



Me Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, Tour de la Bourse
Montréal, Québec
H4Z 1G3
Fax : 514-864-6381
e-mail: consultation-en-cours@lautorite.qc.ca

The Secretary
Ontario Securities Commission
20 Queen Street West
22nd Floor
Toronto, Ontario
M5H 3S8
Fax: 416-593-2318
e-mail: comments@osc.gov.on.ca

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Re: Request for Comment - CSA Consultation Paper 52-404 *Approach to Director and Audit Committee Member Independence*

Sirs/Mesdames,

Thank you for the opportunity to provide comments on CSA Consultation Paper 52-404 regarding the regulatory approach to director and audit committee member independence as set out in National Instrument 52-110 Audit Committees (the "Audit Committee Rule").

Institutional Shareholder Services Inc. ("ISS") is a leading provider of corporate governance solutions to the global financial community, including corporate governance analyses and voting recommendations for institutional investors (also referred to as proxy advisory services). More than 1,700 global clients rely on ISS' expertise in providing background research and voting recommendations to help them make more informed voting decisions. In Canada, ISS operates through its wholly-owned subsidiary, Institutional Shareholder Services Canada Corporation, which is based in Toronto.

Our comments below reflect our views in our capacity as a proxy advisor and thought leader in the area of corporate governance, and not necessarily those of our clients.

ISS' corporate governance research and voting recommendations are policy based. ISS' voting policies are the result of an inclusive and transparent annual update process that includes consultative review and trend analysis of specific corporate governance practices. The most effective application of ISS' voting policies depends upon the complete and detailed public disclosures made by reporting issuers. A key element of policy application with respect to evaluating director nominees relies on the ability to determine, based on available, disclosed information, the independence of said director nominees. Accordingly, the requirements contained in National Instrument 52-110 are critical to this

determination, not only for purposes of audit committee membership, but also as it relates to independence determinations under other corporate governance standards and contexts.

Our comments will generally follow the order of the Consultation Questions in section 6.

Question 1

Appropriateness of the Current Approach:

The introduction of the current corporate governance regime in Canada is generally viewed as a positive development in the evolution of corporate governance best practices. As indicated in Section 3.1 of the Consultation Paper (Relevance of Independence), the definition of independence is a central component of the Canadian corporate governance regime.

ISS concurs that the current approach is, for the most part, appropriate for all issuers in the Canadian market and provides a reasonable carve-out for venture issuers. We would agree that there is a need for significant alignment with the concepts of independence adopted by U.S. exchanges due to the large number of companies inter-listed in Canada and the U.S. Further, controlled companies should be subject to no less rigorous of an independence requirement than all other reporting issuers, due to the potential for conflicts of interest. For example, such conflicts may arise where control is held by means of a dual class capital structure with unequal voting rights, as the interests of the controlling shareholder(s) may not be aligned with those of minority or subordinate class shareholders. Where a company is controlled, minority shareholders must have confidence that their interests and shareholder rights are protected under any scenario or circumstance given the considerable power wielded by the controlling shareholder(s), including the power to ensure the passage of ordinary resolutions at shareholders' meetings. The ability to elect independent directors who are charged with protecting the interests of all shareholders is particularly important in a controlled company scenario.

Benefits of the Current Approach:

The current approach for determining director independence provides a high degree of certainty and ease of comparability for institutional investors who, (i) need to formulate and apply their voting policies in an informed manner across their portfolio companies and on behalf of their clients, and (ii) have expressed the view, generally, that non-employee directors should not provide any services for payment from a company other than in the context of board fees for service on the board of directors, nor have any ties to the company other than shareholdings acquired through market purchases and/or received in lieu of the cash fees paid for board or committee service. The current Audit Committee Rule supports this view.

As well, the current approach containing bright line tests provides a high degree of certainty for smaller reporting issuers who may not have the benefit of extensive legal resources to assist in determining director independence under a more flexible approach which provides less clarity. Requiring smaller issuers to comply with the same rigor of independence assessment also provides consistency as these issuers grow and graduate to Index status.

Limitations of the Current Approach:

N/A

Considerations for Clarifying the Definition of Independence (Regulatory Guidance and/or Regulatory Amendment)

Independence Status of the Chair of the Board

As currently defined in the Audit Committee Rule, the term "Executive Officer" is defined to include the chair of the entity. Section 1.4 (3)(a) indicates that an individual who is, or has been within the last three years, an employee or executive officer of the issuer is deemed to have a material relationship with the issuer and is therefore deemed to be not independent. This creates a potential disconnect with respect to the treatment of a Board chairperson who has no current or prior affiliation with the company and could result in that individual being characterized as non-independent when, in fact, the presence of an independent chair running the Board of Directors is viewed as a corporate governance best practice. We have seen this potential confusion in practice, in particular at smaller reporting issuers where the non-employee chair of the board is sometimes categorized as non-independent by the company in its information circular without further explanation even though in reality the individual has no other apparent material ties to the company and should be classified as independent.

Definition of Affiliate

"Affiliate" is currently defined in terms of "control", where "control" is defined as the direct or indirect power to direct or cause the direction of the management and policies of a person or company, whether through ownership of voting securities or otherwise. "Affiliate" is further clarified in section 1.3 (4), to not include an individual who owns, directly or indirectly, ten percent or less of any class of voting securities of the issuer; and is not an executive officer of the issuer. The current wording of this definition seems to have created confusion among issuers and others based on the inconsistencies in director independence determinations respecting non-employee directors. Certain company boards deem such a director holding, directly or indirectly, ten percent of the voting shares to be independent, whereas other company boards deem a director holding, directly or indirectly, ten percent of the voting shares to be non-independent, without further explanation even though these individuals have no other apparent material ties to the company.

Professional Relationships/Commercial Relationships/Transactional Relationships/Related Party Transactions

One difference between the U.S. exchange rules regarding director independence and the Canadian Audit Committee Rule, is the treatment of related party transactions between directors and reporting issuers. The NYSE and NASDAQ independence requirements include bright line tests that result in independence disqualification where the director is a current employee (as defined), or an immediate family member is a current executive officer, of an organization that has made to, or received from, the company payment for property or services in an amount which, in any of the last three fiscal years, exceeds the respective exchange's enumerated materiality threshold. The Canadian Audit Committee Rule section 1.5 (1) specifies that an individual who accepts any consulting, advisory or other compensatory fee from the issuer or its subsidiary entity is considered to have a material relationship with the issuer. Section 1.5 (2) elaborates further than any consulting, advisory or other compensatory fee includes: accounting, consulting, legal, investment banking or financial advisory services, but does not address transactional relationships which may generally be disclosed as related party transactions which would impact independence. Nor does the Audit Committee Rule establish a materiality threshold for payments received by, or paid to, a director or any entity for which the director is a principal, partner, direct or indirect owner or controlling entity of, executive or employee. The Audit Committee Rule, which sets out the definition of independence, also does not address the materiality of continuous professional service or transactional relationships between the company and a director or any entity for which the director is a principal, partner, direct or indirect owner or controlling entity of, executive or employee, receiving payment for such services. This lack of clarity and guidance has been raised by some institutional investors in discussions with ISS regarding related party transactions since they believe that a director who benefits directly or indirectly through an entity from payments on an ongoing basis, over a period of several years or intermittently over a period of several years, should be deemed to

have a material relationship with the company and be deemed non-independent. Several investors have expressed their views that a specified materiality threshold for this purpose seems warranted. There are currently several companies listed on the TSX with directors who have and have had, directly or indirectly, professional services or transactional relationships with the company for payment, over a period of years, some of whom are deemed by the company to be independent. Some of ISS' institutional investor clients have raised this as a concern and asked ISS to develop a voting policy to address their concerns. However, this may be a concern more appropriately dealt with through regulatory guidance and/or amendment to the Audit Committee Rule, which defines independence, for greater certainty and consistency of application.

Management Service Entities

One other area lacking clarification under the current approach, is the application of the Audit Committee Rule independence definition to externally managed issuers. ISS has tracked a number of Canadian reporting issuers who substantially outsource the responsibilities of senior management to external third-party entities who provide executive officers and other management level employees and are also responsible for executive compensation decisions. In most cases, the third-party provider has one or more director representatives on the issuer's board of directors, who are principles, partners, owners or controlling shareholders, executives or employees of the third-party service provider and are deemed independent. This raises concerns regarding the ability of investors to determine director independence where disclosure is lacking or non-existent with respect to private third-party management service entities and their principals.

Question 3

The current approach to determining independence provides a large degree of flexibility, which creates certain inconsistencies and possible confusion in its application, without further regulatory guidance.

In our view, a more principles based approach is not warranted to accommodate controlling shareholders who, in our view, should be subject to substantial rigor in determining director independence given the potential for conflicts of interest and the significant power they have to influence board decisions and voting outcomes even where their interests may not be aligned with those of minority shareholders.

Concluding Remarks

As a first step, formal guidance related to the application of the Audit Committee Rule definition of independence to corporate governance standards, particularly with respect to those areas highlighted above may improve the consistency of application of the rule to director independence generally, in addition to the requirements governing audit committee service. Additional guidance may, in our opinion, reduce those instances where no explanation is given for non-independence determinations even though no material tie or relationship to the company is disclosed.

While the current amount of flexibility and discretion that is already provided may be supportable, further alignment of the Audit Committee Rule which governs the definition of independence in this market, with the more defined approach set out by the U.S. exchanges may also be warranted with respect to directors providing services for payment or those involved in related party transactions. The establishment of materiality thresholds and a three-year reporting period within which directors involved in professional service or transactional relationships with the company would be deemed non-independent under the Audit Committee Rule, would remove much of the concerns raised by a number of ISS' institutional clients.



A more principles based and less defined approach to determining director independence may, in our opinion, lead to further concerns regarding inconsistency of application and the inability of investors to have reasonable certainty that their board representatives are providing independent oversight in the best interests of all shareholders.

Respectfully,

Debra L. Sisti,
Executive Director,
Head of Canadian Research,
ISS Canada
debra.sisti@issgovernance.com

Anjeet Bening,
Associate Director,
Deputy Head of Canadian Research,
ISS Canada
anjeet.bening@issgovernance.com