-110. In subsection 2.3(8), we suggest inserting the word "partners" after the phrase "hiring policies regarding" and adding the phrase "during the prescribed period" at the end of the subsection. We note that in s.1.4(4), the term "prescribed period" is defined "for the purposes of subsection (3)" of s.1.4. If you make our change to S.2.3(8), the lead-in phrase will have to be changed to "for the purposes of this Instrument".

Also in s.2.3(8), the phrase "present and former external auditors" should be changed to "current and former external auditors" to conform the wording to other places in the Instrument. See s.1.4(3)(b) for example.

S.2.4 MI 52-110 - De Minimis Non-Audit Services. For clarity, we suggest that the lead-in words, "An audit committee may satisfy the pre-approval requirement in subsection…if", be changed to "Non-audit services do not have to be pre-approved by the audit committee under subsection…if".

S.2.4(c) MI 52-110 – De Minimis Non-Audit Services. This is the only place where the term "audit committee" is followed by the words "of the issuer" and the words "of the issuer" should be deleted.

Ss.2.5(1) and 2.5(2) MI 52-110 - Delegation. The requirement that delegated powers be approved at the next scheduled meeting of the "full" audit committee implies that every audit committee member has to attend, not just a quorum. The word "full" should be deleted

S.3.1(4) MI 52-110 - Composition. The words ", or become financially literate within a reasonable period of time after his or her appointment to the audit committee." may be added at the end of s.3.1(4). This proposed change is based on the U.S. rules.

S.4.1(c) – Authority. Audit committee members must have the authority to communicate directly with management as well as the internal and external auditors. Accordingly, we recommend amending s.4.1(c) along the following lines:

> "(c) to communicate directly with <u>management of the issuer and its subsidiary entities and</u> the internal and external auditors."

III. RESPONSE TO SPECIFIC REQUESTS FOR COMMENTS

The following are our comments in response to certain of your specific requests for comments.

1. **<u>Independence</u>**. We think the basic definition in s.1.4(1) of MI 52-110 is appropriate. We believe that the elaboration of "material relationship" in s.1.4(2) is also appropriate, except that "reasonably" does not make sense as a modifier to "interfere" and accordingly, we suggest that words be amended to read: "which could, in the view of the issuer's board of directors, reasonably <u>be expected to</u> interfere with the exercise of a member's independent judgement." We think that for clarity, the following words or something similar should be added to s.1.4(2) at the end: "regarding matters within the mandate and responsibilities of the audit committee".

We are of the view that the provision of s.1.4(3), which, in effect, deems certain relationships to exclude persons from being "independent", should not be automatic. We believe that the board should consider these matters, among others, in making its determination of independence but these relationships should

not be automatically exclusionary. We believe the board can and should make these judgements.

We also believe that, by excluding certain persons who have the specified relationships, the board may not focus adequately on what other factors should be looked at in each particular case to satisfy itself on the independence of a candidate for the audit committee.

By referencing "officers" of the issuer in s.1.4(3)(a), and not "executive officers" as in the other sections, the provision excludes Chairs and Vice-chairs of the board of directors from being considered independent, even if non-executive and part-time. We submit that the provision should be amended so as to permit such persons to be considered independent and allowed to sit on the audit committee.

A large shareholder who is a member of the board, if non-executive and part-time (i.e., only a board member), should also be considered independent and allowed to sit on the audit committee. The current proposal is not clear on this point. Independence should be from management, of course; shareholding per se should not disqualify a director, unless the relevant shareholder is also active manager of the issuer.

We consider the "prescribed period" to be appropriate provided the categories in s.1.4(3) are made discretionary. If the deeming provisions are to remain, we are of the view that a two-year cooling off period would be adequate. There needs to be a balance between risk to independence and adding special value to the board and audit committee through knowledge of the issuer and its industry.

2. **Audit Committee Financial Expert**. Despite the views of the CSA on their intent not to heighten the potential liability of audit committee financial experts or to lessen the responsibilities of the other audit committee members, the CSA views will not bind a court examining personal civil liability and may not even be determinative in a proceeding of a CSA member e.g. the *YBM Magnex* decision which clearly differentiated among directors based on their skills, knowledge and level of participation. S.138.4(7) of Bill 198 also appears to likely increase the potential liability of any financial expert.

We strongly feel that the CSA should clarify in MI 52-110 (and not in Policy 52-110CP) that the designation and public identification of an audit committee financial expert does not affect that person's duties, obligations or liabilities as an audit committee member or a board member. We note that the SEC also originally took the view that audit committee financial experts would not be exposed to increased liability, but decided to codify a safe harbour provision in its

final rule to clarify this: see the SEC's Final Rule: Disclosure Required by Sections 406 and 407 of the *Sarbanes-Oxley Act of 2002*, SEC Release No. 33-8177.

Venture Issuer. We agree that the exemptions for venture issuers is appropriate in the current draft MI 21-110.

IV. CONCLUSIONS

We appreciate being given the opportunity to comment on the important and worthy initiatives contained in MI 52-110. If you wish to discuss any of our comments, please do not hesitate to contact any of George C. Glover, Jr. in our Toronto office, Gilles Leclerc of our Montreal office or Lata Casciano of our Vancouver office. The contact particulars are set out below.

Please find enclosed a diskette including a Word version of the foregoing submission.

Respectfully submitted,

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