

CSA CONSIDER REFORMS TO DETERMINING DIRECTOR AND AUDIT COMMITTEE MEMBER INDEPENDENCE

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Overview of CP 52-404

The Canadian Securities Administrators (the “**CSA**”) released CSA Consultation Paper 52-404^[1] (“**CP 52-404**”) on October 26, 2017 seeking comments with respect to the current definition of independence as it pertains to director and audit committee members of public issuers. CP 52-404 considers whether or not the current approach to determining independence unnecessarily precludes individuals with the requisite experience and competencies from being considered independent and serving as directors or as audit committee members of non-venture issuers.

CP 52-404 discusses whether changes should be made to the bright line approaches to determining director and audit committee member independence.

Relevance of Independence to Public Issuers

National Instrument 52-110 – Audit Committees (“**NI 52-110**”) requires that subject to certain exceptions, audit committee members of non-venture issuers must be composed solely of independent directors. Venture issuers are exempt from the requirement that every audit committee member must be independent, but are required, subject to narrow exceptions, to have a majority of audit committee members who are not executive officers, employees, control persons or affiliates of the issuer.

National Policy 58-201 – Corporate Governance Guidelines (“**NP 58-201**”) provides voluntary corporate governance guidelines for public issuers other than investment funds with respect to independence including, that:

- The board of directors should be comprised of a majority of independent directors.
- The chair of the board of directors should be an independent director.
- Independent directors should hold regularly scheduled meetings at which non-independent directors and members of management are not in attendance.
- A nominating committee should be comprised of entirely independent directors.

- A compensation committee should be comprised of entirely independent directors.

With respect to disclosure, National Instrument 58-101 – *Disclosure of Corporate Governance Practices* (“**NI 58-101**”) requires issuers, subject to narrow exceptions, other than venture issuers to disclose whether or not a majority of directors are independent, and if not, to describe what the board of directors does to facilitate the exercise of independent judgment in carrying out its responsibilities. Additionally, NI 58-101 requires issuers other than venture issuers to disclose whether nomination and compensation committees are comprised entirely of independent members, and if not, to describe what the board of directors does to ensure objective decision making for these committees. Finally, 58-101 requires disclosure respecting the frequency of director meetings at which non-independent directors and members of management are not in attendance as well as disclosure related to the independence of the chair of the board of directors.

Current Approach to Determining Independence

To be considered independent, directors or audit committee members must not have a direct or indirect material relationship with the issuer. A material relationship is defined as a relationship which could, in the view of the board of directors, be reasonably expected to interfere with the exercise of a member’s independent judgement. Notwithstanding any determination made by an issuer’s board of directors, the bright line factors indicative of the existence of the presence of a material relationship between an issuer and an individual include, in relation to the board and audit committee member independence, whether or not within the last three years, the individual is or has been^[2]:

- An employee or executive officer.
- A partner or an employee of the issuer’s internal or external auditor or a former partner or employee of the internal or external auditor who personally worked on the issuer’s audit (subject to certain narrow exceptions).
- An executive officer of another entity if a current executive officer of the issuer serves or served, at the same time, on the compensation committee of that other entity.
- In receipt of more than \$75,000 in direct compensation from the issuer during any 12 month period excluding fees for acting as a director or committee member, or compensation under a retirement or deferred compensation plan for prior service with the issuer.

Immediate family members having relationships similar to those referenced above will generally be considered to have a material relationship with an issuer.

NI 52-110 provides further bright line factors applicable to audit committee members with respect to determining the existence of a material relationship, including if the individual^[3]:

- Accepts, directly or indirectly, any consulting, advisory or compensatory fee from the issuer or any subsidiary entity of the issuer, other than as remuneration for acting as a member of the board of directors or any board committee or as a part-time chair or vice-chair of the board or any board committee.
- Is an affiliated entity (as such term is defined in NI 52-110) of the issuer or any of its subsidiary entities.

Benefits and Limitations of the Current Approach

CP 52-404 characterizes the current bright line factors associated with determining independence as certain, consistent and predictable, as the factors highlight specific relationships that preclude an individual from being considered independent of an issuer. However, CP 52-404 notes that the current approach has been characterized as inflexible and having overly restrictive parameters that may unduly limit the pool of qualified candidates who could serve as independent directors or audit committee members.

Comparative Analysis

CP 52-404 provides a comparative overview of the approaches to determining director and audit committee member independence in Australia, Sweden, the U.K., and the US. CP 52-404 notes that although the approaches across all of these countries are substantially similar, only Canada and the US employ bright line factors to determine independence whereas Australia, Sweden and the U.K. supplement the definition of independence with guidance.

Consultation Questions

The consultation questions posed by CP 52-404 include:

- Is the current approach to determining director and audit committee member independence appropriate for all issuers in the Canadian market.
- What are the benefits or limitations of the current approach to determining independence.
- Does the current approach strike an appropriate balance in terms of:
 - i. the restrictions imposed on issuers' boards in exercising their discretion to make independence determinations; and
 - ii. the certainty it provides boards in making those determinations and the consistency as well as predictability it provides other stakeholders in evaluating the independence of an issuer's directors or audit committee members.

- Should changes be made to the approach to determining independence as prescribed by NI 52-110 including changes to:
 - i. the definition of independence;
 - ii. the bright line tests for directors and audit committee members; or
 - iii. the exemptions to the requirement that every audit committee member be independent.

What are the advantages and disadvantages of maintaining the current approach to determining independence versus replacing it with an alternative approach.

Conclusion

The CSA has posed a comprehensive set of consultation questions in CP 52-404 regarding the status quo of determining independence of directors and audit committee members of public issuers. The deadline for submitting comments to the CSA is January 25, 2018. Please contact a member of McMillan's Capital Markets Group if you have any questions or seek assistance with the preparation of a comment letter.

by Jason A. Chertin and Alex Bruvels

[1] CSA Consultation Paper 52-404 Approach to Director and Audit Committee Member Independence.[ps2id id='1' target='']

[2] This list is not exhaustive; please refer to section 1.4 of NI 52-110 for a comprehensive list of all factors.[ps2id id='2' target='']

[3] This list is not exhaustive; please refer to section 1.5 of NI 52-110 for a comprehensive list of all factors.[ps2id id='3' target='']

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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