Kenmar Associates
Investor Education and Protection

December 1, 2017

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Superintendent of Securities, Nunavut

CSA Consultation Paper 52-404 Approach to Director and Audit Committee Member Independence
http://osc.gov.on.ca/en/SecuritiesLaw_csa_sn_20171026_52-404_committee-member-independence.htm

Kenmar Associates is an Ontario-based privately-funded organization focused on investment fund investor education via on-line research papers hosted at www.canadianfundwatch.com .Kenmar also publishes ***the Fund OBSERVER*** on a bi-weekly basis discussing investor protection issues primarily for investment fund investors. An affiliate, Kenmar Portfolio Analytics, assists, on a no-charge basis, abused investors and/or their counsel in filing investor complaints and restitution claims.

We are pleased to comment on this consultation.

Introduction

"There are no bad companies, only bad boards. Look to the board, not the company" - R. Leblanc, Editor of Handbook of Board Governance

In a broad sense an independent director is a non-executive director who does not have any kind of relationship, direct or indirect, with the company that may affect the independence of his/her judgement and decisions. Kenmar view independent directors as a guide to the company. For us, their roles broadly include improving corporate credibility, integrity and governance standards functioning as a watchdog, and playing a vital role in risk management, strategy development and social responsibility. Independent directors play an active role in various committees set up by the company to ensure good governance such as the audit committee, strategy committee and disclosure committee. Independent directors are fiduciaries. As such, the independent director is a key element of Investor protection.

It must be said that the drive for director independence should not compromise the need for director competency. In many cases industry experience is a critical success factor for director effectiveness. There exists a positive relationship between industry expertise of boards and performance and between industry experience and monitoring.

The consultation paper informs us that some stakeholders have expressed concern about the appropriateness of the current CSA approach to determining director independence. They believe that the approach has precluded individuals with the requisite expertise and sound judgement from being considered independent members of the board or being able to serve as audit committee members. In other instances, it has been argued that the application of the CSA approach has limited the pool of individuals who could be considered independent to the detriment of certain issuers.

At one time some firms asserted that were not enough qualified women to act as board directors. That assertion has been proven to be grossly exaggerated. We suspect a similar situation exists with filling independent Director positions.

Boards are becoming far more active and are investing significant time in their duties and responsibilities. The issues facing corporations today go well beyond maximizing EPS and growth. Social responsibility issues such as use of contractor child labour, workplace safety / sexual harassment, indigenous rights and employee reward systems are increasingly falling on the shoulders of boards.

There are major changes taking place in how boards are structured .This has already occurred as external auditors now report to the board instead of the CEO or CFO as was the tradition in the past. There will be more changes. For instance,

there is a view that certain functional management activities should report directly to the Board such as cyber security, climate change or the environment. Given these trends, it seems to us that the board needs even tighter definitions of independence rather than looser ones.

Based on experience, conduct failure happens when a board is complacent and fails to act when it should. Conflicts-of-interest are a significant factor that can impair the effective performance of a board, the company and return to shareholders/ stakeholders. That is why investors, boards and regulators ought to treat the issue of Director independence seriously. Attempts to water down the principles of Director independence should be viewed with constructive concern.

Discussion

It may well be that the current definition has precluded some otherwise qualified individuals from acting as Directors or being members of audit committees. That is a reasonable trade-off in the sense that investor confidence in public markets is maintained because of improved corporate governance and the public perception of good governance.

We could find no independent research that demonstrates there are material limitations imposed by the current CSA definition of independence. On the contrary, we find that the current CSA definition could easily be met by increasing Board diversity/ women on boards. The current statistics of women on boards is horrible suggesting there is a vast treasure trove of very qualified women readily available to fill the needs of Boards. Research has also shown that Boards with both women and men tend to be more active in overseeing the strategic direction of the company, and in reinforcing accountability through audits and risk management. See *Gender Diversity in the aboard of Directors: A corporate Governance Perspective* R, Valsan July, 2015 https://cloudfront.ualberta.ca/-/media/eucentre/pdfs/working-papers/remus-valsanworking-papergender-diversity.pdf One can therefore only conclude that the pool of available independent directors will grow and board governance quality will simultaneously improve.

Governance at investor Protection entities

There are two related issues regarding director independence but they relate to entities with public interest mandates.

1. IIROC Governance

Investor advocates have expressed a deep concern about the governance at IIROC and its impact on investor protection.

The IIROC issue is critical as it is the defacto national regulator for retail investors. Recently the Public Investors Arbitration Bar Association, a group of U.S. lawyers that represents retail investors who sue brokerage firms, in a new report took aim

at perceived conflicts-of- interests at the board of governors of the Financial Industry Regulatory Authority Inc., the U.S. equivalent of IIROC. The report claims that many so-called "public governors" on Finra's 24-person board have connections to Wall Street, serve on too many corporate boards to represent the public effectively and face conflicts-of-interest.

We believe the same situation exists here. See SIPA paper *Investor Protection and IIROC Governance* at http://sipa.ca/library/SIPAsubmissions/500_SIPA_REPORT_InvestorProtection_IIROCGovernance_20161009.pdf Accordingly, Kenmar recommends that the IIROC Board include designated positions for industry-independent (i.e. no prior financial services connection) directors that would represent the voice of the retail investor.

2. OBSI governance

Another big issue involves the OBSI, the sole official Ombudsman service recognized in the Canadian securities marketplace. At this time the issue is not only independence but representation for the Retail Investor. Three consecutive independent reviews have recommended that a designated Board position(s) be assigned for the Retail Investor. The board's of OBSI have consistently opposed this representation including the current board. The absence of a designated position for retail investor participation creates a serious governance gap for an institution designed to act in the Public interest.

There is also fairness on the cost side. Ultimately, consumers pay for industry participation in OBSI. If the costs of Ombuds services are to be embedded in the transaction, there must be an allocation to consumer representation at the board level.

Currently, the so-called Community Directors of OBSI can be ex-financial services industry participants per OBSI criteria subject to a short two-year cooling off period. This can result in a board stacked with current and former investment industry participants and the mindset that surrounds that mindset.

Kenmar are of the firm conviction that all the Community director positions should be reserved for representatives of the community, not those who have worked in the Bay Street culture. Industry culture bias is very hard to eliminate. More importantly, there is more than an ample supply of highly qualified industry-independent OBSI Director candidates to satisfy any foreseeable demand .If the lobbyist for Canada's banking industry can have an allocated position, so should the retail investor, the central stakeholder in OBSI. Kenmar recommends that there should be members of the board of directors of OBSI with a role and responsibility to bring to OBSI's governance independently sourced grass roots expertise, knowledge and perspectives on consumer rights and issues and the factors that impact them.

Mutual fund governance

As for Kenmar, we believe there is big issue of investor protection re mutual fund governance Canadian mutual funds represent a growing influence in corporate securities ownership, both in Canada and across the globe. By September 2017, Canadian mutual funds exceeded C$1.4 trillion in collective assets under management. There is a high level of investment by the Canadian mutual fund industry in the Canadian securities market. Mutual funds are a major element in the retirement income security of Canadians and hence how they are governed is a critical socio-economic factor.

Mutual funds are a unique security in that they hold investments in the common stock of companies and in the bonds of those companies. The voting rights associated with those stocks and bonds lies in the hands of the mutual fund manufacturer and not in the hands of the individual investors in the mutual fund. This means that the voting power associated with the securities holding lies with the fund manufacturer. The vast majority of usual find assets are in funds that have been sold by the largest financial institutions in Canada so that there is a concentration of voting power among the banks and insurance companies.

Banks and insurance companies are financial conglomerates so that enormous conflicts-of-interest exist between the fund, the fund sponsor, affiliates of the fund sponsor and unit holders. Traditional views of independent directors do not hold with such manufactured securities. (this includes but is not limited to index-linked GIC's, Segregated Funds, Principal Protected Notes, ETF's and a host of other structured products). Kenmar do not view mutual fund governance in Canada to be robust so that there are a number of regulatory issues related to governance / investor protection that need to be considered.

One simple example is that mutual funds pay trailer commissions to dealers for service and advice. However, in the case of discount brokers mutual funds pay trailers when such brokers cannot and do not provide advice to clients raising the issue of a conflict-of-interest between the fund manufacturer and it's unitholders. One estimate of the amount of such improper payments is approximately $190 million per year. This is why we feel that fund governance merits a high priority by securities regulators with independent directors replacing the relatively weak Independent Review Committees incorporated in NI81-107.

Another example comes from a research report by Brock University Prof. Samir Trabelski et al. The researchers found that corporate class funds, which have a separate board of directors for the fund, charge higher fees than trust funds. However, corporate class funds deliver superior performance that more than compensate for their higher fees. For corporate class funds, it was found that a board with smaller size, CEO duality, and higher percentage of independent directors is more likely to charge lower fees. In addition, more independent boards are strongly associated with higher fee-adjusted performance. See *Mutual Fund Fees, Performance, and Governance Structure in Canada* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2201213

Response to Consultation Questions

a. Do you consider our approach appropriate for all issuers in the Canadian market? Please explain why or why not.
b. In your view, what are the benefits or limitations of our approach to determining independence? Please explain.
c. Do you believe that our approach strikes an appropriate balance in terms of:
i. the restrictions it imposes on issuers' boards in exercising their discretion in making independence determinations, and
ii. the certainty it provides boards in making those determinations and the consistency and predictability it provides other stakeholders in evaluating the independence of an issuer's directors or audit committee members?
d. Do you have any other comments regarding our approach?
RESPONSE: We believe the CSA approach to Director independence strikes an appropriate balance of interests. There is no apparent crisis in filling boards with competent people. As boards move towards acceptance of diversity, we fully expect there will be a solid pipeline of competent directors. We would however use this opportunity to encourage CSA members to follow the example of the OSC in establishing a strong Whistleblower program. The U.S. SEC whistle blower program has been very effective at exposing corporate wrongdoing and conflicts-of-interest.

In the U.S., the Sarbanes-Oxley Act requires a company's outside auditors to "attest" to the strength of the company's internal controls and place that attestation in a distinct place in financial reports. All companies above $75-million (U.S.) in market capitalization are subject to the rules. Canadian securities laws do not make companies bring in their auditors to that discussion, allowing management to make its own decision about whether controls were weak. The disclosure occurs in the MD&A, in a location at the company's discretion. It may be time to reconsider the CSA Rule.

Other related issues related to governance are securities lending by investment funds (impacts corporate democracy), dual-class shares, family-controlled firms and dual Chair-CEO functions. These long-standing issues are, in our view, a higher priority than the subject of this consultation.

2. Should we consider making any changes to our approach to determining independence as prescribed in NI 52-110, such as changes to:
a. the definition of independence;
b. the bright line tests for directors and audit committee members; or
c. the exemptions to the requirement that every audit committee member be independent?
Are there other changes we should consider? Please explain.
RESPONSE: We feel the existing definition and bright line tests are doing their job, albeit imperfectly. It could be that some tweaks (e.g. term limits, annual independence certifications) are appropriate but we cannot think of any dramatic changes that are necessary. We would prefer to see regulators err on the side of caution in defining independence.

Independent research has found that there are often exists a difference between the independence displayed by a director as observed and assessed by external assessors and by directors themselves and the regulator-defined independence of that director. Because regulatory independence is normally measured externally using disclosed data, such measurements may not be robust proxies for the actual displayed independence while serving on the board. Independent directors of course can be captured by management in many ways as well documented in the literature. If academics and regulators were to measure the independence displayed and assessed by directors themselves, the relationship between board independence and corporate financial performance might be found to be deeper.

We recommend that the CSA consider consulting with governance experts to validate the regulatory definitions and bright line tests of independence It may not be inappropriate to provide better regulatory guidance or definitions based on the latest independent academic research and evidence.

We also must mention the role of external auditors, compensation consultants, strategy advisors and the like. If these are under the sole control of management, the independence of the board can be unduly influenced by these judiciously selected “experts”. The CSA may want to provide some regulatory guidance as regards the use of and independence of, outside independent advisors.

3. What are the advantages and disadvantages of maintaining our approach to determining independence versus replacing it with an alternative approach? Please explain.
RESPONSE: The main advantage of retaining the current process is that directors understand the rules of the game and existing Director educational courses can continue without major revision. We can think of no investor protection disadvantage to maintaining the status quo.

If the assertions that enforcement will be dramatically increased under the CMRA, this is further rationale for supporting a robust definition of independence rather than watering it down to address claims that it is hard to find independent directors. It would definitely not be in the Public interest to lower standards knowing that stronger more vigorous enforcement is on the way.

We would be happy to address any questions you may have or to meet with you to discuss these and related issues in greater detail. We appreciate the time you are taking to consider our point of view. Do not hesitate to contact us if there are any questions regarding our Comment letter.

Permission is granted for public posting.

Sincerely,
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President, Kenmar Associates
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REFERENCES

The following articles and research papers influenced our thinking in responding to this consultation:

Handbook of Board Governance : A Comprehensive Guide for Public, Private and Not-For-Profit Board Members ,R. Leblanc, Wiley , 2016 - See Chapter 8

Governance Blog » **The Problem with Independent Directors**
http://rleblanc.apps01.yorku.ca/the-problem-with-independent-directors/

12 ideas for better governance: Governance blog
http://rleblanc.apps01.yorku.ca/

What management isn't saying: A potential blind spot for Canadian stock investors - The Globe and Mail
"...These two companies are more the norm than the exception, according to a new study by Robert Pozen, a senior lecturer at Massachusetts Institute of Technology's Sloan School of Management, and Olga Usvyatsky, vice-president of research at Audit Analytics. They found 78 restatements between 2009 and 2016 among Canadian-listed companies with a market capitalization above $75-million. Of those 78 companies, only 18 disclosed a material weakness in its internal controls...."
https://www.theglobeandmail.com/globe-investor/inside-the-market/canada-may-be-due-to-revise-financial-disclosure-regulations/article35612519/

Ties that bind: How business connections affect mutual fund activism
https://poole.ncsu.edu/gradecon/images/pages/Cvijanovic_Paper_How_Business_Connections_Affect_Mutual_Fund_Activism.pdf

Mutual fund Proxy voting record Report: SHARE
https://riacanada.ca/wp-content/uploads/RIA-Proxy-Voting-Survey-20131.pdf

Canadian open-ended Mutual Funds: Bank of Canada
http://www.bankofcanada.ca/wp-content/uploads/2015/06/fsr-june15-ramirez.pdf

Nobody will go to jail for Canada's biggest stock scandal – G&M
The Sino-Forest case raises questions about the robustness of governance practices and the effectiveness of external auditors and independent directors.
https://www.theglobeandmail.com/report-on-business/economy/economic-insight/not-much-sign-of-real-justice-in-the-sino-forest-scandal/article29726671/

CSA STAFF NOTICE 58-306 2010 CORPORATE GOVERNANCE DISCLOSURE COMPLIANCE REVIEW December 2, 2010
" .. Over half of the issuers reviewed were required to make prospective enhancements to their corporate governance disclosure**. We view the level of non-compliance with the disclosure requirements of the Corporate Governance Instrument to be unacceptable** [emphasis added]. Although

significant efforts have been made to comply with the corporate governance disclosure requirements, issuers need to further improve their disclosure…" http://www.osc.gov.on.ca/documents/en/Securities-Category5/csa_20101203_58-306_2010-corp-gov-disclosure.pdf

CSA Staff Notice 52-327 CERTIFICATION COMPLIANCE UPDATE Oct. 15, 2010
"…We selected a sample of eight non-venture issuers that restated and re-filed their 2009 interim or annual financial statements to correct accounting errors. Based on our discussion with the issuers, we concluded that issuers did not always consider if the misstatement in the financial statements related to a material weakness in the issuer's ICFR. As a result, we found deficiencies in the disclosure of material weaknesses, in the conclusions about the effectiveness of ICFR and DC&P and in the disclosure of material changes to ICFR that were made to remediate a material weakness…".
http://www.osc.gov.on.ca/documents/en/Securities-Category5/csa_20101015_52-327-cert-comp-update.pdf

Securities fraud still largely undetected in Canada and the U.K. – CFA Institute study | Economy | Business in Vancouver
"According to the study, there were 3,037 litigated frauds between 2005 and 2011 in the U.S. on the three exchanges analyzed in the study but only 48 in Canada and 49 in the U.K. in the same period of time. "Having such a low rate of fraud in Canada could infer that Canadians are super-ethical," Cumming said sardonically. "But more realistically, more needs to be done in Canada to detect fraud."…"
https://www.biv.com/article/2013/9/securities-fraud-still-largely-undetected-in-canad/

Securities Enforcement Reform in Canada: If Not Now, When?
"..Margaret Franklin, CFA, chair of the Board of Governors of CFA Institute today called for fundamental changes to securities enforcement practices in Canada, including an overhaul of the RCMP's Integrated Enforcement Market Teams (IMET). In a speech to The Canadian Club of Toronto, Franklin cited failures in Canada's enforcement practices while making the case - supported by a series of recommendations - that strong and efficient enforcement of the securities industry should be a priority for government, regulators and investment professionals. Further, Franklin made the case that effective enforcement is essential to restoring the public's trust in our capital markets and the investment profession...." http://www.newswire.ca/news-releases/securities-enforcement-reform-in-canada--if-not-now-when-507453481.html

Penn West to pay out $53 million in accounting scandal | Calgary Herald
"Penn West said some expenses were incorrectly classified as property, plant and equipment costs instead of operating expenses, while others were incorrectly classified as royalties instead of operating expenses. The company later said it had boosted oversight and training of its finance and accounting staff, reassuring investors that controls have been put in place to ensure such errors don't occur again.,," This case also raises questions about the effectiveness of external audit

and audit committees. http://calgaryherald.com/business/energy/settlement-revealed-to-be-53-million-in-penn-west-accounting-scandal

Valeant- Canada's sleaziest corporate scandal | National Observer
https://www.nationalobserver.com/2015/12/14/news/canadas-sleaziest-corporate-scandal

How will it end?: 3 possible outcomes for Home Capital Group: BNN
http://www.bnn.ca/three-ways-the-home-capital-scandal-ends-1.732499

ISSUE BRIEF: VENTURE EXCHANGES AND INVESTOR RETURNS Feb., 2013
A New Look at Reporting Issues, Fraud, and Other Problems by Exchange
https://www.cfainstitute.org/ethics/documents/venture_exchange_issue_brief_final.pdf

Women on Boards: A Competitive Edge
http://www.swc-cfc.gc.ca/initiatives/wldp/wb-ca/booklet-en.html

Gender Diversity and Securities Fraud
Abstract: We formulate theory on the effect of board of director gender diversity on the broad spectrum of securities fraud, and generate three key insights. First, based on ethicality, risk aversion, and diversity, we hypothesize that gender diversity on boards can operate as a significant moderator for the frequency of fraud. Second, we advance that the stock market response to fraud from a more gender-diverse board is significantly less pronounced. Third, we posit that women are more effective in male-dominated industries in reducing both the frequency and severity of fraud. Results of our novel empirical tests, based on data from a large sample of Chinese firms that committed securities fraud, are largely consistent with each of these hypotheses
http://amj.aom.org/content/58/5/1572.abstract

Canada's approach to board diversity needs a rethink - The Globe and Mail
The challenge is to spark the impetus within firms to adopt internal action – the CSA found that only 9 per cent of companies have internal targets for women on their boards, with a mere 2 per cent having targets for women in executive positions. Enforcing quotas for women's representation on boards would leave companies with no option but to examine internal processes and policies and ultimately to implement change. Such a move would not be unprecedented. In fact, several of the largest countries in Europe – France, Germany, Belgium, Iceland, Italy and Norway – have all adopted quota requirements for boards. These countries have recognized that gender disparity in corporate leadership will not be fixed by market forces alone, even with voluntary disclosures.'https://www.theglobeandmail.com/report-on-business/rob-commentary/canadas-approach-to-board-diversity-needs-a-rethink/article34386450/

Meet Kevan Cowan: Ontario Securities Commission

"…The creation of the CMRA presents an historic opportunity for Canada and Canadian capital markets. The CMRA will establish something that has been dreamed about in Canada for a long time: an efficient and effective cooperative capital markets regulator that brings together all of the expertise and strengths of the constituent pieces in a way that is greater than the sum of its parts. There are a lot of opportunities that come from harmonizing regulation in Canada, which is very difficult to do across separate organizations. There are also opportunities around coordinated enforcement which will be good for investors. **Federal criminal and systemic risk jurisdiction will be coming together with provincial securities jurisdiction in a way that allows for much more coordinated enforcement activities, which will help better protect investors** [emphasis added]…." https://www.getsmarteraboutmoney.ca/resources/publications/investor-news/interviews/meet-kevan-cowan/