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Response to CSA Consultation Paper 52-404 *Approach to Director and Audit Committee Member Independence* (the "Consultation Paper")

We are pleased to provide our response to the Consultation Paper referred to above. Hansell LLP provides expert, independent, legal and governance counsel to boards, shareholders and management teams in special situations and in respect of their governance practices generally. We are regularly retained to advise boards in respect of their board composition and succession planning, including determining whether a proposed director or audit committee member is independent under the rules adopted by the Canadian Securities Administrators (the "CSA"). We also strive to be thought leaders in key areas of governance that are of interest to directors and shareholders.

We are providing our comments on the Consultation Paper based on our experience and discussions with Canadian directors and shareholder representatives. We also draw upon our expertise and understanding of corporate governance practices from a wide range of issuers, including controlled companies and venture issuers.

Our letter is divided into three parts. First, we provide general comments on the issues raised in the Consultation Paper and the current approach to determining director and audit committee member independence. Next, we comment on the benefits of the current approach. Finally, we comment on the limitations of the current approach and offer suggestions for improvement. As we explain in this letter, we believe the current approach generally strikes an appropriate balance for the Canadian capital markets. In some cases, however, we believe the parameters of some of the bright-line tests should be reviewed in the context of issues raised by controlled companies.

The current approach to board and audit committee member independence was introduced in 2004 and was largely influenced by the requirements by the New York Stock Exchange ("NYSE") and the Nasdaq Stock Market ("Nasdaq") for their listed companies, and the additional requirements mandated by the Securities and Exchange Commission, in response to several U.S. financial reporting scandals. The approach was also informed by comments from cross listed companies and other market participants that Canadian requirements should be substantially similar to U.S. requirements. These considerations were predicated on the size of the Canadian market (relative to the U.S. market) and the fact that companies seek to attract capital from investors located in the U.S. and internationally.

Since 2004, board composition practices have evolved considerably in response to increased scrutiny from regulators and institutional investors, among others. Institutional investors have established their own set of criteria for assessing director independence. Typically, the approach taken by institutional investors goes beyond the standards set by the CSA and is applied on a case-by-case basis. In doing so, institutional investors assess the "independent mindedness" of directors by looking, for example, at the board's processes, the individual and collective decisions taken by directors, and the company's performance.[1]

In addition to scrutinizing individual directors' qualifications and independence, institutional investors assess whether the board reflects a diverse mix of skills, experience and diversity, and whether the board has an effective succession plan in place. In doing so, institutional investors engage with the companies and endorse more robust disclosure in the issuer's proxy circular about the process followed by the board and the nominating committee for selecting new director candidates and board self-assessments.

Moreover, institutional investors have regard to the proxy voting guidelines and recommendations of proxy advisors. Institutional Shareholder Services Inc. ("ISS") and Glass Lewis & Co., LLC ("Glass Lewis") have each adopted their own definitions of independence which, in some instances, go beyond the CSA's definition. For example, ISS' definition of director independence includes a five-year cooling-off period (as opposed to three-years under

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[1] See, for example, Ontario Teachers' Pension Plan, 2018 Corporate Governance Principles & Proxy Voting Guidelines, at p. 13.

the bright-line tests) for a former CEO of the issuer and captures an individual who is an immediate family member of the former CEO.[2] Glass Lewis' definition of independence also includes a five-year cooling-off period for any individual who was employed by the issuer.[3]

Despite the increased scrutiny from investors and their advisors on board composition practices, it continues to be appropriate for securities regulators to play a role in defining director and audit committee member independence. Regulatory standards set minimum criteria that boards of all issuers regardless of size and resources available must follow. Issuers raise capital from both retail and institutional investors. Venture issuers represent 69% of the total number of entities listed on the Toronto Stock Exchange ("TSX") and the TSX Venture Exchange ("TSXV") combined. Venture issuers generally receive less attention from analysts, institutional investors and other commenters, which increases the need for consistent and transparent regulation.

The context that informs the Consultation Paper follows prior initiatives from the CSA proposing a principles-based definition of independence,[4] in part to respond to concerns of some stakeholders that remain relevant today. However, we are concerned that removing the bright-line tests would cause unnecessary disruption. Among other things, significant time and testing would be required before a consistent approach to interpreting the guidelines could emerge. The better approach, in our view, would be to preserve the current regime and target for reform, specific aspects of the current regime that have proven to be problematic. We offer our suggestions to address these issues in Part 3 of this letter.

1. Benefits of the Current Approach

The current approach for determining director and audit committee member independence has been in place for over a decade now. It is well understood and provides generally accepted baseline requirements for all Canadian issuers.

As stated in the Consultation Paper the current approach is aligned with the U.S. requirements, which provides consistency and predictability for companies cross listed in Canada and the U.S. Uniformity, to extent possible, between the Canadian and U.S. requirements also provides investors with consistent standards.

As shown in the chart below, one-third of TSX-listed companies are cross listed today.[5] With few exceptions, these issuers qualify as foreign private issuers for the purposes of U.S. disclosure requirements.

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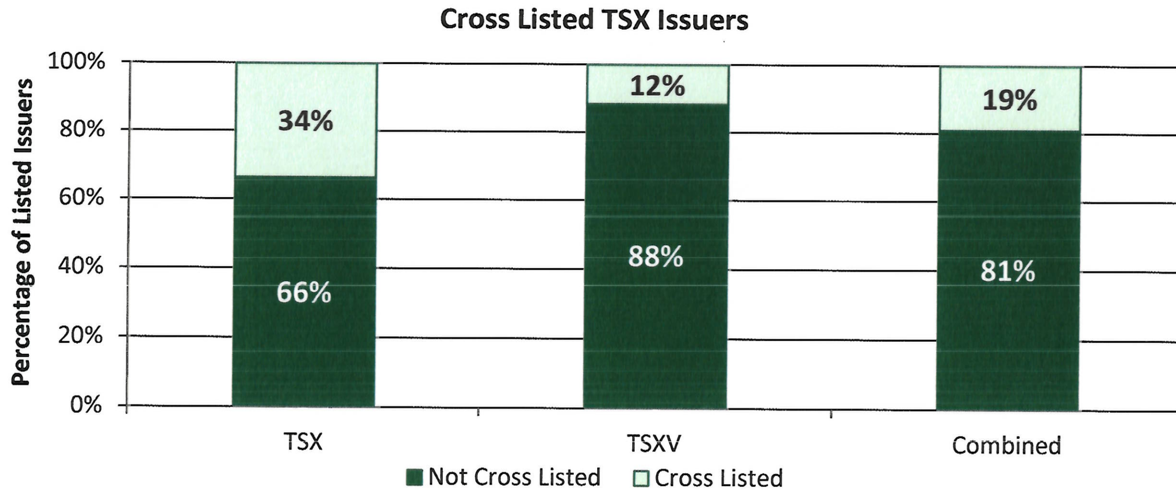
2 Institutional Shareholder Services, Inc., 2018 Americas Proxy Voting Guidelines Updates (published November 16, 2017).

3 Glass Lewis, 2018 Guidelines: An Overview of the Glass Lewis Approach to Proxy Advice (Canada).

4 Canadian Securities Administrators, Request for Comment – Proposed Repeal and Replacement of NP 58-201 *Corporate Governance Guidelines*, NI 58-101 *Disclosure of Corporate Governance Practices*, and NI 52-110 *Audit Committees* and Companion Policy 52-110CP *Audit Committees* (December 19, 2008).

5 TSX Market Intelligence Group Report - November 2017. TSX figures exclude companies listed in the "Closed-End Funds" and "ETP" sectors.



2. Limitations of the Current Approach

We have identified three areas where we believe the bright-line tests should be reviewed to provide more flexibility.

(a) Relationships with the Issuer's Internal or External Auditor

The bright-line test in paragraph 1.4(3)(d) of NI 52-110 is overly broad and not aligned with the comparable standards adopted by NYSE and Nasdaq. More specifically, the bright-line test includes a director whose spouse, child or stepchild who shares a home with the director, is employed with the issuer's internal or external auditor and participates in the firm's audit, assurance or tax compliance practice. Given the size and the international network of the larger accounting firms, this criteria captures individuals who work in the firm's offices located in another city or country from where the issuer's audit is carried out, and who are not otherwise involved in the issuer's audit. The words "shares a home" with the director may also produce odd results from a policy perspective. For example, a university student living at home and working for an accounting firm during the summer would throw his or her parent offside the bright-line test (and therefore be deemed to be non-independent for purposes of the definition in section 1.4 of NI 52-110) if that accounting firm happens to be the issuer's external auditor. If the university student instead continues to live in his or her dorm room over the summer, the problem does not arise. It would be more practical for the CSA to adopt the approach used in the listing requirements of NYSE and Nasdaq. Each restricts the bright-line test to an immediate family member *who personally works on the listed company's audit* [Emphasis added].

We also note that, since the current approach was introduced, the Canadian Public Accountability Board ("CPAB") was established to promote the integrity of financial reporting. According to its mandate, CPAB annually inspects the larger audit firms to enhance overall audit quality. CPAB's inspection criteria includes key functions related to audit quality, including the independence of individual engagement teams.

(b) Additional Independence Requirements for the Audit Committee

Audit committee members are subject to a higher standard of independence. A director will be deemed to be non-independent for purposes of the audit committee, if the director accepts *any* direct or indirect compensation from the company (apart from compensation as a director), or the director is an "affiliated entity" to the issuer or any of its subsidiary entities (for example, a representative of the controlling shareholder).[6]

In our view, it is appropriate to reconsider whether the additional bright line tests for audit committee members continue to be relevant. In our experience, the additional bright line tests create anomalous results that negatively impact the board's flexibility to populate its audit committee. For example, directors are ineligible to serve on the audit committee where an immediate family member (such as a son or daughter) receives an insignificant amount of compensation paid by the issuer in connection with an immaterial employment relationship. From a policy perspective, it is unclear how these immaterial relationships are likely to interfere with the exercise of the director's independent judgment as a member of the audit committee, but not interfere in respect of the director's other responsibilities on the board. While we note that the CSA has granted discretionary relief in extreme cases,[7] the need to seek relief adds unnecessary costs and uncertainty to issuers.

One solution would be to amend the definition of "indirect acceptance" of compensation by the issuer to capture only an immediate family member who is employed on a full-time basis in a senior capacity with the issuer, including performing a policy-making function in respect of the issuer.

(c) Reconcile the Governance Differences of Controlled Corporations

Many Canadian issuers are controlled by a family, a parent company or a group of shareholders who together control a sufficient number of common shares to be able to elect of the board of directors or to direct the management or policies of the issuer. For greater context, the chart below identifies the number of companies on the S&P/TSX Composite Index with one or more significant shareholders.[8]

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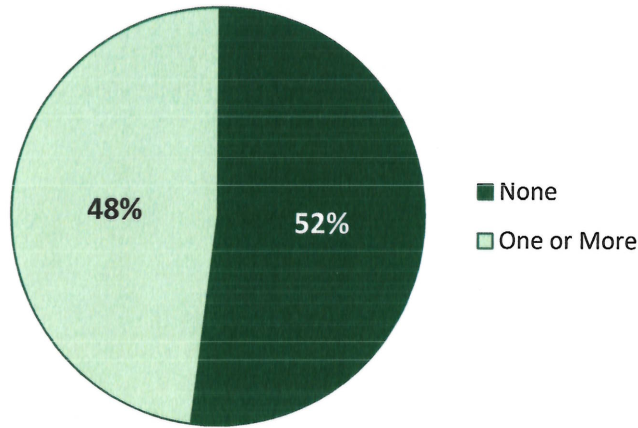
6 Section 1.5 of NI 52-110.

7 See, for example, *Re PrairieSky Royalty Ltd.*, 2016 ABASC 128 (CanLII); *Canadian Tire Corporation, Limited (Re)*, 2012 CanLII 19014 (ON SEC); and *Progress Energy Resources Corp.*, 2011 ABASC 135 (CanLII)

8 Source: Clarkson Centre for Board Effectiveness. Companies with dual class share structures have been excluded. "Significant Shareholder" is defined as a shareholder or group of shareholders acting in concert holding 10% or more of outstanding voting rights. S&P/TSX Composite Index as of October 2017.



Research also suggests that family-controlled corporations generally outperform their peers over the long term. A 2015 study by National Bank of Canada ("NBC") showed that 30 public companies included in the NBC Canadian Family Business Index outperformed the S&P/TSX Composite Index by 120% over a 10-year period.[9] The report also highlighted factors that explain why family-controlled companies have outperformed, including the ability to resist short-term market pressures by taking a longer-term view. For example, the report found that companies in the NBC Canadian Family Business Index have a more conservative capital structure, including less debt and higher earnings quality than the S&P/TSX Composite Index.

When the CSA adopted the current approach in 2005, it committed to review the approach to address the concerns raised by some market participants, including the impact of the current approach on controlled companies. The deeming provision that precludes a controlling shareholder who is not a member of the issuer's management from sitting on the audit committee is a continuing concern for controlling shareholders. Specifically, NI 52-110 deems an executive officer or employee of the issuer's "parent" corporation to have a material relationship with the issuer (and therefore not be independent).[10] Moreover, the controlled company exemption in section 3.3 does not fully address the concerns of controlling shareholders since its application is limited solely to a director of the affiliated entity.

In our view, the CSA should review the current deeming provisions to address the concerns raised by controlled companies. The exemption in section 3.3 should be broadened to permit the controlling shareholder and its representatives, who are otherwise independent of the issuer and management, to participate on the audit committee of the controlled subsidiary. This amendment

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9 National Bank of Canada, *The Family Advantage: The Sustainable Outperformance of Canadian Family-Controlled Public Companies* (October 2015), online: https://www.bnc.ca/content/dam/bnc/en/about-us/news/news-room/press-releases/study-the-family-advantage-national-bank.pdf

10 Subsection 1.4(8) of NI 52-110 provides that "[f]or the purpose of section 1.4, an issuer includes a subsidiary entity of the issuer and a parent of the issuer".

would be consistent with the CSA's statement in the Companion Policy to NI 52-110 that shareholding alone may not interfere with the exercise of a director's independent judgment.

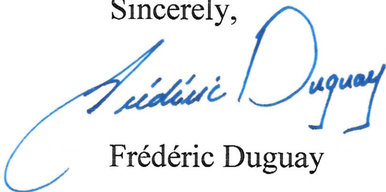
A control person or significant shareholder should not be disqualified automatically from the audit committee. The participation of the controlling shareholder on the board's key committees promotes rigour and a strong ownership mindset that benefits minority shareholders. Controlling shareholders who are independent of management also have an interest in ensuring strong oversight of the issuer's financial reporting function.

The governance concerns that are typically associated with significant or controlling shareholders are related to conflict of interest and self-dealing, as opposed to independence. These concerns are largely addressed under corporate law and securities regulatory requirements requiring or encouraging the use of a special committee of independent directors to review related party transactions and other conflicted decisions.[11] Moreover, under the fiduciary principles of corporate law, courts will look to whether the director is "disinterested", which is a broader determination than the definition of independence under securities regulation. Under this broader analysis, personal relationships between directors and members of management or the controlling shareholder will be subjected to increased scrutiny.

More specific concerns related to the influence of the controlling shareholder on the audit committee can be appropriately managed through regular *in camera* sessions following each meeting without the presence of the controlling shareholder. To further promote the audit committee's independence, the composition requirements for controlled companies should require every member to be independent of management and a majority, including the chair of the audit committee, to be unrelated to an affiliated entity or significant shareholder of the issuer.

We hope these comments are helpful. Please feel free to contract Carol Hansell chansell@hanselladvisory.com or Frédéric Duguay fduguay@hanselladvisory.com to discuss any aspects of our comments with you in greater detail.

Sincerely,



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[11] Sections 6.1(6) and (7) of Companion Policy 61-101CP *Protection of Minority Security Holders in Special Transactions.*