

Notice of Multilateral Instrument 52-110 Audit Committees

Multilateral Instrument 52-110 *Audit Committees*, Form 52-110F1, Form 52-110F2 (collectively, the Instrument) and Companion Policy 52-110CP *Audit Committees* (the Companion Policy) are initiatives of certain members of the Canadian Securities Administrators (the CSA or we).

The Instrument has been made, or is expected to be made, as:

- a rule in each of Québec, Alberta, Manitoba, Ontario, Nova Scotia and Newfoundland and Labrador,
- a Commission regulation in Saskatchewan and Nunavut,
- a policy in each of New Brunswick, Prince Edward Island and in the Yukon Territory, and
- a code in the Northwest Territories.

It is expected that the Companion Policy will be implemented as a policy in Québec, Alberta, Saskatchewan, Manitoba, Ontario, Nova Scotia, Newfoundland and Labrador, New Brunswick, Prince Edward Island, Nunavut, the Yukon Territory and the Northwest Territories.

We expect to implement the Instrument and Companion Policy on March 30, 2004.

In Ontario, the Instrument and other required materials were delivered to the Minister of Finance on January 14, 2004. The Minister may approve or reject the Instrument or return it for further consideration. If the Minister approves the Instrument or does not take any further action by March 15, 2004, the Instrument will come into force on March 30, 2004. The Companion Policy will come into force on the date that the Instrument comes into force.

In Québec, the Instrument is a regulation made under section 331.1 of *The Securities Act* (Québec) and must be approved, with or without amendment, by the Minister of Finance. The Instrument will come into force on the date of its publication in the *Gazette officielle du Québec* or on any later date specified in the regulation. It must also be published in the Bulletin.

In Alberta, the Instrument and other materials were delivered to the Minister of Revenue. The Minister may approve or reject the Instrument. Subject to Ministerial approval, the Instrument and Companion Policy will come into force on March 30, 2004. The Alberta Securities Commission will issue a separate notice advising of whether the Minister has approved or rejected the Instrument.

Background

In July of 2002, the *Sarbanes-Oxley Act of 2002 (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 Instrument, to address the issue of investor confidence and to maintain the reputation of our markets internationally. The 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 (the **SEC**) and listing requirements of the New York Stock Exchange and Nasdaq.

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

Substance and Purpose

The purpose of the 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.

The Instrument requires that every reporting issuer have an audit committee to which the issuer's external auditor must directly report. In addition, every audit committee must be responsible for:

- overseeing the work of the external auditor engaged for the purpose of preparing or issuing an audit report or related work;
- pre-approving all non-audit services to be provided to the issuer or its subsidiary entities by the issuer's external auditor; and
- reviewing the issuer's financial statements, MD&A, and annual and interim earnings press releases before they are publicly disclosed by the issuer.

Every audit committee must recommend to the board of directors the external auditor to be nominated for the purpose of preparing or issuing an auditor's report (or any related work), as well as the compensation to be paid to the external auditor.

The Instrument also establishes composition requirements for audit committees. Every audit committee must have a minimum of three members, and each member must be financially literate and independent. A member 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. In addition, certain categories of persons are considered to have a material relationship with the issuer.

The Instrument requires that every audit committee 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.

The Instrument exempts venture issuers from the requirements of Parts 3 (*Composition of the Audit Committee*) and 5 (*Reporting Obligations*) of the Instrument. As a result, the members of a venture issuer's audit committee are not required to be either independent or financially literate; however, venture issuers must provide, on an annual basis, the alternative disclosure required by Form 52-110F2.

The Instrument also contains an exemption for issuers who are U.S. listed issuers.

The Companion Policy provides interpretive guidance and other background information regarding the Instrument.

Summary of Written Comments Received by the CSA

The Instrument and the Companion Policy were published for comment on June 27, 2003. We have subsequently received submissions from 50 commenters. We have considered the comments received and thank all the commenters. The names of all the commenters are contained in Appendix A of this Notice.

Generally, the commenters were supportive of the Instrument and the Companion Policy, although many had comments on specific portions of the Instrument and Companion Policy. A summary of these comments is contained in Appendix B of this Notice, together with our responses to those comments.

Upon considering the comments, we made several revisions to the Instrument and the Companion Policy. Blacklined versions of these documents, which highlight all of the revisions that were made, are published as Appendix C of this Notice. We have not republished the Instrument and Companion Policy for comment, as we believe that the revisions do not constitute material changes to the Instrument or Companion Policy. In reaching this conclusion, we note that the fundamental purpose and approach of the Instrument remain unchanged, and that for the most part the revisions reflect either clarifications to the Instrument or certain additional exemptions to the Instrument that we do not believe materially alter the Instrument.

Summary of Changes

Set out below are noteworthy changes made to the Instrument and Companion Policy since those materials were published for comment on June 27, 2003.

1. Application of the Instrument

Section 1.2 has been revised so that the following classes of issuers will not be subject to the Instrument:

- (a) **SEC foreign issuers.** An “SEC foreign issuer” has the meaning set out in National Instrument 71-102 *Continuous Disclosure and Other Exemptions Relating to Foreign Issuers*.
- (b) **Exchangeable security issuers.** Issuers that are “exchangeable security issuers” are not subject to the Instrument, provided that they qualify for the relief contemplated by, and are in compliance with the requirements and conditions set out in, section 13.3 of National Instrument 51-102 *Continuous Disclosure Obligations*.
- (c) **Credit support issuers.** Issuers that are “credit support issuers” are not subject to the Instrument, provided that they qualify for the relief contemplated by, and are in compliance with the requirements and conditions set out in, section 13.4 of National Instrument 51-102 *Continuous Disclosure Obligations*.

In addition, the Companion Policy now incorporates additional guidance regarding the application of the Instrument to income trusts and other non-corporate entities.

2. Meaning of Independence

The meaning of independence has been revised to more closely parallel similar provisions in the U.S. We have also added guidance to the Companion Policy that discusses the origins of our definition of independence.

3. Audit Committee Responsibilities

Section 2.3 has been revised to clarify the audit committee’s responsibilities regarding the pre-approval of non-audit services.

- (a) **Pre-approval of non-audit services.** Subsection 2.3(4) of the Instrument has been revised to clarify that it is the provision of non-audit services by the issuer’s external auditors that must be pre-approved by the issuer’s audit committee, regardless of whether the non-audit services are provided to the issuer or a subsidiary entity of the issuer.

(b) Pre-approval policies and procedures. Section 2.6 now provides that an audit committee satisfies the pre-approval requirements in subsection 2.3(4) through the adoption of specific policies and procedures for the engagement of non-audit services. In addition, the Companion Policy now includes additional guidance regarding the development and application of such policies and procedures.

4. New Exemptions from the Composition Requirements

Part 3 of the Instrument has been amended by the addition of certain exemptions.

(a) New exemption for controlled companies. To accommodate controlling shareholders, we have added an additional exemption to section 3.3 of the Instrument. The new exemption exempts an audit committee member from the independence requirements where:

- (i) the member would be independent, but for his or her status as an “affiliated entity”;
- (ii) the member is not an executive officer, general partner or managing member of a publicly traded affiliated entity, or an immediate family member of such a person;
- (iii) the member does not act as the chair of the audit committee; and
- (iv) the board determines in its reasonable judgement that
 - (A) the member is able to exercise the impartial judgement necessary for the member to fulfill his or her responsibilities as an audit committee member, and
 - (B) the appointment of the member is required by the best interests of the issuer and its shareholders.

The exemption is not available to a member unless a majority of the audit committee members will be independent. When an audit committee member relies on this exemption, the issuer must make certain disclosure. See Item 5 of Form 52-110F1.

(b) Temporary exemption for limited and exceptional circumstances. A new exemption has been added to the Instrument as section 3.6. It provides an exemption from the independence requirements for a period of up to two years, provided that

- (i) the member is not an individual described in paragraphs 1.4(3)(f)(i) or 1.4(3)(g) of the Instrument.
- (ii) the member is not an employee or officer of the issuer, or an immediate family member of such a person;

- (iii) the board, under exceptional and limited circumstances, determines in its reasonable judgement that
 - (A) the member is able to exercise the impartial judgement necessary for the member to fulfill his or her responsibilities as an audit committee member, and
 - (B) the appointment of the member is required by the best interests of the issuer and its shareholders; and
- (iv) the member does not act as the chair of the audit committee.

The exemption is not available to a member unless a majority of the audit committee members will be independent. When an audit committee member relies on this exemption, the issuer must make certain disclosure. See Item 5 of Form 52-110F1.

(c) **Financial literacy.** Section 3.8 has been added to the Instrument to clarify that an audit committee member who is not financially literate at the time of his or her appointment to the audit committee will be permitted a reasonable amount of time in which to become financially literate. However, where this provision is relied upon, Form 52-110F1 now requires an issuer to disclose the name of the member in question and the date by which the member expects to become financially literate.

5. **Restriction on Use of Certain Exemptions**

As previously published, Form 52-110F1 required issuers that relied upon certain exemptions contained in the Instrument to disclose an assessment of whether, and if so, how, such reliance could materially adversely affect the ability of the audit committee to satisfy the other requirements of the Instrument. Upon reflection, we recognized that this disclosure requirement would act as a *de facto* condition to the use of the exemption, and that such a provision should more appropriately be included in the Instrument. This provision has therefore been added as section 3.9 of the Instrument.

6. **Disclosure Regarding Audit Committee Financial Experts**

The Instrument no longer requires an issuer to disclose whether or not an audit committee financial expert is serving on its audit committee. Instead, issuers are required to describe, for each member of the audit committee, that member's education and experience that relate to his or her responsibilities as an audit committee member (see Item 3 of Form 52-110F1). Guidance regarding the application of this disclosure requirement has been included in the Companion Policy.

7. Exemption for U.S. Listed Issuers

The conditions applicable to the exemption for U.S. listed issuers in section 7.1 has been revised to clarify that

- an issuer using the exemption must be in compliance with the requirements of the U.S. marketplace applicable to issuers other than foreign private issuers, and
- only issuers incorporated, continued or otherwise organized in Canada must comply with the AIF disclosure requirement in clause 7.1(b).

8. Effective Date and Transition

The effective date of the Instrument is March 30, 2004. However, it will not apply to issuers until the earlier of

- (a) the first annual meeting of the issuer after July 1, 2004, and
- (b) July 1, 2005.

9. Audit committee procedures

The Companion Policy has been revised to clarify that nothing in the Instrument is intended to restrict the ability of the board of directors or the audit committee to establish the audit committee's quorum or procedures, nor to restrict the committee's ability to invite additional parties to attend audit committee meetings.

Authority for the Instrument – Ontario

In those jurisdictions in which the 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 Instrument.

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 Instrument is related to 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 Instrument and the Companion Policy are discussed in the paper entitled, *Investor Confidence Initiatives: A Cost-Benefit Analysis* (the Cost-Benefit Analysis), which was published on June 27, 2003. A response to comments received on the Cost-Benefit Analysis has been published together with this Notice, and is incorporated by reference into this Notice.

Alternatives Considered

As noted above, the 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 Instrument; however, because an aim of the 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 Instrument, we did not rely upon any significant unpublished study, report or other written materials.

Questions

Questions regarding the Instrument and Companion Policy 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 Mader
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 and Companion Policy

The text of the Instrument and Companion Policy follows.

DATED: January 16, 2004.

APPENDIX A

LIST OF COMMENTERS

The Advisory Group on Corporate Responsibility Review
Agrium Inc.
Association for Investment Management and Research
Association of Chartered Certified Accountants
Automodular Corporation
BDO Dunwoody LLP
Jean Bédard
Bennett Jones LLP
Blake, Cassels & Graydon LLP
British Columbia Securities Commission
Canadian Bankers Association
Canadian Council of Chief Executives
The Canadian Institute of Chartered Accountants
Canadian Oil Sands Trust
Canadian Pacific Railway Limited
Certified General Accountants Association of Canada
Davies Ward Phillips & Vineberg LLP
Deloitte & Touche LLP
EnCana Corporation
Ernst & Young LLP
Fasken Martineau
Joel Fried
Grant Thornton LLP
Imperial Oil Limited
Institute of Corporate Directors
Institute of Internal Auditors
KPMG LLP
Leon's Furniture Limited
MacPherson Leslie & Tyerman LLP
Mendelsohn
Robert W. A. Nicholls and Robert F.K. Mason
Ontario Teachers' Pension Plan Board
Ogilvy Renault
Osler, Hoskin & Harcourt LLP
Power Corporation of Canada
PricewaterhouseCoopers LLP
Raymond Chabot Grant Thornton
Thomas P. Reilly
Simon Romano
Stephen D. Rotz
Harry G. Schaefer
Sears Canada Inc.

Shoppers Drug Mart Corporation
Talisman Energy Inc.
TELUS Corporation
TransCanada Corporation
TransCanada Power,L.P.
Torys LLP
TSX Group
Winpak Ltd.

L:\Projects\Corp_Fin\Sarbanes_Oxley\Audit Committee\Final Materials January 2004\Final notice re audit cmmtee (January 8 2004).doc