



Institute for governance
of private and public organizations

CSA Consultation Paper 52-404

Approach to Director and Audit Committee Member Independence

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Submission of IGOPP to the Canadian Securities Administrators and the Autorité des marchés financiers in reply to request for comments on the current rules and guidelines concerning the independence of board members.

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For a Value-Creating Governance®

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January 25, 2018

VIA EMAIL

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Alberta Securities Commission
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Autorité des marchés financiers
Superintendent of securities, Prince Edward Island
Nova Scotia Securities Commission
New Brunswick Securities Commission
Securities Commission of Newfoundland and Labrador
Superintendent of Securities, Yukon Territory
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Nunavut

Attention:

c/o The Secretary
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Attention:

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FOREWORD

Beginning in the late 1990s, the independence of board members has been the cornerstone (some might say the philosopher's stone) of good governance. Indeed, in an earlier time, the requirement that a majority of board members be independent from management did represent a significant, even momentous, improvement on the governance practices of yore when boards were made up of members of management, their friends and related parties.

Responding to financial fiascos, securities commissions and authorities have adopted a mixture of guidance and regulations to give some substance to the notion of board independence in general and that of the audit committee, in particular. Over the years, various refinements and adjustments in guidelines and mandatory rules ("bright line tests" in the jargon of the CSA) have created "inflexibility and overly-restrictive parameters".

In spite of this extreme focus on independence of boards, the concept has not aged well. The gradual, initially latent, erosion of the legitimacy of boards became more tangible after 2008. The conventional structure of a management overseen by a board of directors has lost much of its legitimacy and has triggered a frontal assault by institutional funds to take over the historic and legal powers and responsibilities assigned to boards

First, no matter how tightly and exhaustively defined, the notion of independence soon appeared *as a necessary but not sufficient condition* of effective governance. It surely did not prevent repeated corporate fiascos culminating in the 2008 crisis brought about by corporations governed by impeccably independent boards. Challenged on the actual usefulness of board independence, some tend to argue that, in effect, independence really means independence of mind and strength of character. While obviously important, such personal attributes cannot be assessed nor measured by an outside observer. Therefore, it may be, as it has been written, that the concept of independence is *of little interest when it is measurable and interesting only when it is incommensurable* (Allaire, 2003; 2005).

Secondly, despite the CSA's belief that *"the exercise of independent judgment contributes to the effectiveness of boards and board committees"*, the fact is that empirical studies provide at best weak or no support for the hypothesis that director independence will lead to better corporate performance. *The exercise of Independent judgment* is not quite what is assessed in the CSA's guidelines and regulations. However, it may be that independent boards, in many circumstances outsiders shall never know about, did succeed in blocking hazardous decisions and ill-conceived actions by management.

Thirdly, the CSA's guideline and rules on independence are heavily influenced by the U.S.'s way of approaching the issue. Yet, Canada's publicly listed corporations show a distinctive ownership structure. For instance, out of the 250 companies making up the S&P/TSX index, 110 have a significant shareholder with more than 10% of the votes. Some 62 corporation

have a shareholder (or related shareholders) with more than 30% of the votes (and 37 with a shareholder with an absolute majority of the votes). For 71 corporations, the significant shareholder is either an individual, a family or another corporation.

Fourthly, in seeking to provide comfort to shareholders that decisions are made in strict pursuit of the interest of the corporation, the concept of independence has in *fact exacerbated the asymmetry of information, experience and expertise between the board and management*.

This asymmetry has been described as the *fundamental flaw* of corporate governance. As per the norms of “good” fiduciary governance, boards rely on the information provided by management, come to believe the plans submitted by management to be adequate and challenging, and base the executives’ lavish compensation on the achievement of these plans.

Instead of stressing “independence” of board members as the Philosopher’s stone of “good” governance, the CSA’s goal should be to foster legitimate and credible boards. Framed as one source of **legitimacy**, the concept of independence gains a restricted but critical role in the functioning of a board. It does provide a relative assurance that the director’s judgment will not be influenced, nor appear to be influenced, by his or her interests rather than by the interests of corporation.

But a board acquires legitimacy through the process of election/nomination of board members and/or from the sizeable financial investment in the company’s shares by board members. Indeed, only through its legitimacy does a board acquire the moral authority to oversee the management of an organization.

Several measures have been proposed to enhance the legitimacy of boards of directors, such as cumulative voting, nomination of candidates for board seat by large shareholders, individual and majority voting for candidates to the board, stakeholder representation on boards, etc. All measures aimed at strengthening the legitimacy of boards deserve a vigorous support from those committed to improving the quality of governance in our private and public organizations.

It must be pointed out that no board has more legitimacy to impose its will on management of a business corporation than a board with a lot of money at stakes.

But **credibility** is the sine qua non of an activist board. Credibility flows from the joint product of competence, integrity, and trustworthiness. The notion of competence here refers to a board member’s expertise about, and experience with, the specific issues and challenges of this particular company operating in this particular industry.

Credibility is not gained by immaculate independence or an impressive biography of business experience if acquired in industries that share few critical competencies with the specific industry in which the corporation to be governed operates.

Increasingly, corporations are seeking board members with *competencies* relevant to the industrial sector in which the company operates. It may well happen that a credible member may not be an independent member, *stricto sensu*. By virtue of his/her work experience in the industry, a candidate board member may fail the exacting, sometimes fussy, tests of “independence” but bring much credibility to the board. Corporations must be prepared to trade off independence for credibility for a number of members of the board, if that became necessary to assemble a credible board.

While it is legitimacy that gives a board the moral authority to impose its will on management, it is through its credibility that a board becomes effective and adds value to the company.

Clearly, for some forms of business ownership, the legitimacy and credibility of their governance is easier to achieve, though difficult issues do arise from time to time. For instance, when a significant or controlling shareholder plays a key role in the governance of the company, legitimacy and credibility may be easier to achieve although they should not be taken for granted.

People with large stakes in the company have great legitimacy to assert their authority over management; they also enjoy that elusive quality of credibility. Frequently, they have actually built the company; they know intimately its every building-block; they are motivated by their monetary commitments and their legacy to invest massively their time and energy in the governance of the company. The need and desire to maintain their good reputation should lead them to a sensitive interaction with key stakeholders including society at large.

Given board members with the requisite experience and intellectual wherewithal, enhancing their credibility requires a large investment of their time to master the particulars of the company's strategic drivers, its competitive challenges, and maintain the currency of that knowledge. At this time, board members will not become or remain credible if they do not master the immense search capability of the Web to ferret out the information pertinent to the company they are called to govern.

These considerations call upon the CSA to broaden its assessment of “independence” to include ***issues of legitimacy and credibility of boards of directors*** so that boards become less vulnerable to information and knowledge asymmetry.

CSA'S CONSULTATION QUESTIONS: ANSWERS TO SOME QUESTIONS

Question 1. a. The ACVM approach to determining director and audit committee member independence is described in section 3.2 of this Consultation Paper. Do you consider this approach appropriate for all issuers in the Canadian market? Please explain why or why not.

In general, it fails to recognize the legitimacy of significant shareholders to play an active role in governance, including on the audit committee (provided that shareholder or his/her representatives play no role in the management of the corporation). The CSA should defer to boards to establish when a significant shareholder may act as an independent board member.

Here is a nit-picking observation: (1.3 (d) an individual whose spouse, **minor child** or stepchild, or child or stepchild who shares a home with the individual:

How can a minor child (i.e. under 18 years old) be a partner in a firm...?

Question 2. Should we consider making any changes to our approach to determining independence as prescribed in NI 52-110, such as changes to:
a. the definition of independence

Again the approach fails to recognize the legitimacy of significant shareholders to play an active role in governance, including on the audit committee (provided that shareholder or his/her representatives play no role in the management of the corporation).

Question 3: What are the advantages and disadvantages of maintaining our approach to determining independence versus replacing it with an alternative approach? Please explain.

The CSA's obsessive focus on the independence of board members is counter-productive in the current context of governance. It is the legitimacy and credibility of boards which are questioned. Modifying, loosening or tightening the definition of independence is a secondary issue. The CSA should recognize that important shareholders, who are not part of management, are legitimate, thus independent, members of the board.

ABOUT IGOPP

Created in 2005 by two academic institutions (HEC Montréal and Concordia University – The John Molson School of Business), the Stephen Jarislowsky Foundation and the Autorité des marchés financiers, the Institute for governance (IGOPP) has become a centre for excellence about governance of public and private organizations. Through research, training programs, policy papers and participation in public debates, IGOPP has become a key reference on all issues of governance in the private and public sectors.

OUR MISSION

- Strengthen fiduciary governance in the public and private sectors;
- Make organizations evolve from a fiduciary mode of governance **to a value creating governance®**;
- Contribute to debates, and the solution, of governance problems by taking positions on important issues and by a wide dissemination of information and knowledge about governance.

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The Institute carries out activities in four particular areas:

- Policy papers
- Research and publications
- Seminars on value-creating governance®
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