



ASSOCIATION FOR  
INVESTMENT MANAGEMENT  
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6 November 2003

John Stevenson, Secretary  
Ontario Securities Commission  
20 Queen Street West  
Suite 1900, Box 55  
Toronto, Ontario M5H 3S8

Denise Brosseau, Secretary  
Commission des valeurs mobilières du Québec  
Tour de la Bourse  
C.O. 246, 22e étage  
Montreal, Québec  
H4Z 1G3

**Re: Multilateral Instrument 52-110—Audit Committees**

Dear Mr. Stevenson and Ms. Brosseau:

The Canadian Advocacy Committee (CAC) of the Association for Investment Management and Research (AIMR)<sup>1</sup> is pleased to respond to the request for comments on the Canadian Securities Administrators' (CSA) Multilateral Instrument 52-110, *Audit Committees* (Proposal). The CAC represents members of AIMR and its eleven Member Societies and Chapters across Canada. The CAC membership includes portfolio managers and other investment professionals in Canada who review regulatory, legislative, and standard setting developments affecting investors, investment professionals, and the capital markets in Canada.

**Summary Position**

We believe that a company's audit committee fulfills an important role in serving as a type of "watchdog" for irregularities and potential improprieties in the financial reporting process. In addition, the role of the committee to oversee the relationship between an issuer and its external auditor helps to ameliorate conflicts of interest that may arise in this relationship. Thus, we strongly support the requirements in this Proposal that audit committee members be independent

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<sup>1</sup> With headquarters in Charlottesville, VA, and regional office in Hong Kong and London, the Association for Investment Management and Research<sup>®</sup> is a non-profit professional organization of more than 67,200 financial analysts, portfolio managers, and other investment professionals in 116 countries of which 54,940 are holders of the Chartered Financial Analyst<sup>®</sup> (CFA<sup>®</sup>) designation. AIMR's membership also includes 127 affiliated societies and chapters in 46 countries.

and financially literate. We believe that such requirements are responsive to current concerns about a company's internal review processes and general issues of investor confidence.

Accordingly, we also support the proposed provisions that would require an issuer to disclose whether it has appointed a financial expert to its audit committee, and if not, why not. As discussed below, we believe that those holding the CFA designation meet, in spirit and intent, the requirements of a financial expert. AIMR formally requests that the CSA officially recognize CFA charterholders as meeting such requirements for purposes of this Proposal.

## **Discussion**

### ***Independence Requirements***

Under the Proposal, each member of the audit committee must be independent and "financially literate". We agree with both conditions, which lie at the heart of this Proposal. Although there is no express discussion in the Proposal of who at the issuer is responsible for making this determination, we presume and urge that this be explicitly delegated to the *independent* directors of the board. We recommend that the CSA provide clarification of this responsibility in the final rule.

### ***Purview of Committee***

Part 2 of the Proposal gives the audit committee three primary responsibilities:

- Overseeing the work of the external auditors that are engaged to prepare or issue an audit report or related work;
- 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; and
- Reviewing the issuer's financial statements, MD&A and earnings press releases before they are publicly disclosed by the issuer.

We agree that these three areas, as well as the other responsibilities listed in Part 2 of the Proposal are appropriate. We recommend, however, that the final rule provide other examples of areas that fall within the audit committee's purview, including, for example, the review of executive expense accounts.

### *Financial Expert*

Among other things, Part 5 of the Proposal requires an issuer to disclose whether or not a “financial expert” is a member of its audit committee. As the Proposal recognizes, some issuers may have difficulty finding qualified financial experts to serve, in light of the definition of “audit committee financial expert”. While we believe that the existence of a financial expert enhances the audit committee’s ability to adequately perform its job, we do not disagree with the approach to require disclosure of, rather than mandate the existence of, a financial expert on an audit committee. We believe it is necessary when there is not an “audit committee financial expert” that issuers disclose the reason for this lack.

We also agree that a financial expert should bring more than specific experience or qualifications to the work of the audit committee. Companion Policy 52-110CP notes that in addition to determining that a person possesses an adequate degree of knowledge and experience to qualify as a financial expert, “an issuer should also ensure that the candidate embodies the highest standards of personal and professional integrity.” We wholeheartedly support this additional qualification.

### *Recognition of CFA Charterholders as Financial Experts*

We believe that a strict reading of the requisite experience/expertise required under the Proposal may well overly limit the pool of candidates, and overlook individuals who bring exactly the type of analytical skills and professional expertise that Multilateral Instrument 52-110 seeks to have in audit committee deliberations. Accordingly, given the emphasis on high ethical standards, along with the role the financial expert is intended to serve, we formally request that the CSA explicitly recognize those holding the Chartered Financial Analyst® (CFA®) designation as meeting the standard of financial expert.

We can appreciate the CSA’s reluctance to create a “bright-line” test for defining financial expert where only certain professions or designations are named. We believe, however, that providing examples of who would qualify will provide additional and helpful guidance to the board of directors in making its determination, and will likely result in a broader range of people serving in this capacity.

In particular, we note the following elements to be considered by the Board of Directors in considering whether an individual possesses the requisite characteristics to qualify as a financial expert, and their relevance to the experience and expertise that CFA charterholders offer:

- An understanding of financial statements and the accounting principles used by the issuer to prepare its financial statements;
- The ability to assess the general application of accounting principles in connection with the accounting for estimates, accruals and reserves;

- Experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issue that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the issuer's financial statements, or experience actively supervising one or more persons engaged in such activities;
- An understanding of internal controls and procedures for financial reporting; and
- An understanding of audit committee functions.

We strongly believe that the CFA examination program addresses all components of the financial expert definition contained in this proposal. By the time one is awarded the CFA designation, he or she has mastered the fundamentals of financial analysis, including generally accepted accounting principles, and financial statements. This mastery requires the ability to apply accounting principles and analyze financial statements that include, for example, accounting estimates, accruals, and reserves. Through the CFA examination program, the CFA charterholder also learns to ask the "hard" questions when conducting financial analysis; part of the training involves developing an approach where financial presentations are not accepted at face value, but must be supported through solid and valid analysis that the information being presented fairly presents the financial condition of the company.

In order to be considered for the CFA designation, a candidate must have accrued at least three years of acceptable professional experience in financial analysis, investment management, securities analysis, and other similar areas. To obtain the CFA designation, a candidate in the program must pass a rigorous series of exams on a broad spectrum of subjects relevant to the knowledge required of a financial expert under this proposal. Included in the range of subjects that must be mastered before award of the charter are:

- Ethical and professional standards;
- Economics;
- Financial statement analysis;
- Analysis of equity investments;
- Analysis of debt investments;
- Analysis of derivatives;
- Quantitative methods; and
- Analysis of alternative investments.

Moreover, other regulatory areas, such as fiduciary duties, disclosures of conflicts, personal trading, misrepresentations, insider trading, suitability of investments, supervisory responsibility and trade allocation are all tested repeatedly at each of the three levels of the CFA exam.

A fuller description of the CFA examination program and requirements for obtaining the CFA designation is provided in *Attachment A* to this letter.

In addition to possessing the knowledge that qualifies charterholders as financial experts, the CFA charterholder brings an additional commitment to high ethical standards that is central to addressing the concerns giving rise to this Proposal. The CFA examination program tests an individual's ability to apply knowledge of applicable laws and regulations, as well as the AIMR *Code of Ethics* and *Standards of Professional Conduct* (*Code* and *Standards*) to recognize and avoid unprofessional practice and violations of standards where issues may not be clear (e.g., conflicts of interest, compensation, inside information, corporate governance, proxies, and the "prudent expert rule").

To remain in good standing and retain the right to use the CFA designation, charterholders must comply with the AIMR *Code* and *Standards* in their day-to-day practice in the investment industry, or risk losing their charter. As a rule, charterholders must attest annually in writing to compliance with this strict *Code* and *Standards*. Sanctions for failure to report and for non-compliance with the *Code* and *Standards* include reprimands, suspensions, and revocation of the right to use the CFA designation and AIMR membership.

We urge the CSA to explicitly recognize groups and designations that fully meet, both in terms of substance and spirit, the financial expert definition. Otherwise, we fear that issuers will hesitate to consider well-qualified individuals for fear that, judged in hindsight, their selection may be called into question. While leaving the discretion to the Board of Directions to make its determinations in accordance with the factors outlined in the Proposal's definition, we thus encourage the CSA to include in its final rule examples of specific groups or designations that should be acceptable determinations.

### ***Venture Issuer Exemption***

Under the Proposal, audit committees of venture issuers would not have to comply with the independence and financial literacy requirements, as well as the Part 5 disclosure requirements. We question this decision. We understand that certain companies may experience more difficulty than others in creating a fully independent audit committee. However, given the significant role that impartiality plays in audit committee decision making, we believe that at least a majority of audit committee members should be independent. We also recommend that venture issuers be required to honor the same disclosure requirements that are applicable to other issuers.

## Conclusion

We generally agree with the proposed measures that require audit committees to have members that are independent and financially literate. We also agree with the provision that would require issuers to disclose whether a financial expert serves on the committee. As discussed above, we encourage the CSA to note in its final rule designations of professions that generally would meet the criteria set forth in the definition, and that qualify as acceptable experts. Specifically, we believe that the CFA designation is precisely the type of designation that embodies the elements that meet in substance and spirit the purpose of having a financial expert on the audit committee.

We appreciate the opportunity to comment on the Canadian Securities Administrators Notice of Proposed Multilateral Instrument 52-110, *Audit Committees*. If we can provide additional information, please do not hesitate to contact David Yu at 416.597.5416, [davidyu.cfa@sympatico.ca](mailto:davidyu.cfa@sympatico.ca), or Linda Rittenhouse at 434.951.5333, [linda.rittenhouse@aimr.org](mailto:linda.rittenhouse@aimr.org).

Sincerely,

*/s/ David L. Yu*

David L. Yu, CFA  
Canadian Advocacy Committee Co-Chair

*/s/ Linda L. Rittenhouse*

Linda L. Rittenhouse  
AIMR Advocacy

Cc: Canadian Advocacy Committee  
Rebecca T. McEnally, Ph.D., CFA – Vice President, AIMR Advocacy

**Attachment A to AIMR Letter to CSA  
Proposed Multilateral Instrument 52-110  
Audit Committees**

**Discussion of CFA Examination Program**

A. Overview of the CFA Program

The CFA Program, which is developed and administered by AIMR, seeks to represent to the investing public, employers, and fellow investment professionals that a holder of the CFA designation possesses the fundamental knowledge and commits to adhere to ethical standards necessary to practice in the investment and securities profession. Accordingly, in order to obtain the CFA designation, a candidate must pass a rigorous series of exams designed to test the CFA candidate on a broad spectrum of subjects that are essential to the competent and ethical practice of investment management activities. These subjects include:

- Ethical and professional standards;
- Quantitative methods;
- Economics;
- Financial statement analysis;
- Corporate finance;
- Analysis of equity investments;
- Analysis of debt investments;
- Analysis of derivatives;
- Analysis of alternative investments; and
- Portfolio management.

Today, the CFA designation is a credential recognized throughout the world as signifying the highest achievement in the investment profession. Since the first CFA designation was awarded in 1963, more than 61,700 professionals have become CFA charterholders.

Each year, the number of candidates who take the CFA exams continues to grow. Over 136,000 candidates from 165 countries enrolled for the 2003 CFA Exam. In the United States alone, over 35,200 individuals have received the CFA designation. The dramatic growth in the number of candidates pays tribute to the value investment professionals place on the CFA Program and their desire to achieve and maintain the highest standards of professional excellence and integrity.

In order to be awarded the CFA designation, a candidate must fully satisfy the program's requirements in three primary areas. First, a candidate must demonstrate comprehensive knowledge of securities analysis and valuation, and investment and portfolio management by sequentially passing a series of rigorous examinations that are administered over a minimum of three years—the Level I, Level II and Level III examinations. Second, the candidate must have

accrued at least three years of acceptable professional experience in financial analysis, investment management, securities analysis and other similar professions. Third, a candidate must agree to comply with a stringent code of ethical and professional standards—the *AIMR Code of Ethics and Standards of Professional Conduct*.

## B. CFA Examinations

### *(a) Competency*

The CFA program is designed so that, by the time a charter is awarded, the CFA charterholder has not only mastered the basic competency areas, but has a substantial breadth of investment knowledge. Unlike other designations, the CFA program is not solely academic. A candidate will not receive the CFA designation until he/she has at least three years of relevant experience in the investment profession. The exam's focus on practical applications of investment management and financial analysis, coupled with practical experience in these fields, allows the CFA charterholder to *apply* his/her education in a meaningful manner. Thus, the process of becoming a CFA charterholder demands a candidate demonstrate broad, substantive knowledge and understanding of all aspects of the investment profession.

### *(b) Requirements of the CFA Examination Program*

To be awarded the CFA designation, a candidate must pass three comprehensive examinations – Level I, Level II and Level III. Each Level exam is administered once a year. Given the degree of difficulty of the exams, candidates do not always pass the exams in successive years. Examination pass rates have varied over time and across exam levels. For example, over the entire history of the examinations, the average pass rate has been 52% for Level I, 55% for Level II, and 69% for Level III. In 2003, the pass rate was 42% for Level I candidates, 47% for Level II candidates, and 68% for Level III candidates.

#### *(i) Sitting for the Exam*

To enroll and sit for the CFA exam, an applicant must, in addition to other requirements: (i) have a bachelor's degree or the equivalent in qualified investment work experience; and (ii) complete an AIMR professional-conduct inquiry form demonstrating that the individual understands, maintains, and adheres to the *AIMR Code and Standards* and that he/she has not been convicted of any felony or, within the last ten years, a misdemeanor for a crime of moral turpitude (e.g., lying, cheating, stealing).

Each exam is prepared at AIMR in conformity with industry testing standards and “best practices.” Exams are printed under secure conditions, sealed prior to delivery, and stored in a locked and access-controlled storage area until distributed to candidates at the exam. Exam site supervisors and proctors ensure the integrity of the testing process in accordance with the AIMR “Security Controls and Procedures” manual specifically prepared for the AIMR CFA Program by security experts.

*(ii) Content – The Candidate’s “Body of Knowledge”*

All three levels of the CFA exam require the candidate to demonstrate a thorough understanding of, and the ability to apply, a substantial amount of information on a broad range of topics. Since the CFA curriculum is grounded in the practice of investment analysis, valuation, and management, AIMR periodically conducts a “job analysis” by surveying CFA charterholders throughout the world on the “elements of the body of investment knowledge” that are most important in their practice. These survey results are the foundation for the development and maintenance of the CFA “Candidate Body of Knowledge” (“CBOK<sup>®</sup>”) and help determine the appropriate emphasis each subject matter receives on the examination.

The CBOK is the basis of the CFA exam curriculum. Each of the three levels of the exam tests candidates on their knowledge of specific subjects contained within the CBOK. It is organized along functional lines to track changes in the investment decision-making process and is updated regularly.

The major functional areas of the CBOK are:

- ethical and professional standards;
- tools and inputs for investment valuation and management (investment tools);
- asset valuation; and
- portfolio management.

*(iii) Selection of Questions*

Questions for the Level I exam are written by AIMR professional staff and selected consultants and reviewed by both domestic and global charterholders. Questions for the Level II and III exams are written by an AIMR standing committee called the “Council of Examiners” (COE). The COE consists of prominent practitioners and academicians, all CFA charterholders. In writing questions, the COE uses learning outcome statements (“LOS”) developed by another AIMR standing committee, the “Candidate Curriculum Committee” (CCC). The CCC, also composed of CFA charterholders, selects the appropriate texts and readings to address the topics in the CBOK, which the candidate will use in studying for the exam. LOS are provided for each assigned reading and indicate the specificity and level of knowledge that is expected for each topic area. The COE writes the exam questions to test the specific “learning outcomes” designed for each reading. All exam questions are reviewed externally, both domestically and globally. In addition, all exam questions are subject to external post-exam analysis of psychometric characteristics.

*(iv) Candidate Preparation*

In order to prepare for each level of the CFA exam, a candidate receives a Study Guide that provides basic information on the CFA program, organizes the assigned readings into separate “study sessions”, and provides the required reading list for the relevant level exam. Primary Readings are the core of the study program and form the basis for exam questions. For the 2004 exams, the required textbook readings consist of ten sources for Level I, thirteen sources for Level II, and nine sources for Level III; these textbooks are supplemented at all three levels by a variety of articles, readings, monographs, and selected textbook chapters. In addition, the Study Guides provide lists of suggested Preliminary Readings and Supplementary Readings on specific study topics. As noted above, each Study Guide also provides LOS or “expected learning outcomes,” which indicate the level of knowledge a candidate should demonstrate with respect to each reading, as well as the relevant CBOK that the candidate is expected to master. Each level exam requires an average of over 250 hours of individual study time.

*(v) Grading*

The CFA Level I exam is a multiple-choice exam and is scored by computer. The format of both the Level II and Level III CFA exams consists of 50% “item set” questions and 50% essay/short answer questions that are assigned maximum point values based on the number of minutes allocated to the question. Item set questions are also scored by computer. The essay/short answer questions on both Level II and Level III exams are graded by a carefully selected group of approximately 650 CFA charterholders from around the world who are practitioners or academics. Each grader is assigned to a grading team that grades a single question which helps to ensure consistency in grading and allows each grader a greater degree of specialization.

Each exam question is graded in accordance with a guideline answer and grading key that are developed by the Council of Examiners and members of AIMR senior professional staff. Each grading team captain receives statistical reports and audit results during grading about the work of his/her team to ensure that grading is done consistently and in accordance with the grading key. Senior graders re-grade marginal exams in their entirety during the second week of grading.

The AIMR Board of Governors determines the “minimum passing score” (MPS) for each level of the exam. The goal of the Board of Governors in determining the appropriate MPS for each level is to maintain the integrity of the CFA charter. With that goal in mind, the Board considers, among other factors

- The top-scoring exam responses as an indication of the difficulty of the examinations;
- Recommendations from a panel of CFA charterholders who review the examinations and the quality of candidate responses (Level I only)
- Feedback from those involved in the grading process on the examinations and the quality of candidate responses; and

- Actual candidate responses in papers above and below the minimum passing scores (Levels II and III only).

### Level I Examination – Knowledge and Comprehension

The CFA Level I exam is the foundation for the CFA program, focusing on ethical practices and the tools and concepts that apply to investment valuation and management. It also provides an overview of asset valuation and portfolio management. This six-hour exam concentrates on:

- ethical and professional standards;
- investment tools;
  - quantitative analysis/techniques
  - macro- and micro-economics
  - financial statement analysis
  - corporate finance;
- asset valuation (equity, fixed income, derivatives, and alternative investments); and
- portfolio management.

### Level II Examination – Analysis and Application

The Level II CFA exam builds on the breadth of knowledge obtained from the Level I exam and emphasizes asset valuation, including applications of the tools and inputs (economics, financial statement analysis and quantitative techniques) to the practice of asset valuation. Specifically, the Level II CFA exam tests a candidate's ability to:

- analyze and value debt, equity, and derivative securities and recommend those with the most (or least) attractive expected return/risk characteristics for purchase (or sale);
- apply a top-down valuation approach based on global trends, national economies, industry- and company-specific factors and individual assets characteristics;
- apply an alternative (bottom-up) valuation approach based on the identification of those companies and industries/sectors that are undervalued regardless of the macroeconomics forecast;
- use a variety of valuation techniques and the duPont approach to financial analysis;
- incorporate international factors in asset valuations; and

- apply a knowledge of applicable laws and regulations and the AIMR *Code and Standards* to recognize and avoid unprofessional practices and violations of standards where issues are not clear (e.g., conflicts of interest, compensation, inside information, corporate governance, proxies, and the “prudent expert rule”).

### Level III Examination – Synthesis and Evaluation

The Level III CFA exam emphasizes portfolio management, including strategies for applying the tools and inputs in managing equity and fixed-income securities. Specifically, the Level III CFA exam tests a candidate’s ability to:

- develop suitable investment policies that meet the specific requirements and circumstances of different types of individual and institutional investors;
- incorporate domestic and international economic forecasts and market conditions into portfolio investment strategies;
- determine asset allocations that are consistent with investment policies and strategies;
- implement portfolio strategies that take into consideration the costs and benefits of timely execution of trades;
- monitor and evaluate portfolio performance and respond to change; and
- design and administer a program of professional and ethical standards within an organization.

Critical regulatory topics, such as fiduciary duty, misrepresentation, disclosure of conflicts, personal trading, insider trading, performance presentation, use of soft dollars, suitability of investments, supervisory responsibility and trade allocation are all tested repeatedly at each level of the CFA exam.

A Level I candidate is expected to demonstrate a thorough knowledge of these topics. Candidates at Level II are expected to differentiate between acceptable behavior in these subject areas and conduct that violates best practices. At Level III, candidates are expected to be able to critique and revise compliance guidelines and policy statements with regard to these subjects. By the time the candidate has completed the CFA Program, he or she is well versed in those subject areas and in the professional practices involved in the investment-decision making process that are subject to intense regulatory scrutiny.

### C. Relevant Work Experience

Successfully completing all three levels of the CFA exam is a major part of achieving the CFA designation. However, to become a CFA charterholder, a candidate must also have three years of acceptable professional work experience in financial analysis, investment management, securities analysis, or similar areas. This work may be accrued before or during the study and

examination period or after completion of all three level exams. Moreover, work experience that will qualify for the eventual award of the CFA charter must consist of activities substantially related to the investment decision-making process, the supervision of those who engage in such activities, or the teaching of such activities.