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# Director independence depends

By Neill May

Independence is a complex issue. At my age, the concept of independence for the most part focuses on our kids' transition to being away at school, having their own cars and generally managing on their own. It's tricky because, in their particular conception of independent functioning, there are limits. For example, when a car's fuel gauge points to E, that is a reason to bring it home for remediation, and furnishing student apartments in my recollection involved watching the old man carry the bar fridge up the stairs and tastefully laughing at his struggles.

Independence is a central element of the regulatory framework for corporate governance. The regime (i) recommends that the chairperson of the board, a majority of the directors of the board and a majority of the nominating and compensation committees of a reporting issuer be independent and, for issuers other than venture issuers; (ii) requires that the entire audit committee be independent; and (iii) requires that disclosure be made in the issuer's annual proxy materials regarding the basis for the board's conclusions as to its members' independence. It is almost as if the regime is a harsh drinking game for securities lawyers, requiring consumption of a shot for each (frequent) mention of the concept of independence. And now independence is topical again because the Canadian Securities Administrators recently published a consultation paper inviting a reconsideration of the securities regulatory approach to the concept.

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The current regulatory approach to the meaning of independence is a hybrid. The basis test is a subjective, principle-based approach: The rules say that a director is independent if he or she does not have a direct or indirect "material relationship" with the issuer, meaning a relationship that could, in the board's view, reasonably be expected to interfere with the exercise of a member's independent judgment. It is a classic legal definition — a person is not independent if he or she cannot function independently. It is similar to the definition of "material contract" — a contract that is material to the issuer. That aside, the principles-based approach provides latitude for the board to exercise judgment. The current approach, however, layers some prescriptive tests on top of the general principle. For example, if a person is an executive officer or employee of the company or a partner with the company's auditor, he or she cannot be considered independent.

The CSA is seeking comment as to whether to dispense with the bright-line disqualifications. As with any good analysis of independence, we look to see what others are doing. For example, Australia, Sweden and the U.K. do not have bright-line tests, and they instead provide only guidance as to how the principle might be applied. The U.S., by contrast, has a hybrid approach similar to ours. Advantages of maintaining the status quo include inertia (there is familiarity with the current regime and some cost to changing), symmetry with the U.S. (across a national border straddled by many public companies) and the clarity of bright lines. The obvious counterweight to this is that bright lines imply inflexibility and can limit the pool of qualified directors.

This is not the first time that our regulators have reconsidered independence criteria. In 2008, the CSA proposed implementing a primarily principles-based definition of independence, replacing the bright-line tests with guidance. That initiative was abandoned because plates were full at the time with the conversion to IFRS and the recovery from the unfolding financial crisis.

These issues cannot be considered in isolation. Issuers have to take into account not just regulatory requirements (for many issuers, in more than one jurisdiction) but also the perspectives of proxy advisors and other market participants. Many governance initiatives, addressing matters such as gender diversity, over-boarding and tenure, tend to imply less flexibility and deference to board members' judgment, although each of these issues has its own context. Further, as noted, a non-independent label generally disqualifies a director from service on an audit committee, but it more generally informs disclosures about board independence and non-binding guidelines about best practices, which raises the question of whether "disclose and explain" frameworks result in positive change in the first place.

I am much better at asking questions then answering them, except I suppose on *Jeopardy*. Perhaps, as is often the case, questions about independence can be clarified by breaking down the word itself. "In" means inside, "de" is a French and Spanish preposition, "pen" is a writing implement and "dence" is a misspelling of something compacted or someone slow-witted. That is pretty clear, but the debate about director independence may endure nevertheless. **CL**

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