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The Association of Canadian Pension Management

L'Association canadienne des administrateurs de régimes de retraite



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ACPM Response to Pension Plan Investment in Canada: The 30 Per Cent Rule

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FOREWORD

ACPM (THE ASSOCIATION OF CANADIAN PENSION MANAGEMENT)

ACPM (The Association of Canadian Pension Management) is a national, non-profit organization acting as the informed voice of plan sponsors, administrators and their service providers in advocating for improvement to the Canadian retirement income system. Our membership represents over 400 companies and retirement income plans that cover more than 3 million plan members.

ACPM believes in the following principles as the basis for its policy development in support of an effective and sustainable Canadian retirement income system:

Diversification through Voluntary / Mandatory and Public / Private Options

Canada's retirement income system should be comprised of an appropriate mix of voluntary Third Pillar and mandatory First and Second Pillar components.

Third Pillar Coverage

Third Pillar retirement income plan coverage should be encouraged and play a meaningful ongoing role in Canada's retirement income system.

Adequacy and Security

The components of Canada's retirement income system should collectively enable Canadians to receive adequate and secure retirement incomes.

Affordability

The components of Canada's retirement income system should be affordable for both employers and employees.

Innovation in Plan Design

Canada's retirement income system should encourage and permit innovation in Third Pillar plan design.

Adaptability

Canada's retirement income system should be able to adapt to changing circumstances without the need for comprehensive legislative change.

Harmonization

Canada's pension legislation should be harmonized.

INTRODUCTION

ACPM welcomes the opportunity to provide submissions to the Department of Finance in respect of its consultation document entitled “Pension Plan Investment in Canada: The 30 Per Cent Rule” (the “Document”). The Document raises ten “consultation questions”, as well as adverting to other issues that may usefully be addressed. Some of the questions raise related points to address. At the risk of repetition of certain of our responses, we have structured this submission to be responsive to the various sets of consultation questions raised, and certain other issues, rather than provide a single integrated response to the entire Document. The following are the ACPM submissions:

Prudential Considerations¹

1. Does the philosophy that plan administrators should act as passive investors continue to be valid. If not, why?

No, this does not continue to be valid – if it ever was. Market structures have changed and, for a large pension funds to be properly diversified so as to reduce risk, investments in the private equity and infrastructure space are appropriate and warranted. Depending on the nature, structure and/or size of the investment, it may not be appropriate for a pension fund to be passively invested in this space if they are to obtain an appropriate return on their investment. The argument that pension plans are meant to be passive investors is highly questionable and potentially detrimental to the interests of pension plan beneficiaries. We note that Canadian pension plans have been recognized as global leaders in this space (the “Maple Revolutionaries” as per The Economist) and are a model for pension plans across the globe.

2. What are the benefits and risks of pension plans taking on a dual role of providing benefits to members and taking an active role in the operations of a business?

This question assumes the provision of benefits and managing investments are not linked. A key ingredient in managing pension liabilities and thus ensuring benefit security and sustainability is an investment policy and asset mix appropriate for the plan’s liabilities and risk tolerances. As noted in the answer to No. 1 above, a properly diversified portfolio may include private equity and infrastructure investments. Taking an active role in overseeing such investments is thus not inconsistent with a plan’s obligations to provide benefits.

3. Are the prudent person and other PBSA standards sufficient to offset potential risks involved in pension plans acquiring a controlling stake in a corporation?

The prudent person requires plans to invest appropriately for the fund. There is a wide array of risk and liability profiles for pension funds. The governors of such funds should be able to pick the investments and the extent and oversight of such investments as may be warranted for the plan and its risk tolerances, consistent with their overall fiduciary obligations to act in the interests of the beneficiaries.

¹ Document, page 5; 4 questions identified

The prudent person rule provides the required level of flexibility, but tempered with the requirement that appropriate governance controls be in place to provide sufficient oversight and to ensure decisions to invest and the extent of that investment are properly made.

4. If a pension plan's investment exceeds a certain threshold, should the plan be subject to additional requirements? If so, what should those requirements consist of and what would be the appropriate threshold?

There is currently no restriction or additional requirements imposed on a pension plan holding more than 30% of the economic value of an entity (provided it holds less than 30% of the director voting interest). Thus any restrictions or additional requirements imposed on a pension plan having a commensurate level of voting interest have the potential of limiting a pension plan's ability to properly manage risks associate with such investment. Such requirements are not necessary.

Investment Performance²

5. Does the 30 per cent rule (the "30% Rule") impede pension administrators from obtaining appropriate investment returns? If so, why?

In the context of an over-arching "prudent investor standard", the additional restriction imposed on pension fund investors by the 30% Rule needlessly inhibits pension plan administrators in the search for appropriate investment returns. While "workaround" solutions have been and continue to be developed, the 30% Rule itself either prevents otherwise prudent investments, or necessitates such workarounds that reduce investment efficiency.

The Document states that the 30% Rule was originally established based on the presumption that pension funds should only be passive investors, and that such investors needed to be insulated from potential losses should a controlled business fail. However, that logic now appears tenuous, and its results for Canadian pension fund investors suboptimal, on the basis that:

- the assumption that pension administrators would actually take an active, day-to-day interest in the running of an acquired business – as opposed to appointing qualified directors to run the business on their behalf – is a dubious one at best. An active investor wants to be able to ensure that the board maintains the direction anticipated at the time that the company interest was acquired and ensure that the assumptions on which the investment was made are brought to fruition. This is contrasted with the desire to make the day-to-day decisions regarding operations and tactics that would be expected of a management team;
- a 2008 study co-authored by researchers from Brunel University and the OECD³ studied investment regulation of pension funds and compared the performance of Canadian funds to

² Document, page 6; 3 questions identified

³ Davis and Hu, *Are Canadian Pension Plans Disadvantaged by the Current Structure of Portfolio Regulation?*; March 25, 2008

that of those in the US and UK. The study concluded that “although Canadian funds often obtain better returns and risks, these are often less than could be obtained given financial market conditions. In contrast, UK and US funds often outperform benchmarks. Although the differences we identify may seem small, they cumulate strongly over time.” Ultimately, the authors argued that the data supports removal of quantitative restrictions such as the 30% Rule and replacement solely with the prudent investment standard;

- a permissible investment of 10% of a pension fund in one passive investment may create a greater risk of financial loss than another investment with greater than a 30% voting interest, were the 30% Rule not in place. The risk of exposure to business failure is more likely to be better managed where the investor has the ability to exert direct control in appropriate circumstances to protect its investment;
- a significant number of pension fund investors in Canada have grown to become large, sophisticated investment organizations. This development has occurred as the size, liability structure and complexity of the associated plans and their regulatory environments have also grown. To assume such organizations need to be “protected” from investment losses by imposition of the 30% Rule is outdated, not evidence based, and could be seen as paternalistic; and
- a presumption that pension fund investors should only be passive investors fails to acknowledge the current reality of pension liability management and the returns necessary to meet those liabilities. If a pension administrator has determined in the exercise of its fiduciary duty that an investment in excess of that permitted by the 30% Rule is prudent, the existence of the 30% Rule needlessly impairs the administrator’s ability to acquire investments that otherwise would be considered appropriate means by which to generate returns to the pension fund. A “passive only” approach may mean passing up opportunities to maximize investment value that can only be achieved (or could more optimally be achieved) through active ownership.

The 30% Rule essentially permits four pension fund co-investors to partner together and actively manage a business. But the 30% Rule attempts to prevent two or three pension fund co-investors from doing the same, or one from doing so where it has determined it has the capacity to do so. In order for such smaller groups or individual investors to invest, workaround solutions are required. This arbitrary distinction creates unnecessary costs or lost opportunities.

The current low interest rate, low growth environment has now persisted to an extent that it can be characterized as the “new normal” with which pension administrators must contend in the funding and investment of their plans. Long term expected rates of return are expected to persist at lower levels than seen in decades for many years to come. As a result, pension administrators need the ability to seek active investments in order to find higher return opportunities than may be available to passive investors, within the particular plan’s risk tolerances. Those opportunities are often available in private and alternative asset classes, such as private equity, infrastructure and the like, where an active approach and control in excess of that permitted by the 30% Rule might be most appropriate in managing the risk that such categories of investments carry (and, as discussed above, is distinguished from exerting control over day-to-day operations).

6. What are the costs, if any, that the 30 per cent rule imposes for pension plans seeking active investments?

The Document makes the statement that “large pension plans have been circumventing the 30 per cent rule through elaborate financial, legal, and organizational structures which effectively allow for control of a corporation with less than 30 per cent of the voting shares.” In ACPM’s view, this is a mischaracterization of rational behavior permitted by existing law. The 30% Rule was crafted using very specific language regarding a restriction on shares to which are attached votes to elect directors. The 30% Rule does not restrict ownership of other securities or restrict control, economic or otherwise. As plan administrators have sought to structure prudent investments where the 30% Rule inhibits investing directly, ACPM is of the view that characterizing such rational behaviour as “circumventing” is inappropriate and unfair.

The structuring, legal, accounting and other costs incurred by pension administrators solely in order to comply with the 30% Rule demonstrate that there are legal means by which to make investments that would not be necessary were the 30% Rule not in place. However, those monies could be better deployed in making investments and paying pensions if the 30% Rule were to be repealed.

In order to access certain investments, which cannot otherwise be accessed due to the 30% Rule, pension administrators must incur costs related to fees charged by managers of such investment structures. This may particularly be the case for certain investments structured as passive investments, when the costs could be avoided if the 30% Rule did not exist and the pension administrator was permitted to invest on an active basis with a higher level of voting control.

Further, the existence of the 30% Rule also creates indirect costs. When pension administrators must forego investments due to the 30% Rule, the cost to the pension fund is effectively the lost returns of such foregone investments. Additionally, when structuring to achieve compliance with the 30% Rule is not cost-effective, otherwise profitable investments may be foregone or the returns on such investments diminished.

7. Does the 30 per cent rule create inequities between large and small pension plans? Conversely, could its removal do so? If so, why?

ACPM is of the view that the 30% Rule does not currently create any material inequities between large and small pension plans. The fact that the size of a pension fund impacts the asset classes to which it may have access is not, in and of itself, inequitable. Smaller funds are less likely to seek out investments where the 30% Rule is an issue due to prudence or “10% rule” concentration concerns.

Larger pension plans need to deploy their capital in a diversified manner while taking appropriate risk and achieving necessary returns. Arbitrary rules which set quantitative limits that restrict otherwise prudent investments create issues for such plans that are less likely to exist for smaller plans. For example, in the search for diversification and returns, larger plans are more likely to seek investments in alternative asset classes, such as private equity and infrastructure, where the available supply of risk-appropriate investments is small. The existence of the 30% Rule can, in some cases, result in such plans having to forego an available investment opportunity.

Smaller plans are less likely to have high allocations to private equity, infrastructure and other alternatives due to size and resource limitations. Where allocations exist, they are more likely to be made through passive investment in managed funds. Such funds do not need to be concerned with the 30% Rule (since it applies on an “indirect” basis to the multiple underlying plan investors), although investing through a managed fund does incur certain additional costs for smaller plans due to the smaller size of the underlying investment. Those costs are not borne by larger plans, but the central point is that larger plans should not be prevented from accessing prudent investment opportunities that their scale would otherwise allow by imposing the arbitrary 30% Rule.

The greater issue is that the 30% Rule creates inequity between Canadian pension fund investors and investors from other countries in competing for investment opportunities. There is a competitive market for available high quality investments in many asset classes. As noted in the Document, the impact of the 30% Rule on Canadian pension fund investors is to require additional structuring that may be seen by the vendor of the asset as less palatable than an offer by another investor not subject to the 30% Rule. Similarly, potential co-investors who are not subject to the 30% Rule may refrain from investing with pension funds who are subject to the 30% Rule. In those cases, the existence of the 30% Rule could again prevent access to quality return-generating assets.

Thus, the 30% Rule does not create inequity between larger and smaller Canadian pension funds nor would its removal cause an inequity. The same rules now apply and would apply to funds of both sizes. The determination of whether any particular investment is appropriate for the plan in question would remain subject to the prudent investment standard applicable to all plans. To the extent differences exist between large and small funds, they are more likely to result from the size of the fund and its more limited ability to access capital than from the 30% Rule.

Tax Policy Considerations⁴

This section of the Document raises a series of interrelated questions which are most efficiently addressed in a unified comment.

- 8. Are any of the tax policy concerns relating to the ability of tax-exempt pension plans to acquire controlling positions in taxable corporations (e.g., potential strategies to eliminate corporate-level taxation, which could provide an advantage to the plans or the businesses they control) material in nature.**
- 9. How does the potential relaxation or elimination of the 30 per cent rule impact any concerns described in respect of the previous question?**
- 10. Should the Government consider implementing tax measures (e.g., thin capitalization restrictions, application of the SIFT tax to pension-controlled trusts and partnerships) to limit the ability of pension plans to undertake tax planning strategies to reduce or eliminate entity-level income tax on business earnings? Are there other potential tax measures that the Government should consider in this regard? What considerations should be taken into account in the assessment of such potential measures?**

⁴ Document, page 11; 3 questions identified

In summary, (i) the 30% rule serves no meaningful purpose from a tax policy perspective, such that tax policy concerns should not create an impediment to the removal of the rule; and (ii) the imposition of specific tax measures, such as those outlined in the Document, is unnecessary given the fiduciary and other investment-related obligations of pension fund administrators that constrain aggressive tax planning by pension funds and may have serious adverse financial impacts on active and retired pension plan members, employers who contribute to pension plans and the Canadian economy as a whole.

As a starting point, there is no indication that the 30% rule was conceived as a means of implementing tax policy. Instead, as noted in the Document, the 30% rule was designed as a risk management tool and to limit pension funds to a more passive investment role. Moreover, the 30% rule is unprecedented in other major developed economies and does not affect Canadian pension funds' status as a tax-exempt entity under either domestic law or Canada's tax treaties with other countries. Consequently, we query whether it is reasonable or appropriate to analyze the 30% rule from a tax policy perspective at all when tax policy objectives do not appear to have been a material consideration in the development of the rule in the first place.

Further, the 30% rule is a very imprecise and unreliable means of addressing the potential tax policy concerns identified in the Document. While the 30% rule may make it more difficult for a pension fund to extract earnings from a business if it prevents the pension fund from having legal control of the business entity, the fund may still obtain practical control through commercial agreements. As a result, removing the 30% rule in and of itself is unlikely to have any material impact on the Canadian tax base.

If the removal of the 30% rule is coupled with the implementation of other tax measures that have the effect of imposing additional tax costs at the level of a pension fund's investments or more directly at the fund level, this will mean reduced investment returns for the fund. Reduced returns could reduce retirement income security for both active and retirement members of the pension plan. Pensioners may find their pensions reduced at a time when they are unable, due to age and/or ill health, to replace such lost income. Active employees and employers may be required to make larger contributions to make up for the investment shortfall created by the additional tax costs.

While there can be a lengthy deferral period from the time income is earned by a pension fund to the time such income is paid out in the form of a pension, or to purchase goods or services, all such payments out of the pension fund contribute to the Canadian economy and, particularly in the case of pensioners, reduce the strain on publicly funded benefits. Further, payments to pensioners are fully taxable when received.

There are a number of existing constraints on pension fund investments that substantially reduce the risk of funds engaging in aggressive or otherwise inappropriate tax planning in connection with investments in active businesses. Specifically, pension fund administrators, as fiduciaries, must follow prudent investment principles in investing fund assets. These principles include risk management through diversification, which reduces the risk of pension funds concentrating investments in a particular asset class, sector of the economy, entity (or group of related entities) or business structure. Loading up an investee company with an abnormally large debt load would generally not be consistent with prudent investment principles, as such behaviour could seriously hamper the growth of the investee and its ability to generate income or gains for the pension fund over the longer term.

As well, Canadian pension funds frequently co-invest with third parties to spread the risk associated with a particular investment. The involvement of one or more third parties in an investment structure would tend to prevent any one party, even a party with a controlling interest, from acting contrary to commercial norms. For example, minority shareholders in a corporation will generally be able to bring oppression claims to curtail behaviour by a controlling shareholder that damages the value of the minority shareholders' investment or other unfair conduct.

In addition, the PBSA prohibits pension funds from investing more than 10% of the fund's value in a single entity or group of related entities, material investments in related parties of the pension fund are prohibited as are investments in employers who participate in the pension fund. These investment constraints under the PBSA also serve to ensure a degree of diversification and minimize conflicts of interest which should reduce the risk of inappropriate tax planning by pension funds that could realistically be expected to have a material adverse impact on the Canadian tax base.

Tax Policy - Other Issues Raised⁵

11. Foreign investors, including foreign pension plans and sovereign wealth funds, are subject to tax rules – known as thin-capitalization rules – which limit their ability to reduce a Canadian corporation's taxable earnings through deductible interest payments on related-party debt. This raises the issue of whether similar limitations should apply to domestic pension plans.

The thin capitalization rules generally deny interest deductions to foreign owned corporations that have a debt to equity ratio that exceeds 1.5 to 1. It would not make sense in tax policy terms to extend the application of the thin capital rules (the "Thin Capital Extension Proposal") to corporations in which pension plans hold a significant interest.

The Document states the following at page 6:

Pension plans are unique and important contributors to Canadian financial market efficiency. Precluding plans from making active investments in Canada could negatively affect capital market efficiency by reducing liquidity, the availability of patient capital, and capital for large-scale projects in which only large institutional investors are active. Also, by constraining an important class of Canadian investors, it could lead to increased foreign takeovers of Canadian businesses.

Given that one of the unique and important contributions of pension plans is providing patient capital and capital for large scale projects, the 1.5 to 1 debt to equity ratio may well be insufficient for such projects.

The Thin Capital Extension Proposal is a blunt instrument in that it does not distinguish between the amount of leverage required for different types of investments. Further, imposing tax on the taxable Canadian corporation has an adverse impact upon both taxable and tax exempt investors in the

⁵ Document, pages 9-10; certain questions identified on page 9, and the comment at the top of page 10

corporation. Extending the application of the thin capital rules to corporations in which pension plans have a significant interest would create an impediment to pension plans providing patient capital and capital for large scale investments.

12. Pension plans could use tax strategies like those discussed earlier to make their entire return on capital from a controlled business effectively tax-deductible. This raises the issue of whether the resulting tax savings to a pension-controlled business on an ongoing basis could allow it to offer more competitive pricing than business competitors, facilitating the corporation's expansion at the expense of businesses owned by taxable Canadian investors and foreign investors.

We are not aware of any circumstances where this has occurred. Given that the fiduciary duty of the pension plan is to obtain the desired investment return within an acceptable level of risk, it would not be consistent with this legal duty for entities controlled by pension plans to sell products at less than market price.

13. Another issue for consideration is whether the greater ability of pension plans to minimize tax costs in respect of active investments relative to passive investments could create a bias in pension plan investment in business toward active investments beyond what would otherwise be dictated by the respective merits of the investments.

We are not aware of any empirical evidence to suggest that this is a material concern. The Document states that the largest six pension plans have at least \$22.25 billion of active investments, outside of the real estate and resource sectors.

When viewed in context, based upon the facts contained in the Document, and the 2014 Asset Mix Report (the "Asset Mix Report") prepared by the Pension Investment Association of Canada ("PIAC"), the concerns relating to pension plans having the ability to acquire controlling interests in taxable corporations (the "Control Concerns") are not material having regard to the size of such controlling investments by pension plans as compared to all investments by all defined benefit pension plans or all investments made by all defined benefit pension plans in infrastructure and private equity. The \$22.25 billion of controlling investments referred to in the Document represents only 1.5% of the total investments made by defined benefit pension plans and represents only 11.3% of the total investments made by defined benefit pension plans in infrastructure, private equity and venture capital.⁶

ACPM extends its gratitude in being able to participate in this consultation and we are available if further discussions are required.

⁶ These percentages are obtained by comparing the \$22.5 billion amount in the Document to the amounts in the Asset Mix Report