Potential Alteration of *INDEPENDENCE* In Canadian Corporate Governance

By Chat Ortved

The Canadian Securities Administrators have issued a consultation paper that, if it were to result in changes to relevant rules under securities law, could affect the composition of boards of directors and key committees of Canadian public companies. The Consultation Paper[1] does not introduce any new rules, or even make any specific proposals for new rules. Rather, it is aimed at facilitating a discussion of the appropriateness of the current definition of "independence" for Canadian issuers, and whether the current combination of a principles-based definition of "independence" with a number of brightline disqualifications allows issuers optimal access to talented directors.

1. CSA Consultation Paper 52-404 - Approach to Director and Audit Committee Member Independence (the "Consultation Paper").

Development of the Current Regime

In Canada, various fundamental elements of corporate governance, including the definition of "independence," are regulated by the provincial securities regulators. In 2004 and 2005, following the high-profile accounting scandals in the United States that resulted in changes to the rules of major U.S. stock exchanges, regulators in Canada introduced certain rules and policies that combined recommendations for "best practices" with positive obligations for board and committee composition and disclosure.

The concept of "independence" is central to those rules and policies. For instance, National Instrument 52-110 - *Audit Committees* ("NI 52-110") requires, subject to some very narrow exceptions, that the audit committee of each non-venture issuer be composed entirely of independent directors. National Policy 58-201 - *Corporate Governance Guidelines* recommends that the chair and a majority of the board be independent and that the nominating and compensation committees be composed entirely of independent directors. National Instrument 58-101 - *Disclosure of Corporate Governance Practices* requires disclosure of which directors are independent, which are not, and the basis for determining the latter, as well as an explanation, where applicable, of why the nominating and compensation committees do not comprise only independent directors.

Under the current regime, a director is "independent" if he or she has no direct or indirect "material relationship" with the issuer. The meaning of "material relationship" has a principles-based component and a bright-line component. The principles-based component encompasses relationships "which could, in the view of the issuer's board of directors, be reasonably expected to interfere with the exercise of a member's independent judgement." The bright-line component encompasses certain relationships that are explicitly enumerated, such as being (or having been in the last three years) an employee or executive officer of the issuer, or being a partner of the issuer's auditing firm.

Possible Alterations to Independence

The Consultation Paper looks to the approaches to determining "independence" that prevail in other jurisdictions, including the U.S., the U.K., Australia and Sweden, noting that the current regime most closely resembles that of the U.S. It notes further that criticism of the current regime has focused on the "inflexibility" and "overly-restrictive parameters" of the bright-line component of NI 52-110, which suggests that the hybrid approach of applying principles and bright lines may be less appropriate in Canada, where the scale of the capital markets is likely closer to those of the other, non-U.S., comparator countries.

Whether a revised definition of "independence" will come into force, and whether and to what extent it will broaden the pool of directors available to Canadian reporting issuers, remains to be seen. Surely there are directors who could presumably exercise independent judgment, yet are currently disqualified by a bright-line rule. At the same time, the elimination of bright-line rules may require an adjustment to the principles that underlie the "principles-based" aspect of the current approach, whether to align it with other jurisdictions or to craft a uniquely Canadian definition, possibly disqualifying a different subset of directors. In other words, there are costs to a change in a definition that is so central to the corporate governance regime that will need to be weighed against the benefit of potentially expanding the universe of "independent" directors. Further, it is notable that at the same time as the CSA are considering moving towards a principles-based approach to the "independence" aspect of corporate governance, a bright-line approach, involving the quota system used in other countries, could be under consideration for the gender diversity aspect of corporate governance. In any event, the lessons of the accounting scandals of the early 2000's have not been forgotten, and the concept of "independence" will remain central to the governance regime under securities laws in Canada. The comment period for whether changes should be considered ends on January 25, 2018.

If you have questions about the Consultation Paper, or the Canadian corporate governance regime more broadly, please contact Chat Ortved or any member of our Board Advisory & Corporate Governance or Corporate Finance & Securities Groups.

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