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Financial and Consumer Services Commission of New Brunswick
Superintendent of Securities, Prince Edward Island
Nova Scotia Securities Commission
Superintendent of Securities, Newfoundland and Labrador
Superintendent of Securities, Yukon Territory
Superintendent of Securities, Northwest Territories
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CSA Consultation Paper 52-404 – Approach to Director and Audit Committee Member Independence

Introduction

This letter is submitted in response to the *Consultation Paper 52-404 – Approach to Director and Audit Committee Member Independence* (**Consultation Paper 52-404**) issued by the Canadian Securities Administrators (the **CSA**) on October 26, 2017. It reflects the views of a working group consisting of issuers having a combined market capitalization of more than $120 billion (the **Working Group**). We thank you for facilitating a broad discussion on the appropriateness of the current Canadian approach to determining director or audit committee member independence and for affording us an opportunity to comment on this important matter.

General comments

Director independence is considered a fundamental corporate governance principle and a “must have” governance tool. It has been a major preoccupation of governance scholars for the last decades. The importance of independence is grounded in the belief that independent directors are more effective in monitoring

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management conduct than inside directors. Professor Langevoort of Georgetown University defines director independence as "a subjective concept that connotes a willingness to bring a high degree of rigor and skeptical objectivity to the evaluation of company management and its plans and proposals."[1]

The exercise of independent judgment contributes to the overall effectiveness of the board. However, some argue that the faith in independent directors has achieved "an almost cult-like status as a magic cure for a variety of corporate governance ills."[2] Although corporate governance scholars agree that director independence is beneficial, they often differ over what exactly constitutes independence in practice.[3]

Members of the Working Group agree that director independence is an important feature of modern corporate law. However, they believe issuers should have greater freedom to tailor their board structure to their particular reality, as they do in other jurisdictions such as the U.K., Australia and Sweden.

National Instrument 52-110 (**NI 52-110**) currently includes a subjective definition of independence but defines certain relationships as material.[4] These relationships are set out as bright line tests, which have the effect of automatically precluding some individuals from being considered independent, regardless of any determination of independence made by the board.

Members of the Working Group believe that the check-the-box approach found in sections 1.4 and 1.5 of NI 52-110 has precluded individuals with the requisite expertise and sound judgment from being able to serve as board or audit committee members. They are of the view that the presumptions of non-independence currently set forth in NI 52-110 are overly-restrictive and do not let the board exercise its judgment, especially in the event that one of the bright line tests has been met but some circumstances warrant a different determination.

Accordingly, members of the Working Group argue that the definition of independence should be modified to provide greater flexibility, while maintaining proper shareholder protection. They are of the view that the bright line tests currently set forth in NI 52-110 should be turned into indicative criteria to leave more flexibility to the board in its determination of independence. They believe a principles-based approach is more in line with the CSA's traditional approach on corporate governance and acknowledges that the board is best positioned to make appropriate independence assessments. In other words, a case-by-case approach is preferable to the current one-size-fits-all regime.

In its factual and contextual analysis, a board should ensure that a director is independent from management and has no relationship which could reasonably be expected to interfere with his independent judgment. However, this analysis should be done without reference to any presumptions as the ones currently set forth in NI 52-110.

A note on controlled businesses

An individual who is, or has been within the last three years, an executive officer or an employee of the issuer's parent, is automatically considered as non-independent pursuant to sections 1.4 and 1.5 of NI 52-110 and generally prevented to sit on its audit committee.[5] Controlled issuers, including family-controlled issuers, are also penalized when they appoint such executive officers and employees on other committees of the board, as National Policy 58-201 (**NP 58-201**) recommends that the board appoint a nominating committee and a compensation committee composed entirely of independent directors.[6] This is especially true given that the

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[1] Donald C. Langevoort, "The Human Nature of Corporate Boards : Law, Norms, and the Unintended Consequences of Independence and Accountability" 89 Geo. L. J. 797, 798 (2001).
[2] Harald Baum, "The Rise of the Independent Director: A Historical and Comparative Perspective" Max Planck Institute for Comparative and International Private Law, Research Paper Series, No. 16/20, p. 3.
[3] Beyond "Independent" Directors: A Functional Approach to Board Independence. (2006). Harvard Law Review, 119(5), 1553-1575. Retrieved from http://www.jstor.org/stable/4093581
[4] See sections 1.4 and 1.5 of NI 52-110. Section 1.5 of NI 52-110 is applicable to audit committee members only.
[5] See sections 1.4 (3) and (8), 1.5(1)(b) and 3.1 and 3.3 of NI 52-110. Certain exemptions exist for employees of the controlling shareholder but they exclude executive officers and must be disclosed in the circular of the issuer pursuant to section 3.3 of NI 52-110 and item 5 of NI 52-110F1.
[6] See sections 3.10 and 3.15 of NP 58-201.

voluntary guidelines provided in NP 58-201 standards have been adopted by certain governance stakeholders and governance ranking organizations.

The Working Group is of the view that the CSA's current approach to independence does not properly address the realities of Canadian controlled companies and fails to acknowledge the value of related directors who are otherwise independent from the issuer's management. An executive officer of a controlling shareholder should not automatically be deemed to be non-independent for purposes of the board of directors of the controlled issuer. Some institutional shareholders, who have tailored their proxy voting guidelines to the realities of controlled companies, now specifically acknowledge the necessity to provide more flexibility in that regard.[7]

For those who might be concerned that the presence of executive officers of the controlling shareholder on the board committees of the controlled issuer might impede independent practices and lead to conflicts of interests, the Working Group points out to various alternatives to manage potential conflicts between the interests of the controlling shareholder and those of the issuer. Such alternatives include the creation of a committee formed exclusively of directors unrelated to the controlling shareholder, having the responsibility for identifying and managing potential conflicts.[8] Other methods, such as regularly scheduled in camera meetings and the use of independent advisors, may also be used to foster independence and manage conflicts.

Conclusion

Members of the Working Group believe that the exercise of independent judgment is essential to the effectiveness of the Board and its committees. However, they are of the view that the current approach is overly restrictive and not appropriate for all Canadian issuers. They recommend a more flexible approach in which the board makes independence determinations on a case-by-case basis. As more fully explained above, members of the Working Group believe bright line tests should be removed and replaced with some guidance to assist boards in their analysis, as it is the case in other jurisdictions such as in the U.K., Australia and Sweden.

Yours very truly,

(signed) Norton Rose Fulbright Canada LLP

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[7] See, for instance, Canadian Coalition for Good Governance's (CCGG) publication entitled *Governance Differences for Equity Controlled Corporations*, online: https://www.ccgg.ca/site/ccgg/assets/pdf/Gov_Differences_of_Equity_Controlled_Corps_FINAL_Formatted.pdf. Reference is made more specifically to Guideline #4: At least one member of each board committee of a Controlled Corporation should be an Independent Director. In addition, a majority of the members of all board committees (with the exception of the compensation committee) should be either Independent Directors or Related Directors who are independent of management of the Controlled Corporation.

[8] The Working Group refers more specifically to section 122 of the *Canada Business Corporations Act* which provides that every director of a corporation, in exercising its powers and discharging its duties, shall act honestly and in good faith with a view to the best interests of the corporation (and not just a single shareholder or group) and the regime of minority shareholders protection provided for by Canadian securities laws, such as Multilateral Instrument 61-101.