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Superintendent of Securities, Newfoundland and Labrador
Superintendent of Securities, Yukon Territory
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Superintendent of Securities, Nunavut

c/o

Me Anne-Marie Beaudoin,
Corporate Secretary
Autorité des marchés financiers
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The Secretary
Ontario Securities Commission
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Dear Sirs/Mesdames:

CSA Consultation Paper 52-404 – *Approach to Director and Audit Committee Member Independence*

We are submitting this comment letter in response to the request for comments regarding the above-noted CSA Consultation Paper ("**Consultation Paper**") on behalf of certain of our clients which are reporting issuers in Canada, listed on the Toronto Stock Exchange and who have a combined market capitalization of over $18 billion. Each client has a significant shareholder.

Our clients appreciate the opportunity to comment on the Consultation Paper as each of them has long been concerned with the application of the director independence definition under Canadian securities laws to controlled companies and each believes that reform is needed. In particular, our clients are of the view that the current approach to the impact of relationships with a controlling shareholder on director independence is flawed,

is inconsistent with practices in all other jurisdictions other than the U.S. and fails to consider the unique role of controlling shareholders in Canadian capital markets compared to the U.S. Instead, director independence should be viewed in terms of independence from management and the nominees of controlled companies should not be automatically disqualified from being considered to be independent. Our clients recommend that National Instrument 52-110 *Audit Committees* ("**NI 52-110**") be revised to delete the words "and a parent of the issuer" from subsection 1.4(8), provide greater flexibility in section 3.3 to include individuals related to the controlling shareholder on the issuer subsidiary's audit committee and delete paragraph 3.3(2)(e).

Importance of Controlled Companies in Canada

Controlled public companies, both today and historically, play a vital role in Canada's economy and the public markets. A study from 2008 found that 27% of the 253 Canadian companies of the S&P/TSX Index had at least one significant shareholder (or related group of shareholders) which controlled more than 20% of the votes.[1] Publicly-listed controlled companies are rare in the United Kingdom and in the United States, but are prevalent in other European countries, while their frequency in Canada is somewhere between the two extremes.[2]

Many of Canada's successful public companies have controlling shareholders. And the majority of Canadian initial public offerings in 2016 and 2017 have been structured so that the controlling shareholder remains in control by retaining multiple voting shares while subordinate voting shares that carry one vote per share are offered to the public.

Controlling shareholders have a legitimate interest in the governance and oversight of the companies in which they invest. Controlling shareholders also have a powerful economic incentive to oversee management as a result of their investment in the corporation. By virtue of the nature and size of their investment, controlling shareholders do not have the same flexibility as other shareholders to take a short term approach to their investment and 'vote with their feet' by selling their interest in the corporation if dissatisfied with corporate performance or strategic direction. As a result, the controlling shareholder is committed to the long-term best interests of the corporation.

Directors related to a controlling shareholder often have a deep-seated understanding of the business which makes them well-positioned to ask pointed questions of management, challenge management's assumptions and contribute to a meaningful discussion of the corporation's best interests. In fact, as a result of the controlling shareholder's sizable

[1] Allaire, Y. «L'actionnariat des grandes entreprises canadiennes: quelques données», Institute for Governance of Private and Public Organizations, August, 2008.

[2] Allaire, Y. "Controlled Companies Briefing: Questions for Directors to Ask", CPA Canada, 2010.

economic interest in the issuer, directors related to a controlling shareholder may be more independent-minded and aligned with other shareholder interests than other directors.

Studies show that controlled companies in the long run outperform their peers. A study by the Clarkson Centre in 2013 concluded "What we found was that Canadian family-controlled issuers have outperformed their peers between 1998 and 2012. Moreover, family firms often appear best able to create value for their shareholders when they choose not to adhere to typical best practices in share structure and independence."[3] A report by National Bank of Canada found that "Over the last 10 years, large Canadian family-controlled public companies have outperformed the S&P/TSX Composite Index by 120%."[4]

Minority shareholders expect the controlling shareholder to exercise oversight over management of its subsidiaries. Investors not only make their investment decisions despite knowledge of the existence and control held by the controlling shareholders, many make their investment decisions because the controlling shareholder has a voting and economic interest in holding management of the issuer appropriately accountable.

The New York Stock Exchange ("**NYSE**") recognized the unique role of a controlling shareholder in the governance of a controlled company by exempting controlled companies from its "independence" requirements (other than with respect to audit committees) and many large U.S. companies have relied on the NYSE exemption. The NYSE explained that "The exception … was made because the ownership structure of these companies merited different treatment. Majority voting control generally entitles the holder to determine the make-up of the board of directors, and the exchange didn't consider it appropriate to impose a listing standard that would in effect deprive the majority holder of that right."

Until 2005, the Canadian corporate governance regime focussed on independence from management and recognized that relationships arising from shareholding did not impact independence.

Until 2005, Canada's corporate governance regime was sensitive to the unique circumstances of a controlled corporation. As noted in the Consultation Paper, the corporate regime in Canada was introduced by and largely based on the report sponsored by the Toronto Stock Exchange ("**TSX**"), *Where were the Directors?* published in 1994

[3] Antonio Spizzirri and Matt Fullbrook, "The Impact of Family Control on the Share Price Performance of Large Canadian Publicly-Listed Firms (1998-2012)", June 2013, Clarkson Centre for Board Effectiveness

[4] Pierre Fournier and Angelo Katsoras, "The Family Advantage – The Sustainable Outperformance of Canadian Family-Controlled Public Companies", October 2015, National Bank of Canada

("**Dey Report**"). Among other things, the Dey Report recommended that the board of every corporation be constituted with a majority of "unrelated directors". The Dey Report defined "unrelated director" as a director who is independent of management and is free from any interest and any business or relationship which could, or could reasonably be perceived to, materially interfere with the director's ability to act with a view to the best interests of the corporation, other than interests and relationships arising from shareholding. The Dey Report also recommended that where a corporation has a significant shareholder, the board should include a number of directors who do not have interests or relationships with either the corporation or the significant shareholder and which fairly reflects the investment in the corporation by shareholders other than the significant shareholder.

Starting in 1995, companies listed on the TSX were required to disclose their approach to corporate governance in relation to the recommendations made in the Dey Report. The Toronto Stock Exchange Committee on Corporate Governance explicitly recognized the important role a controlling shareholder plays in the governance of a corporation and the right of that shareholder to exercise control through the election to the board of individuals related to the controlling shareholder. In the Dey Report, relationships arising from shareholdings were specifically excluded from the definition of "unrelated director".

However, the treatment of controlled companies changed with respect to audit committee composition in 2004 and director independence generally in 2005 with the adoption of new rules and policies under Canadian securities laws which, as noted in the Consultation Paper, were modelled on changes to U.S. securities laws and stock exchange requirements. The changes followed the U.S. approach of adopting bright line tests to disqualify a director from being considered independent, although there are some differences between the Canadian and U.S. bright line tests. And the independence assessment no longer focussed on independence from management. In particular, the changes adopted resulted in individuals being deemed to be not independent based on certain relationships with a controlling shareholder even if the board of directors of the corporation determined the individual was otherwise independent.

When it comes to director independence, the regulatory approach to Canadian controlled companies is more restrictive than any other jurisdiction.

As noted in the Consultation Paper, in Australia, Sweden and the U.K., it is up to the board of directors of the issuer to determine whether a director is or is not free of any relationship which could be reasonably expected to interfere with the exercise of the director's independent judgement after consideration of all applicable relationships, including relationships to the controlling shareholder. In Canada, however, the board's determination is expressly overridden by the "bright line" tests.

Although the "bright line" approach is reflected in the NYSE listing rules, as noted above controlled companies are entitled to an exemption from the NYSE "independence" requirements (other than with respect to audit committees) and many large U.S. companies have relied on the NYSE exemption. There is no corresponding exemption under the Canadian rules, with the result that even though Canada has a much higher proportion of controlled companies than the U.S., Canadian controlled companies are subject to a higher standard.

It is misleading to deem a director to be non-independent for disclosure purposes when the board has concluded the director is independent.

As discussed earlier, a director related to a controlling shareholder may be more independent-minded and aligned with other shareholder interests than other directors by virtue of the controlling shareholder having a sizable economic interest in the issuer. But while a board may reasonably determine that such a director is independent, the "bright line" tests may nevertheless deem the director to be non-independent. Deeming an individual who is related to the controlling shareholder to be non-independent despite the board having reached the opposite conclusion results in the issuer being required to apply a misleading label to the director.

It has been argued that the effect of classifying a director as non-independent is non-material because, with the exception of audit committee composition, the only consequence to the issuer is that it must provide additional disclosure. For example:

- If a majority of the board members are not independent, the issuer must describe what the board does to facilitate exercise of independent judgement in carrying out its responsibilities.

- If the nominating committee is not entirely independent, the issuer must describe the steps the board takes to encourage an objective nomination process.

- If the compensation committee is not entirely independent, the issuer must describe the steps the board takes to ensure an objective process for determining compensation.

This argument misses the point – it is the definition that is flawed and a director related to the controlling shareholder should not be identified as non-independent when the board has reached the opposite conclusion. The result is that the issuer either has to explain why the approach reflected in Canadian securities rules is misguided or remain silent and risk being perceived as being somehow non-compliant with appropriate practice.

Changes to National Instrument 52-110 to correct the treatment of controlled companies are simple and necessary.

Our clients propose that:

- Subsection 1.4(8) of National Instrument 52-110 *Audit Committees* ("**NI 52-110**") be revised to delete the words "and a parent of the issuer"; and

- Section 3.3 be revised to provide greater flexibility to include directors related to a controlling shareholder on the issuer subsidiary's audit committee and to delete paragraph 3.3(2)(e).

Application of Deeming Tests to a Parent

The effect of subsection 1.4(8) of NI 52-110 is to apply all the "bright line" director independence tests at the subsidiary and parent levels. While an executive, officer or employee of a downstream affiliate of an issuer should be disqualified from being considered to be an independent director, the same is not true at the parent level. In light of a parent corporation's ability to cause management of the issuer to be replaced, there is adequate assurance that an employee or executive employed by the parent will be able to exercise judgement that is independent of management of the issuer subsidiary.

In addition, the application of subsection 1.4(8) to controlled companies is unclear and introduces an inconsistent approach to controlled companies.

Subsection 1.4(8) was adopted in the June 30, 2005 version of Multilateral instrument 52-110 *Audit Committees* (NI 52-110) to reflect changes made to NYSE listing rules. But the term "parent" is not defined in NI 52-110 and is not defined elsewhere under Canadian securities laws.

The language of subsection 1.4(8) is different from the language used in the NYSE rules. The NYSE rules state "In addition, references to the "listed company" or "company" include any parent or subsidiary in a consolidated group with the listed company or such other company as is relevant to any determination under the independent standards set forth in this Section 303A.02(b)." And guidance from the NYSE states "The term consolidated group refers to a company, its parent or parents, and/or its subsidiaries that would be required under U.S. generally accepted accounting principles to prepare financial statements on a consolidated basis. To the extent that a parent or subsidiary of a listed company is consolidated with the financial statements of the listed company, the bright line tests of Section 303A.02(b) apply to those entities as though they were the listed company."

It is unclear whether NYSE guidance with respect to the term "parent" is applicable in Canada. There is also no guidance on whether "parent" refers solely to the entity immediately up the organizational chain, or could include entities at levels above. Further, subsection 1.4(8) does not apply where an individual serving as a director holds a majority of the outstanding voting shares in the director's personal capacity instead of through an intermediate holding entity.

As noted above, our clients believe a better approach would be to leave the determination of whether a director is or is not free of any relationship which could be reasonably expected to interfere with the exercise of the director's independent judgement to the board of directors of the issuer to determine in light of all applicable circumstances. That can be accomplished by simply deleting the words "and a parent of the issuer" from subsection 1.4(8) of NI 52-110. Doing so, would align the Canadian approach with the practices of Australia, Sweden and the U.K – where the relationship with the controlling shareholder does not deem a director to be independent but is a factor to be considered by the board in making its determination.

It is acknowledged that this change would introduce a difference from the director independence definition in the U.S. But while it is desirable for there to be general alignment between Canadian and U.S. approaches to director independence for corporate governance purposes, it is worth noting that differences already exist between the two regimes. For example:

- NYSE listing rules include an additional bright line test based on whether the director is an employee, or has an immediate family member who is an executive officer of a company that has made payments to, or received payments from, the issuer.

- NYSE listing rules disqualify a director who has an immediate family member who is a current employee of the issuer's audit firm and personally works on the issuer's audit whereas under NI 52-110 the director is disqualified even if the immediate family member did not work on the issuer's audit so long as the immediate family member participates in the audit, assurance or tax compliance (but not tax planning) practice of the issuer's audit firm. However, for this test NI 52-110 only considers the director's spouse, minor child or a child who shares the director's home as being an immediate family member while the NYSE listing rule also includes parents, all children (regardless of age or residence), siblings, in-laws, and anyone (other than a domestic employee) who shares the director's home.

Moreover, it is appropriate for the director independence definition under NI 52-110 to differ from the U.S. definition due to the much greater prevalence of controlled

companies in Canada than in the U.S. and the absence in Canada of a blanket exemption for controlled companies corresponding to the one that exists under NYSE rules.

Finally, the proposed change would not result in significant additional costs and, as applicable to controlled companies, is far less dramatic a change than when the TSX corporate governance disclosure rules were superseded by the adoption of National Instrument 58-101 – *Disclosure of Corporate Governance Practices*.

Directors Related to a Controlling Shareholder on the Audit Committee

Section 1.5 of NI 52-110 generally results in many directors related to a controlling shareholder being considered to be an "affiliated entity" of the issuer and therefore disqualified from service on the issuer's audit committee. The exemption in section 3.3 of NI 52-110, however, permits the controlling shareholder to have representatives on the issuer's audit committee provided that no such director is an executive officer, general partner or managing member of an affiliated entity that has publicly traded securities, and meets the other requirements of that section.

The participation of senior employees of a parent corporation on the audit committee can be very valuable. Such employees have the interests of the shareholders very much in mind and are very independent from the issuer's management. However, section 3.3 of NI 52-110 would not permit an executive officer of the parent corporation to serve on the issuer subsidiary's audit committee if the parent corporation has publicly traded securities. This is unduly restrictive. There might be a potential for concern if the issuer's audit committee were to be dominated by executives of upstream public companies which consolidate the issuer's financial results with their own, because the public reporting obligations of their employer in some cases might result in less objective evaluation of the issuer's financial reporting. However, having an executive officer of the publicly traded parent serve as a member of the audit committee of the issuer subsidiary would afford many benefits, while ensuring that a majority of the audit committee members are independent of both management of the issuer and of the parent corporation.

We also propose that paragraph 3.3(2)(e) be deleted as it is either unnecessary or its purpose is unclear. Section 3.3 only provides an exemption from the "bright line" tests for director independence and on its terms does not override the requirement under subsections 1.4(1) and (2) for the board of directors to make a determination that the audit committee member is independent. Accordingly, subparagraph 3.3(2)(e)(i) is unnecessary, or if it is intended to impose a different test it is not clear what the nature of that test would be. As directors are subject to a fiduciary duty at common law and under corporate statutes to act honestly with a view to the best interests of the corporation, including when appointing directors to the audit committee, subparagraph 3.3(2)(e)(ii) is

also unnecessary, or if it is intended to impose a different test it is not clear what the nature of that test would be.

The changes to the treatment of directors related to a controlling shareholder would not increase risks to minority shareholders

Minority investors also can take comfort in the existence of a well-established body of laws and rules designed to protect their interests. It is settled law in Canada that directors owe their fiduciary duty to the corporation, and not to any single shareholder or shareholder group. Corporate laws contain several statutory provisions which protect minority shareholder interests, including dissent rights, the oppression remedy and rights respecting derivative actions. Additional protections for going private, related party and other transactions are set out in Multilateral Instrument 61-101 – *Protection of Minority Security Holders in Special Transactions*. It is not necessary to use director independence rules to provide additional protection to minority shareholders.

* * * *

Thank you for the opportunity to comment on the Consultation Paper. We would be pleased to discuss our thoughts with you further. If you have any questions or comments, please contact Andrew J. MacDougall (416.862.4732 or amacdougall@osler.com).

Yours very truly,