

## Corporate Securities Law

October 30, 2017

### Canadian Securities Regulators Re-evaluating Criteria for Director and Audit Committee Member Independence

On October 26, 2017, the Canadian Securities Administrators (CSA) published for comment CSA Consultation Paper 52-404 *Approach to Director and Audit Committee Member Independence*. The Paper is intended to facilitate discussion about the appropriateness of the current approach to determining director and audit committee member independence and, in particular, whether to abandon current “bright-line” disqualification categories in favour of a purely principles-based approach that provides greater discretion to boards to determine whether a director is independent.

#### Background

The concept of director independence is of central importance to the Canadian corporate governance regime. Interestingly, it is Canadian securities law that explicitly addresses the question of “independence”.

The regime established by the CSA (i) recommends that the chair of the board, a majority of the directors of the board and of the nominating and compensation committees of a reporting issuer be independent, (ii) requires that the entire audit committee of a reporting issuer be independent and (iii) requires that disclosure be made in a reporting issuer’s management information circular regarding the basis for determining which directors are, and which directors are not, independent.

The CSA’s current approach to determining whether a director or audit committee member is independent was introduced in 2004 with the adoption of what is now

National Instrument 52-110 *Audit Committees* (“NI 52-110”) and is largely based on the concept of independence adopted more than 15 years ago by the New York Stock Exchange and the Nasdaq following financial reporting scandals in the U.S.

NI 52-110 provides that a director of a reporting issuer is independent only if he or she does not have a direct or indirect material relationship with the issuer. A “material relationship” is defined by the CSA as a relationship that could, in the board’s view, reasonably be expected to interfere with the exercise of a member’s independent judgement. NI 52-110 deems a number of relationships (e.g., being an executive officer or employee of the company, or a partner with the company’s auditor) to be “material relationships”. If a director has one of the enumerated relationships, then the director cannot be independent for the purposes of the regime established by the CSA, regardless of the board’s view as to the potential for that relationship to interfere with the director’s judgement.

This combination of a principles-based definition combined with bright-line disqualification categories is similar to the U.S. approach, but differs from the solely principles-based approaches utilized in Australia, Sweden and the U.K.. While regulators in those jurisdictions have provided guidance about when certain relationships (many of which are the same as the bright-line categories incorporated into the Canadian and U.S. rules) could impact a director or audit committee member’s independence, the ultimate decision about whether a particular director or audit committee member is independent is made by the board based on all relevant circumstances.

#### Potential Changes to Canadian Definition of Independence

The CSA are now considering whether a model that is more similar to the ones employed in Australia, Sweden and the U.K. – that is, a principles-based

# Goodman's Update

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approach without bright-line disqualification categories – is more appropriate for the Canadian capital markets. The impetus for this review is said to be concern expressed by some stakeholders that the current approach unduly restricts the pool of potential directors by presumptively precluding individuals with the requisite expertise and sound judgement from being eligible to be independent members of the board or to serve as nominating committee, compensation committee or audit committee members, to the detriment of certain issuers. At this time, the CSA has not proposed a specific alternative approach to determining independence.

This is not the first time the CSA has reviewed independence criteria. In 2008, as part of a broader proposal to overhaul the Canadian corporate governance regulatory framework, the CSA proposed implementing a primarily principles-based definition of independence that would have, with one exception, left the ultimate decision of a director's independence to the board of directors. Under the 2008 proposal, a director would be independent if he or she (i) was not an employee or executive officer of the issuer, and (ii) did not have, or had not had, any relationship with the issuer, or an executive officer of the issuer, which could, in the issuer board's view having regard to all relevant circumstances, be reasonably perceived to interfere with the exercise of his or her independent judgment. In addition, the existing bright-line tests would have been replaced with guidance for assessing independence and a non-exhaustive list of relationships that could affect an individual's independence. Ultimately, the CSA concluded that it was not an appropriate time to implement significant changes to the corporate governance regime (including the definition of independence) because issuer's were focusing on transitioning to International Financial Reporting Standards and on business sustainability issues following the 2008 financial crisis.

Notably, the principles-based test in the 2008 proposal differed in some important respects from the existing principles-based test (including the use of the word

“perceived” and reference to past relationships). As a result, while the 2008 proposal might have liberalized the concept of independent for some individuals, it could also have resulted in some individuals who are independent under the current regime no longer being independent.

The period for comment on whether the current approach should be changed is open until January 25, 2018.

Please contact any member of our Corporate Securities Group to discuss these developments.