MSC NOTICE 2003-31

REQUEST FOR COMMENTS

NOTICE OF PROPOSED MULTILATERAL INSTRUMENT 52-110, FORMS 52-110F1 AND 52-110F2 AND COMPANION POLICY 52-110CP

AUDIT COMMITTEES

This Notice accompanies proposed Multilateral Instrument 52-110 *Audit Committees* (the Proposed Instrument), Forms 52-110F1 and 52-110F2 (together, the Forms) and proposed Companion Policy 52-110CP (the Proposed Policy), each of which are being published for comment. We invite comment on these materials generally. In addition, we have raised a number of questions for your specific consideration.

Introduction

The Proposed Instrument, the Forms and the Proposed Policy are initiatives of certain members of the Canadian Securities Administrators. The Proposed Instrument and Forms are expected to be adopted as a rule in each of Québec, Alberta, Manitoba, Ontario, Nova Scotia and Newfoundland and Labrador, as a Commission regulation in Saskatchewan, as a policy in New Brunswick, Prince Edward Island and the Yukon Territory, and as a code in the Northwest Territories and Nunavut. It is expected that the Proposed Policy will be implemented as a policy in Québec, Alberta, Manitoba, Ontario, Nova Scotia, Newfoundland and Labrador, Saskatchewan, New Brunswick, Prince Edward Island and the Yukon Territory, the Northwest Territories and Nunavut (the Adopting Jurisdictions).

The purpose of the Proposed Instrument is to encourage reporting issuers to establish and maintain strong, effective and independent audit committees. We believe that such audit committees enhance the quality of financial disclosure made by reporting issuers, and ultimately foster investor confidence in Canada's capital markets.

Background

In July of 2002, the *Sarbanes-Oxley Act* (SOX) was enacted in the United States. SOX prescribes a broad range of measures designed to restore the public's faith in the U.S. capital markets in the wake of several U.S. financial reporting scandals. These measures include requirements regarding the responsibilities and composition of audit committees. Since our markets are largely integrated with and affected by the U.S. markets, they are not immune from real or perceived erosion of investor confidence in the United States. Therefore, we have initiated measures, including the audit committee requirements set out in the Proposed Instrument, to address the issue of investor confidence and to maintain the reputation of our markets internationally.

The Proposed Instrument is based on the audit committee requirements currently being implemented in the United States. In particular, it is derived from the audit committee requirements in SOX, certain requirements of the U.S. Securities and Exchange Commission[1] (the SEC) and proposed listing requirements of the New York Stock Exchange and Nasdaq.[2]

---

[1] See Exchange Act Rule 10A-3 and SEC Release No. 33-8220 *Standards Relating to Listed Company Audit Committees*, as am.; see also SEC Release No. 33-8177 *Disclosure Required by Sections 406 and 407 of the Sarbanes-*

Recent U.S. financial scandals have demonstrated that a conflict of interest may arise when management assumes the role of overseeing the relationship between an issuer and its external auditor. In particular, a conflict arises when the external auditor begins to consider management, and not the issuer and its shareholders, as its client. As a result, U.S. listed issuers will now be required to have an independent audit committee which is directly responsible for the appointment, compensation, retention and oversight of the work of the external auditor and to whom the external auditor must report directly. By barring management from any oversight role with respect to the external auditor, the U.S. audit committee requirements facilitate the independent review and oversight of a company's financial reporting processes and the work of the external auditors.

The Proposed Instrument requires certain reporting issuers to comply with provisions similar to those in the United States. The Proposed Instrument differs from the U.S. audit committee requirements to the extent required by Canadian corporate law and certain realities of the Canadian markets (*ie*., the high number of public junior issuers and controlled companies).

Summary and Discussion of the Proposed Instrument and Forms
The Proposed Instrument has nine parts.

Part 1
The definition of certain terms and phrases that are used in the Proposed Instrument are contained in Part 1. National Instrument 14-101 *Definitions* also sets out definitions for commonly used terms and should be read together with the Proposed Instrument.

In addition, Part 1 establishes the scope of the Proposed Instrument. It applies to all reporting issuers other than investment funds, issuers of asset-backed securities, designated foreign issuers and certain subsidiary entities of reporting issuers.[3]

Part 2
Part 2 requires every issuer to have an audit committee to which the external auditors must directly report. In addition, Part 2 provides that each audit committee must be responsible for, among other things:

- overseeing the work of the external auditors engaged for the purpose of preparing or issuing an audit report or related work (*subsection 2.3(3)*);

- pre-approving all non-audit services to be provided to the issuer or its subsidiary entities by its external auditors or the external auditors of the issuer's subsidiary entities (*subsection 2.3(4)*); and

- reviewing the issuer's financial statements, MD&A and earnings press releases before they are publicly disclosed by the issuer (*subsection 2.3(5)*).

Oxley Act of 2002 dated January 24, 2003, as am. and SEC Release No. 33-8183 *Strengthening the Commission's Requirements Regarding Auditor Independence* dated January 28, 2003, as am.

[2] New York Stock Exchange amended and restated proposal filed with the SEC on April 4, 2003; Nasdaq proposal filed with the SEC on October 9, 2002, as amended by Amendment No. 1 filed on March 11, 2003.

[3] In addition, the Proposed Instrument provides certain exemptions for issuers that are venture issuers and for issuers that are subject to the U.S. audit committee requirements. See Parts 6 and 7 of the Proposed Instrument.

Subsection 2.3(2) also requires that an audit committee recommend to the board of directors the external auditors to be nominated for the purpose of preparing or issuing an audit report (or any related work), as well as the compensation to be paid to such auditors. This necessarily differs from the U.S. audit committee requirements because under Canadian corporate law, an audit committee cannot appoint, compensate or retain the external auditors.[4] Nevertheless, this provision, together with paragraph 5 of Form 52-110F1 (which requires an issuer to disclose in its AIF if the board of directors has not adopted a nomination or compensation recommendation of the audit committee), will ensure that the independent audit committee's recommendations are discernible to the shareholders.

Section 2.4 provides an exemption from the requirement that an audit committee pre-approve non-audit services provided by the external auditors, so long as the non-audit services in question are *de minimis*. Section 2.5 permits the audit committee to delegate its pre-approval responsibilities to one or more of its independent members.

Part 3

Part 3 of the Proposed Instrument sets out the audit committee composition requirements. Every audit committee must have a minimum of three members, and each member must be independent and financially literate. The Proposed Instrument does not, however, require an issuer to appoint an audit committee financial expert to its audit committee.[5]

The requirement that each audit committee member be independent lies at the heart of the Proposed Instrument. Subsection 1.4(1) provides that a member of an audit committee is independent if the member has no direct or indirect material relationship with the issuer. A material relationship is defined as a relationship that could, in the view of the issuer's board of directors, reasonably interfere with the exercise of a member's independent judgement. Subsection 1.4(3) identifies certain categories of persons that are considered to have a material relationship with the issuer.

For an audit committee member to competently discharge his or her duties, we believe that the member must be financially literate. Section 1.1 defines financial literacy as the ability to read and understand a set of financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of the issues that can reasonably be expected to be raised by the issuer's financial statements. An individual's financial literacy must therefore be determined in relation to the issuer in question.

Part 3 provides certain exemptions from the requirement that each audit committee member must be independent:

- *Initial Public Offerings* — section 3.2 provides exemptions for a period of up to one year following an issuer's initial public offering.

- *Controlled Companies* — section 3.3 provides an exemption for audit committee members who sit on the board of directors of affiliated entities of the issuer.

---

[4] The external auditors must generally be elected by, and report to, the shareholders. See, for example, section 162 of the *Canada Business Corporations Act* (Canada).

[5] But see section 5.1 of the Proposed Instrument and paragraph 3 of Form 51-110F1, which require an issuer to disclose whether it has an audit committee financial expert serving on its audit committee, and if not, why not.

- *Events Outside Member's Control* — section 3.4 provides that where an audit committee member ceases to be independent for reasons outside that member's reasonable control, the member may continue to sit on the audit committee until the later of (i) the next annual meeting and (ii) the date six months from the day the member ceased to be independent.

In addition, section 3.5 provides that where the death, disability or resignation of an audit committee member has resulted in a vacancy that the board of directors is required to fill, the member appointed to fill the vacancy is exempt from the independence and financial literacy requirements until the later of (i) the next annual meeting and (ii) the date six months from the day the vacancy was created.

Specific Request for Comment

1. Independence is defined in subsection 1.4(1) of the Proposed Instrument as the absence of a material relationship between the issuer and the director. Subsection 1.4(2) provides that a material relationship is one that that could, in the view of the board of directors, reasonably interfere with the exercise of a member's independent judgement. Do you consider this definition of independence appropriate?

2. Notwithstanding the definition of material relationship in subsection 1.4(2), subsection 1.4(3) deems certain categories of persons to have a material relationship with the issuer. As a result, these individuals are precluded from serving on the issuer's audit committee.

    (a) Do you think that the categories of precluded persons are appropriate? Are there other categories that should be added?

    (b) Certain of the categories reference a "cooling off" period (or a "prescribed period") of up to three years. Is this period appropriate? Is it too long? Too short?

    (c) Certain individuals may be precluded from serving on an audit committee as a result of their employment, or the employment of an immediate family member. Should these categories be restricted to individuals earning a minimum monetary amount (*e.g.*, $75,000)?

    (d) Some categories contained in subsection 1.4(3) were derived from U.S. legislation (*i.e.*, SOX), while others were based upon the listing requirements of the New York Stock Exchange. Do you believe that all of these categories should be incorporated into the Proposed Instrument, given their differing levels of authority in the United States?

3. Do you believe that the exemption in section 3.3 appropriately addresses the concerns of controlling shareholders?

4. Section 1.4 provides that a person who is an affiliated entity of the issuer is not independent of the issuer. Section 1.3 defines an "affiliated entity" in terms of its ability to control, or be controlled by, the issuer, and specifically includes a director of an affiliated entity who is also an employee of the affiliated entity. In light of this, do you believe that the exemption for controlled companies in section 3.3 is necessary?

5. In your view, does the definition of financial literacy provide sufficient guidance to allow an issuer to adequately assess a member's compliance with the Proposed Instrument?

6. The exemptions in sections 3.2, 3.4 and 3.5 are designed to address certain transitory circumstances where issuers may find it difficult to comply with the independence and, in some cases, the financial literacy requirements contained in the Proposed Instrument. Do you believe these exemptions are appropriate? Are there additional exemptions that you believe are necessary?

Part 4

Part 4 provides that every audit committee must be provided with the authority to engage and compensate independent counsel and other advisers which the committee determines are necessary to carry out its duties. Every audit committee must also have the authority to communicate directly with the internal and external auditors. In our view, these powers are essential to enable an independent audit committee to perform its role without reliance on management.

Part 5 and Form 52-110F1

Part 5 provides that an issuer must include in its AIF the information required by Form 52-110F1. Among other matters, Form 52-110F1 requires an issuer to disclose:

- the composition of its audit committee;
- whether an audit committee financial expert is serving on its audit committee;
- if it is relying on certain exemptions contained in the Proposed Instrument;
- if an audit committee recommendation regarding the nomination or compensation of the external auditors has not been adopted by the board of directors; and
- the service fees (by category) that the issuer has paid its external auditors.

If management of an issuer solicits proxies from the security holders of the issuer for the purpose of electing directors to the issuer's board of directors, the management information circular must also include a cross-reference to those sections in the issuer's AIF which contain the required audit committee disclosure.

Specific Request for Comment

1. An audit committee financial expert, with his or her enhanced level of financial sophistication and expertise, can serve as an important resource for the audit committee as a whole in carrying out its duties. However, because certain issuers may find it difficult to appoint audit committee financial experts to their audit committees, the Proposed Instrument does not require that every audit committee have an audit committee financial expert. Instead, paragraph 3 of Form 52-110F1 requires that an issuer disclose the identity of the audit committee financial expert(s), if any, that are serving on its audit committee. If the audit committee does not have an audit committee financial expert, an issuer must disclose that fact and explain why.

The disclosure required by Form 52-110F1 encourages issuers to appoint audit committee financial experts to their audit committees. It is not our intention that the designation of the audit committee financial expert should impose on that member any duties, obligations or liability that are greater than the duties, obligations and liability imposed on that member in the absence of the designation. Conversely, we do not intend that the designation of an audit committee financial expert should affect the duties and obligations of other audit committee members or the board of directors. Nevertheless, some concern has been expressed that merely identifying an individual as an audit committee financial expert may result in increased legal liability for that individual.

In light of the foregoing, do you believe this disclosure requirement is an appropriate alternative to requiring every audit committee to have an audit committee financial expert? Can you suggest other meaningful ways to encourage issuers to appoint audit committee financial experts to their audit committees?

2. Section 5.1 requires that an issuer include in its AIF the information required by Form 52-110F1. Do you think the AIF is the most appropriate location for this disclosure? If not, why not?

Part 6 and Form 52-110F2

An exemption for venture issuers is contained in Part 6. By creating this exemption, we are acknowledging that it may be difficult or impossible for many small issuers to comply with the independence and financial literacy requirements in the Proposed Instrument.

A venture issuer is defined in section 1.1 of the Proposed Instrument as an issuer that does not have any of its securities listed or quoted on any of the Toronto Stock Exchange, the New York Stock Exchange, the American Stock Exchange, the Nasdaq National Market, the Nasdaq SmallCap Market, the Pacific Exchange or a marketplace outside of Canada or the United States.

Part 6 exempts venture issuers from the Parts 3 (*Composition of the Audit Committee*) of the Proposed Instrument. Consequently, the members of a venture issuer's audit committee are not required to be either independent or financially literate. Venture issuers relying on this exemption are also exempt from Part 5 (*Disclosure Obligations*); however, venture issuers must provide, on an annual basis, the alternative disclosure required by Form 52-110F2. Among other matters, Form 52-110F2 requires a venture issuer to disclose:

- the composition of its audit committee and whether each member is (i) independent, and (ii) financially literate;
- if an audit committee recommendation regarding the nomination or compensation of the external auditors has not been adopted by the board of directors;
- the service fees (by category) that the venture issuer has paid its external auditors; and
- that the venture issuer is relying upon the exemption.

This disclosure must be provided in the venture issuer's management information circular or in its AIF or management's discussion and analysis.

Specific Request for Comment

1. Do you believe this exemption is appropriate? Should audit committee composition requirements (*e.g.,* independence, financial literacy) be imposed on venture issuers? If so, should these requirements be the same as for other issuers?

Part 7
Section 7.1 provides that an issuer whose securities are listed on a national securities exchange or listed in a automated inter-dealer quotation system of a national securities association registered pursuant to the 1934 Act is exempt from the requirements of the Proposed Instrument. The exemption is conditional upon compliance with U.S. audit committee requirements and, where applicable, the disclosure requirement in paragraph 5 of Form 52-110F1.[6]

Notwithstanding this exemption, Canadian investors should have access to disclosure regarding audit committees as a result of proposed National Instrument 51-102 *Continuous Disclosure Obligations*, which will require issuers registered with the SEC to make reciprocal filings with the appropriate Canadian securities regulatory authorities or regulators.

Part 8
Part 8 provides that the securities regulatory authority or regulator may grant an exemption from the Instrument.

Part 9
Part 9 sets out the effective date for the Proposed Instrument. The Proposed Instrument will only apply to issuers commencing on the earlier of (i) the first annual meeting of the issuer after January 1, 2004, and (ii) June 30, 2004.

Summary of the Proposed Policy
The purpose of the Proposed Policy is to provide information relating to how we intend to interpret and apply the Proposed Instrument. The Proposed Policy includes a discussion regarding

- the role of the audit committee,
- the meaning of independence,
- audit committee financial experts, and
- the pre-approval of certain non-audit services.

Authority for the Instrument – Ontario
In those Adopting Jurisdictions in which the Proposed Instrument is to be adopted or made as a rule or regulation, securities legislation provides the securities regulatory authority with rule-making or regulation-making authority regarding the subject matter of the Proposed Instrument.

---

[6] Some issuers relying on the exemption in Part 7 of the Proposed Instrument will be companies governed by Canadian corporate law. Because Canadian corporate law may not permit an audit committee to appoint, compensate or retain the issuer's external auditors, we believe that the issuer should disclose if the board of directors has not adopted a nomination or compensation recommendation of the audit committee. See paragraph 5 of Form 52-110F1.

Paragraph 143(1)57 of the *Securities Act* (Ontario) authorizes the Ontario Securities Commission to make rules requiring reporting issuers to appoint audit committees and prescribing requirements relating to the functioning and responsibilities of audit committees, including requirements in respect of the composition of audit committees and the qualifications of audit committee members, including independence requirements.

Related Instruments
The Proposed Instrument is related to proposed National Instrument *51-102 Continuous Disclosure Obligations* and National Instrument 71-102 *Continuous Disclosure and Other Exemptions Relating to Foreign Issuers*.

Anticipated Costs and Benefits
The anticipated costs and benefits of implementing the Proposed Instrument and Proposed Policy are discussed in the paper entitled *Investor Confidence Initiatives: A Cost Benefit Analysis*, which has been published together with this notice. The anticipated costs and benefits identified in that paper are incorporated by reference into this notice.

Alternatives Considered
As noted above, the Proposed Instrument is largely derived from the audit committee requirements currently being implemented in the United States. The U.S. requirements are being adopted to restore the public's faith in the U.S. capital markets. Because our markets are largely integrated with and affected by the U.S. markets, we determined it appropriate to propose similar requirements. We did consider proposing an instrument or policy which would contain less onerous requirements than those found in the Proposed Instrument; however, because an aim of the Proposed Instrument is to foster investor confidence in Canada's capital markets, we determined that it was necessary to propose requirements that are as robust as those proposed in the United States.

Reliance on Unpublished Studies, Etc.
In developing the Proposed Instrument, we did not rely upon any significant unpublished study, report or other written materials.

Comments
Interested parties are invited to make written submissions on the Proposed Instrument and Proposed Policy. Submissions received by September 25, 2003 will be considered. **Due to timing concerns, comments received after the deadline will not be considered.**

Submissions should be addressed to the following securities regulatory authorities:

Alberta Securities Commission
Saskatchewan Securities Commission
Manitoba Securities Commission
Ontario Securities Commission
Commission des valeurs mobilières du Québec
Nova Scotia Securities Commission
Securities Administration Branch, New Brunswick
Office of the Attorney General, Prince Edward Island
Securities Commission of Newfoundland and Labrador
Registrar of Securities, Government of Yukon
Registrar of Securities, Department of Justice, Government of the Northwest Territories

Registrar of Securities, Legal Registries Division, Department of Justice, Government of Nunavut

Please deliver your comments to the addresses below. Your comments will be distributed to the other participating CSA members.

John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
Suite 1900, Box 55
Toronto, Ontario M5H 3S8
Fax: (416) 593-2318
E-mail: jstevenson@osc.gov.on.ca

Denise Brosseau, Secretary
Commission des valeurs mobilières du Québec
Tour de la Bourse
800, square Victoria
C.P. 246, 22e étage
Montréal, Québec, H4Z 1G3
Fax: (514) 864-6381
E-mail: consultation-en-cours@cvmq.com

A diskette containing the submissions (in Windows format, preferably Word) should also be submitted.

Comment letters submitted in response to requests for comments are placed on the public file in certain jurisdictions and form part of the public record, unless confidentiality is requested. Comment letters will be circulated among the securities regulatory authorities, whether or not confidentiality is requested. Although comment letters requesting confidentiality will not be placed in the public file, freedom of information legislation in certain jurisdictions may require securities regulatory authorities in those jurisdictions to make comment letters available. Persons submitting comment letters should therefore be aware that the press and members of the public may be able to obtain access to any comment letters.

Questions may be referred to the following people:

Rick Whiler
Ontario Securities Commission
Telephone: (416) 593-8127
E-mail: rwhiler@osc.gov.on.ca

Michael Brown
Ontario Securities Commission
Telephone: (416) 593-8266
E-mail: mbrown@osc.gov.on.ca

Denise Hendrickson
Alberta Securities Commission
Telephone: (403) 297-2648
E-mail: denise.hendrickson@seccom.ab.ca

Fred Snell
Alberta Securities Commission
Telephone: (403) 297-6553
E-mail: fred.snell@seccom.ab.ca

Sylvie Anctil-Bavas,
Commission des valeurs mobilières du Québec
Telephone: (514) 940-2199 ext. 4556
E-mail: sylvie.anctil-bavas@cvmq.com

Frank Madder
Nova Scotia Securities Commission
Telephone: (902) 424-5343
E-mail: maderfa@gov.ns.ca

Richard Squires
Securities Commission of Newfoundland and Labrador
Telephone: (709) 729-4876
E-mail: rsquires@gov.nl.ca

Instrument. Forms and Policy
The text of the Proposed Instrument, Forms and Proposed Policy follow, together with footnotes that are not part of the Proposed Instrument, but have been included to provide background and explanation.

Dated: June 27, 2003