CSA/ACVM Canadian Securities Administrators Autorités canadiennes en valeurs mobilières

CSA Staff Notice 52-330
Update on CSA Consultation Paper 52-404 Approach to Director and Audit Committee Member Independence

July 26, 2018

Introduction

On October 26, 2017, the Canadian Securities Administrators (**CSA** or **we**) published for comment CSA Consultation Paper 52-404 *Approach to Director and Audit Committee Member Independence* (the **Consultation Paper**).

The purpose of the Consultation Paper was to facilitate a broad discussion on the appropriateness of our current approach to determining director and audit committee member independence. The Consultation Paper was structured as follows:

- key historical developments relating to our corporate governance regime;
- approach to determining independence in Canada;
- comparative overview of the approaches to determining independence in Canada and in other jurisdictions; and
- discussion on the benefits and limitations of the Canadian approach.

In addition to any general feedback, we also invited comments on specific questions.

This notice provides an update on the status of the consultation.

Stakeholder feedback received

The comment period ended on January 25, 2018. We received 27 comment letters from various stakeholders, including:

- investors;
- investor advocacy groups;
- issuers;
- national organisations representing corporate directors and other professionals;
- law firms;
- other stakeholders.

We wish to thank all commenters for contributing to the consultation. A summary of comments presenting the various views expressed in response to the Consultation Paper is attached as Appendix A.

We have reviewed and discussed the comments received, and we note the following:

- Most commenters expressed general support for our current approach. These commenters indicated that our approach is appropriate for all issuers in the Canadian market and that it provides certainty, consistency and predictability in determining independence.

- Most commenters prefer maintaining our current approach on the basis that it is well-understood by market participants and that it is generally aligned with the approach applicable in the United States.
- Some commenters proposed enhancements to our current approach (e.g., additional guidance on the application of the approach).
- A few commenters suggested reassessing certain bright line tests (e.g., thresholds or parameters) to confirm their appropriateness.
- Certain commenters expressed that they were generally not supportive of our current approach. These commenters suggested that the current approach is "one-size-fits-all" and not appropriate for all issuers, creating inflexibility and overly-restrictive parameters in determining independence.
- Certain commenters submitted that our current approach does not recognize the particular circumstances of certain issuers and that it eliminates valid candidates from serving as independent directors or audit committee members.
- Certain commenters proposed replacing the bright line tests with a more principles-based approach providing greater discretion to boards of directors in determining independence. These commenters suggest that independence is a question of fact that should be determined by the board on a case-by-case basis.

Overall, most commenters expressed general support for our current approach and there were no common trends or views in respect of suggested changes.

Determination

Considering the realities of the Canadian market and the comments received, the CSA have concluded that it is appropriate to maintain our current approach to determining director and audit committee member independence.

We recognize that our current approach has benefits and limitations. Upon review, we are satisfied that it strikes an appropriate balance between affording sufficient discretion to the board of directors to determine whether an individual could reasonably be expected to exercise independent judgement, and providing prescriptive elements that preclude an individual from being considered independent in certain circumstances. The certainty, consistency and predictability of maintaining our approach assists boards in making independence determinations and enables stakeholders to evaluate the independence of directors and audit committee members.

Our current approach has been in place since 2004 and we note that stakeholders understand and have adapted accordingly. Making changes to our current approach or replacing it with an alternative approach could result in additional costs for issuers and efforts for investors to adapt to such changes. We are of the view that, in this case, any potential benefits of a change to our approach are outweighed by the potential negative impact of implementing such a change.

Questions

Please refer your questions to any of the following:

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APPENDIX A

SUMMARY OF COMMENTS

GENERAL COMMENTS
Generally supportive of our current approach
17 commenters expressed general support for our current approach. These commenters noted a number of benefits, including that our approach: • is appropriate for all issuers in the Canadian market; • provides certainty, consistency and/or predictability in determining independence; • sets clear, minimum requirements that preclude an individual from being considered independent or serving on an audit committee; • strikes an appropriate balance in terms of discretion and prescriptive elements; • does not unduly limit the pool of qualified candidates who can serve as independent directors or audit committee members, and issuers can expand the pool of qualified candidates by considering more women; • is understood and has been incorporated in board and committee processes; • is useful for investors in making proxy voting decisions; and • is in line with the approach to determining independence in the United States.
Generally not supportive of our current approach
10 commenters did not generally support our current approach. These commenters noted a number of limitations, including that our approach: • is not appropriate for all issuers in the Canadian market, particularly controlled companies; • has created inflexibility and overly restrictive parameters in determining independence; • eliminates valid candidates from serving as independent directors or audit committee members; • does not recognize the need for directors to have company-specific knowledge and the requisite skills and experience; • has resulted in negative perceptions, lower governance scores and adverse voting recommendations for holding companies and group companies; • has resulted in controlled issuers, including family-controlled issuers, being penalized when they appoint an executive officer or employee of the issuer's parent on other committees of the board, as National Policy 58-201 *Corporate Governance Guidelines* (**NP 58-201**) recommends that the committees be composed entirely of independent directors; • does not recognize the fact that any concerns which may exist in a controlled company relating to conflicts of interest or self-dealing can be resolved directly through a committee of directors who are independent of the controlling shareholder;

- does not recognize the legitimacy of significant shareholders to play an active role in governance, including on the audit committee;
- does not recognize the unique and inherent advantages of family control with respect to long-term sustainable profitability;
- does not recognize the significant presence of family-controlled companies in Canada's economy;
- unnecessarily uses director independence rules to provide additional protection to minority shareholders, given that pursuant to:
    - common law and corporate statutes, directors are subject to a fiduciary duty to the corporation, and not to any single shareholder or shareholder group; and
    - Multilateral Instrument 61-101 *Protection Of Minority Security Holders In Special Transactions*, minority shareholders are already provided with robust protections; and
- is not in line with the CSA's traditional approach on corporate governance which provides greater flexibility to the board.

PROPOSED CHANGES TO OUR CURRENT APPROACH

4 commenters expressed support for our current approach without proposing any changes.

While generally supportive of our current approach, 13 commenters have proposed certain changes, including:

- removing the venture issuer exceptions in our current regime;
- providing additional guidance related to the application of our current approach including:
    - clarifying that the principle underlying the independence test is the board's obligation to determine whether any relationships exist that could interfere with the exercise of independent judgement without relying solely on the enumerated list of those individuals that are not independent; and
    - providing examples of additional relationships for boards to consider when fulfilling the aforementioned principle;
- adding guidance addressing the impact of board tenure on independence;
- adopting a best practices model, similar to the comply or explain model, in addition to our current approach to take into account the particular circumstances of an issuer;
- reviewing whether our current approach continues to be appropriate for controlled companies including:
    - if the exemption in section 3.3 of National Instrument 52-110 *Audit Committees* (**NI 52-110**) should be broadened to permit the controlling shareholder and its representative, who are otherwise independent of the issuer and management, to participate on the audit committee of the controlled subsidiary;
    - that 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; and
    - deleting the "deeming rule" that provides that officers and employees of affiliates (other than subsidiaries of the issuer), notably a controlling shareholder

are deemed to be not independent. However, in specific contrast, other commenters also generally supportive of our current approach expressly stated that our current approach continues to be appropriate for controlled companies, that the relationships set out in the bright line test comprise a very narrow group and are of such a nature that they should not present merely a rebuttable presumption that they compromise independence, and that the CSA should consider measures to address concerns relating to dual-class share structures and tightly-held corporations by enhancing the independence of these directors;

- revisiting and reassessing the bright line tests to confirm their appropriateness and relevance, or better alignment with the comparable standards applicable in the United States where appropriate including:
    - if certain thresholds (for example, the $75,000 direct compensation threshold) in our current approach should be modernized and better harmonized with those in the U.S., although others took the view that certain thresholds (i.e., the $75,000 threshold) should not be increased;
    - reconsidering the definition of "affiliate" in light of the nature of complex organizations and adding clarity to the meaning of the term "worked on the issuer's audit";
    - reassessing if the bright line test in paragraph 1.4(3)(d) of NI 52-110 (family member employed with internal or external auditor) is still appropriate;
    - reconsidering whether the additional bright line tests for audit committee members continue to be relevant;
    - revisiting the independence criteria prescribed in subsection 1.4(3) to subsection 1.4(7) of NI 52-110 to ensure they are still appropriate; and
    - reassessing if there are other factors that may be relevant in determining independence (for example, where an individual's shareholdings in an issuer is material);
- enhancing director independence for tightly-held and dual-class issuers, while fine-tuning the nuances of our current approach as it relates to widely-held issuers;
- augmenting the definition of "financial literacy" so that it tracks more closely to section 407 of *Sarbanes-Oxley Act of 2002* in the U.S.; and
- requiring all directors or proposed directors to disclose circumstances and relationships applicable to them that could reasonably be perceived as material.

10 commenters who were generally not supportive of our current approach proposed certain changes, including:

- replacing the bright line tests with a more principles-based approach, allowing the board to determine whether or not the individual:
    - is independent from the issuer and its management; and
    - has any other relationship, which in light of the circumstances, could interfere with independent judgement;
- recognizing that a relationship with a control person or a significant shareholder does not, in and of itself, compromise independence;
- recognizing that independence is a question of fact that should be determined by the board on a case-by-case basis;
- if the bright line tests are not eliminated, the corporate governance regime should be updated to distinguish between directors that have a relationship with an issuer's

management, and directors that have a relationship with the controlling shareholder, but are independent of the issuer's management;

- replacing the bright line tests with enhanced disclosure of the criteria applied by boards in independence determinations;
- providing more discretion to the board in determining independence;
- the bright line tests of the current approach should be turned into indicative criteria to leave more flexibility to the board;
- distinguishing between non-independent directors and related directors in NP 58-201 and Companion Policy 52-110CP *Audit Committees* to allow greater participation by related directors on the board generally and on board committees;
- providing more flexibility to allow:
    - a director related to a controlling shareholder to serve on the issuer's audit committee; or
    - a non-independent director to serve on the audit committee in circumstances where the board determines that the director is not conflicted and would be a qualified member;
- considering whether an exemption for controlled companies similar to the one available from NYSE requirements is appropriate;
- amending NI 52-110 as follows:
    - deleting the words "and a parent of the issuer" in subsection 1.4(8);
    - revising section 3.3 to provide greater flexibility to include directors related to a controlling shareholder on the issuer subsidiary's audit committee; and
    - deleting paragraph 3.3(2)(e) regarding impartial judgment and best interests concepts; and
- changing the focus from independence to legitimacy and credibility of boards of directors.

ADVANTAGES AND DISADVANTAGES OF MAINTAINING OUR CURRENT APPROACH VERSUS REPLACING IT WITH AN ALTERNATIVE APPROACH

Advantages

17 commenters who expressed general support for our current approach have highlighted a number of advantages of maintaining the current approach, including:

- preserving the consistency and predictability of an approach that is well-understood by market participants;
- maintaining the alignment with the approach applicable in the United States given the high degree of integration of our capital markets and the number of inter-listed issuers;
- avoiding additional costs for issuers and efforts for investors to adapt to an alternative approach;
- allowing investors (including institutional investors) to quickly evaluate the level of independence on a board;
- maintaining a higher standard for determining independence; and
- maintaining investor confidence in the capital markets.

Disadvantages

10 commenters who were generally not supportive of our current approach highlighted a number of disadvantages of maintaining the current approach, including:

- maintaining a one-size-fits-all approach that does not enable issuers to take advantage of their unique strengths for the benefit of all stakeholders;
- placing undue reliance on bright line tests to the detriment of a fuller and more careful assessment of independence; and
- eliminating qualified individuals based on technical points rather than the facts.