



DELIVERING THE POTENTIAL OF DC RETIREMENT SAVINGS PLANS

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PREPARED BY THE
ACPM ADVOCACY & GOVERNMENT
RELATIONS COMMITTEE
DC ISSUES SUB-COMMITTEE



ACPM/ACARR

The Association of Canadian Pension Management
L'Association canadienne des administrateurs de régimes de retraite

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A. EXECUTIVE SUMMARY

It is becoming apparent that member-directed retirement savings plans will play a larger role in the Canadian retirement income system in the future. The Association of Canadian Pension Management (ACPM) believes that it is time to undertake a comprehensive and balanced analysis of these plans. It is hoped that this document will become the starting point for a discussion among retirement system stakeholders that will end with fair and practical recommendations for improvements to retirement income savings plans in Canada.

- We have identified three principal areas where retirement savings plans and their regulatory environment should be improved:
 1. Lack of coverage;
 2. Adequacy of retirement income;
 3. Availability of retirement income alternatives.
- To encourage greater pension coverage ACPM recommends:
 1. Simpler laws;
 2. Uniform laws;
 3. Safe Harbour;
 4. Additional flexibility in dealing with terminated members;
 5. Administrative simplicity;
 6. Automatic enrolment with opt out;
 7. Encouragement of Multi-Employer/Association Savings Plans.
- To increase the likelihood that retirement savings plans will produce their intended level of retirement income ACPM recommends that:
 1. The purpose of the plan is stated in terms of contributing to retirement income;
 2. A target retirement income goal is articulated;
 3. Employment standards legislation be changed so that plan sponsors may automatically deduct contributions;
 4. There be a greater focus on fees with the goal of making them more transparent to members and ensuring that sponsors take steps to ensure

fees are reasonable;

5. The number of investment choices should be optimized to correspond with the plan's purpose;
 6. Plan default option should be appropriate for the plan's purpose;
 7. Contribution limits should be raised;
 8. Investment advice should be offered at the discretion of the sponsor;
 9. The financial literacy of the public should be improved.
- To help retirement savings plan members manage risks in retirement ACPM recommends:
 1. The creation of retirement income products that mitigate sequence of return risks;
 2. Flexibility in retirement income product design;
 3. More information should be provided to plan members about retirement income options.

This Report will detail the ACPM's policy recommendations for retirement savings plans.

B. FOREWORD

I. Introduction

Employment pension plans in Canada are at a crossroads. Canada's population is aging and the large cohort known as the "baby boomers" is beginning to retire. Over the past 15 years, however, pension plan membership, particularly in the private sector, has been in decline.¹ In fact, only 25% of employees working for private employers have a registered pension plan of any sort. Among the declining number of employers who do offer pension plans, there is a discernable trend from defined benefit (DB) pension plans to defined contribution (DC) pension plans and group registered retirement savings plans (Group RRSPs). For the purposes of this Report, DC pension plans and group registered retirement savings plans will collectively be referred to as "retirement savings plans". This trend is driven by economic and social factors, by cost considerations, by more exacting accounting standards, by changes in demographics and by the regulatory and legal environment. How will this trend impact Canadians?

Important questions about the efficacy of retirement savings plans are being asked and must be answered.

It is worth noting that employers are offering a variety of other savings plans and stock-based plans that may have some impact on the monies available at the retirement of their employees. We have chosen however to focus on retirement savings plans because of their unequivocal relationship with retirement. As such, the issues discussed may have some application to deferred profit sharing plans when offered in conjunction with a group registered retirement savings plan for the purpose of retirement savings. The issues discussed in this Report would also have some application to "hybrid" pension plans – that is, plans that couple DB pension benefits with retirement savings plans. The discussion of these issues and the formulation of appropriate recommendations, however, could vary significantly, depending on the design of a particular plan. Hybrid pension plans are therefore not considered separately in this Report. In addition, we are not referring to so-called "brokerage plans", in which the employer simply offers employees uninhibited access to the markets through a registered broker dealer.

Important questions about the efficacy of retirement savings plans are being asked and must be answered. Can a retirement savings plan make a significant contribution to a reasonable retirement income? Will retirement savings plan sponsors and members contribute enough? Will members invest these contributions appropriately? Should investment advice be provided to members? Who will provide investment advice to members? How will retired members manage mortality or longevity risk – the risk that they could outlive their money? Do members understand the risks and costs that they bear? What can be done to help them manage these risks and reduce these costs?

¹ The registered pension plan (RPP) coverage rate, or the percentage of paid workers covered by an RPP, declined from 46.2% in 1977 to 38.5% in 2005. In 2005, the RPP coverage rate in the private sector was 25.9%, while 84% of workers in the public sector were covered by an RPP. (Statistics Canada, CANSIM tables 280-0008 to 280-0026)

2. Purpose of Report

It is becoming apparent that member-directed retirement savings plans will play a larger role in the Canadian retirement income system in the future. There is a concern by some in the retirement sector, however, that the typical retirement savings plans offered to Canadians will not contribute meaningfully to an adequate retirement income. The Association of Canadian Pension Management (ACPM) therefore believes that it is time to undertake a comprehensive and balanced analysis of retirement savings plans in Canada.

The ACPM does not advocate for DB, DC or any other specific pension model. Rather, we are advocating for a level playing field for employers and employees to choose the pension model that suits them best and the ability of any model chosen to make a significant contribution to employees' retirement income. This Report will document this analysis, and detail the ACPM's policy recommendations for retirement savings plans.

The mission of the ACPM is to advocate for a healthy and sustainable Canadian retirement income system.

The ACPM's objective, however, goes beyond the creation of a discussion paper. The mission of the ACPM is to advocate for a healthy and sustainable Canadian retirement income system. It is hoped, therefore, that this document will become the starting point for a discussion among retirement system stakeholders that will end with fair and practical recommendations for improvements to retirement savings plans in Canada.

3. Association of Canadian Pension Management

The Association of Canadian Pension Management is the informed voice of Canadian retirement income plan sponsors, administrators and their allied service providers. The ACPM's individual and institutional members across Canada represent plans with assets of over \$300 billion with over 3 million plan members.

Since its founding in 1976, the ACPM has developed and advocated policy recommendations that promote a healthy and sustainable retirement income system in Canada. The ACPM champions the following principles:

- Clarity in legislation, regulations and retirement income arrangements;
- Balanced consideration of other stakeholders' interests;
- Excellence in plan governance and administration.

This Report is the fourth in a series of policy reports created to encourage public debate on the retirement income system in Canada. The previous three reports were:

- 1997 – “A Retirement Income Strategy for Canada: Creating the Best Retirement Income System in the World”;

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- 2000 – “Dependence or Self Reliance: Which Way for Canada’s Retirement Income System?”;
 - 2005 – “Back from the Brink: Securing the Future of Defined Benefit Pension Plans”.

C. HOW DID WE GET HERE?

I. History

The history of pensions in Canada begins in the public sector with the creation of a pension plan for Canadian Government employees in 1870. Over the next forty years, Canada's largest private employers including railways, banks and utilities offered pension arrangements. In some respects these first plans were similar to the DB pension plans of today. In other ways, they were quite different. For example, most were unfunded, "pay as you go" plans.

From the beginning, Canada's retirement income system included a significant "money purchase" or DC element. In 1889, a Canadian Royal Commission recommended a form of personal savings program designed to encourage individuals to provide for their own retirement. After years of debate, covering many of the same issues that still concern the pension regulators of today (vesting, locking-in benefits, spousal protection), the Government Annuities Act was passed in 1908 permitting the purchase of annuities with individual contributions.

From the beginning, Canada's retirement income system included a significant "money purchase" or DC element.

This legislation created Canada's first national personal retirement savings program. Under this program, the Federal Government subsidized annuities at retirement, both to individuals, and through group contracts to private employers, non-profit organizations and pension societies. Government annuities played an important role in Canada's retirement income system until this legislation was repealed in the mid 1970's.

Pension plan membership in Canada has ebbed and flowed over time, although it has never exceeded about 50% of the workforce. The proportion of DB and DC pension plans has also shifted over time. Pension coverage expanded late in the nineteenth century and through the middle of the twentieth century during periods of rapid industrialization. More DC pension plans have been formed since the early 1980's, in response to changes in tax legislation and relative growth in the service sector. Since 1990, in response to increasingly restrictive pension legislation, more Group RRSPs have been formed as a simpler and more flexible alternative to a registered pension plan.²

In the twenty-first century, a combination of factors is creating a significant shift in the balance between DB and retirement savings plans in Canada, mainly in the private sector. Volatile investment markets, low interest rates, a rapid increase in life expectancy and new "mark to market" accounting rules have all contributed to increasing rates of DB pension plan closures and terminations. While it would appear, therefore, that more Canadians will depend on retirement savings plans as their principal employment

² Benefits Canada, 2007. Most recent data indicates the number of Group RRSP plan sponsors has increased from 32,069 in 2004 to 33,351 in 2007 (there is no number for 2003). Assets in Group RRSP arrangements have increased from \$26 billion in 2003 to \$44.3 billion in 2007. The number of lives has increased from 1.9 million in 2004 to 2.1 million in 2007.

pension, particularly in the private sector, there are concerns about the ability of these plans to successfully contribute to individual's retirement savings needs. Some of these concerns are based on a lack of awareness of the capabilities of retirement savings plans.

The majority of retirement savings plans in Canada have been formed over the past twenty-five years.³ They have been modeled on the dominant capital accumulation plan in the United States – the 401(k) plan.⁴ Canadian retirement savings plans offer a tax-deferred account to which periodic, deductible contributions can be made. However, most do not target any particular retirement income level.

Like many 401(k) plans, the typical retirement savings plan design in Canada includes a modest required contribution, sometimes leaving the employee free to contribute more if he or she wishes. The plan also leaves it to the employee to select investments from a menu of available investment options. Typically employees who do not make any choice are defaulted into a low risk / low return fund. Finally, subject to the withdrawal limits set out in income tax and pension legislation, these plans typically leave it to the member to determine how quickly to withdraw their accumulated benefits in retirement.

Whether registered as a DC pension plan or a Group RRSP, retirement savings plans have become the “plan of choice” for employers who wish to offer a retirement benefit. They offer cost certainty and a lower regulatory burden than a DB pension plan. They are therefore perceived to be less risky from the employer's perspective. Given the age of most Canadian retirement savings plans, it has yet to be determined whether these plans will contribute significantly to an adequate retirement income for plan members. As a result, therefore, it is also too early to say whether employees, employers or society as a whole will bear the risk if they do not.

Given the age of most Canadian retirement savings plans, it has yet to be determined whether these plans will contribute significantly to an adequate retirement income for plan members.

³ The past 30 years has seen a slow but fairly significant erosion in the number of RPP members belonging to DB plans (from 93% in 1974 to 82% in 2004). Over this same time frame, the number of DC pension plans in Canada increased by 4.5 times. (Statistics Canada Cat. No. 74-507-XCB)

⁴ 401(k) plans are named after a section in the U.S. Internal Revenue Code that permits employees to defer salary into retirement savings arrangements sponsored by their employer. In 1986, the U.S. Federal Government reduced the benefit under its DB plan and created a generous 401(k) plan for its employees known as the Thrift Savings Plan. Since that date 401(k) plans have become the fastest growing type of retirement plan in the U.S. In most 401(k) plans, employees are free to participate or not, as they see fit. If they do decide to participate, they are free to decide how much to contribute. Employers have the discretion whether to make matching or any contributions. Again, in most, employees are free to invest their accumulated benefits in a wide variety of investment options. Finally, employees are typically free to cash out their balances every time they change their employment.

D. BENEFITS OF RETIREMENT SAVINGS PLANS

The employment scene today is more and more frequently characterized by the trend toward providing employees with more control over their benefits and retirement planning. The trend is a reflection of the fact that today's employees are better educated and demand more autonomy than employees of the past. It also reflects employers' desire to obtain cost certainty in an era of increasing life spans and shorter careers. Many employees work for a number of different employers throughout their careers and therefore require flexibility and portability in programs designed to provide retirement benefits. The combination of these factors creates an environment that is well suited to the benefits provided by retirement savings plans.

Plan members, plan sponsors and the plan service providers each wish the plan member to accumulate as much capital as possible to use towards providing a retirement income.

Aside from the most important societal benefit of funding a stream of retirement income for millions of Canadians, retirement savings plans:

- (a) Provide employers with the ability to attract and retain workers;
- (b) Pool the assets of individual Canadians so that they are invested more efficiently back in to the Canadian economy, normally through the use of professional money managers;
- (c) Provide opportunities for scale through pooling of capital, which in turn leads to lower cost for the user and access to a variety of investment vehicles which are often the same as those used in a DB pension plan;
- (d) Nurture the independence and self-reliance of Canadians who will then be less likely to look to the public purse for support during retirement.

The success of retirement savings plans in achieving these benefits can be attributed in no small part to the natural alignment of interests between the main stakeholders to these arrangements. Plan members, plan sponsors and the plan service providers each wish the plan member to accumulate as much capital as possible to use towards providing a retirement income. As a result, in this regard conflicts of interest are minimized to the benefit of all and innovations in plan design are in constant development.

From the plan member perspective, the positive features of a retirement savings plan could be summarized as:

- (a) A clear, familiar contribution promise which leads to greater comprehension and an environment more conducive to member participation;
- (b) In the ordinary course, the member is permitted to invest the assets in his or her account and has continuous access to the status of that account;
- (c) Investment and plan information together with education/training on how to use them are widely available and are subject to minimum standards

provided by the CAP Guidelines;

(d) The oversight activities of the plan sponsor help to ensure a smoothly functioning plan that delivers value; by way of example:

- The buying power of the plan sponsor provides the plan member with access to lower fees and more diverse investment options than the plan member could obtain individually;
- Pre-screening by the plan sponsor helps to narrow the available investment options to those that are relevant to the purpose of the retirement plan;
- The plan can be designed to provide both investment diversity for the financially astute plan member or simplicity for those that desire others to control the investing decisions;
- Plan members can gain access to professional investment managers, a spectrum of asset classes including alternative investments and different investment structures;
- For those that do not wish to assume all of the investment risk, the plan can provide guaranteed return investment options and potentially contractual level guarantees of the return of the entire account balance;
- Plan members can readily create a guaranteed retirement income stream through annuitization, or rollover their account into a group priced retirement income product;
- Plan balances can easily be transferred upon employment transition and account balances remain invested following employment termination.

The oversight activities of the plan sponsor help to ensure a smoothly functioning plan that delivers value.

For plan sponsors retirement savings plans currently provide the benefit of:

- (a) A clear, familiar contribution promise that is understood by plan members leading to fewer disputes among plan stakeholders, and a more concrete value placed on that plan;
- (b) Avoidance of the investment risk and mortality risk that can be associated with providing a DB retirement income benefit;
- (c) Benefit cost certainty;
- (d) Low administrative costs and administrative simplicity, particularly with Group RRSPs;

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- (e) Ongoing plan member engagement or access leads to a constant reminder of the employment benefit and positive enforcement of the employment relationship.

With refinement and innovation retirement savings plans could offer a flexible, predictable cost alternative that has the potential to meet the needs of all plan stakeholders.

E. AREAS FOR DESIGN IMPROVEMENT

The previous section identified the many benefits of retirement savings plans. And yet there are many who feel that retirement savings plans are not delivering these benefits as effectively as they might. Instead, the regulatory environment and the way in which plans are structured and administered, restricts retirement savings plans from delivering their potential.

We have identified three principal areas in which retirement savings plans and their regulatory environment should be improved.

1. Changes should be made to facilitate improved workplace coverage. Barriers to the establishment of new retirement savings plans and the expansion of existing plans need to be eliminated.
2. Recognizing that retirement savings plans generally provide only a part of the member's retirement income, in conjunction with Canada Pension Plan, Old Age Security and personal savings, there should be a focus on optimizing the contribution that retirement savings plans can make during the accumulation phase toward generating an adequate retirement income.
3. There needs to be a greater focus on the mechanics of converting the members' accumulations into a secure retirement income.

The ACPM believes that this lack of coverage is not in the public good as an employee whose employer chooses not to offer a retirement savings plan is forced to rely on his/her own skill set and motivation for retirement savings.

This section addresses each of these deficiencies and proposes various improvements to the retirement savings plan system. The suggested improvements have in certain cases been implemented in other countries. The countries and the aspects of their retirement systems that we considered are listed in Appendix A. While not an exhaustive list, the countries chosen have a legal and economic environment sufficiently similar to Canada's to allow meaningful comparison and opportunity for implementation.

I. Lack of Coverage

As evidenced by the coverage statistics described earlier, employers seem increasingly reluctant to offer DC pension plans to their employees. Instead, there is a tendency to favour Group RRSPs over DC pension plans but even growth in that plan type is not sufficient to extend retirement plan coverage to all working Canadians. Combined, this represents a weakness in the coverage of Canadian employees under these retirement savings plans. The ACPM believes that this lack of coverage is not in the public good as an employee whose employer chooses not to offer a retirement savings plan is forced to rely on his/her own skill set and motivation for retirement savings. In addition, he/she loses the "group" benefits of an employer sponsored retirement savings plan, including typically lower costs. For these reasons, we believe that expansion of retirement savings plan coverage is a desirable policy objective.

Although it would obviously improve coverage, we do not support government mandated retirement savings plans. Employers and employees should be free to establish the terms of employment that suit their needs. Similarly, employees should not be forced by law to join their employer's plan. Instead, we support expansion of choice and removal of the obstacles to increased coverage.

The administrative burden for sponsors of retirement savings plans acts as an obstacle to their maintenance and to the creation of new such plans. The laws applicable to DC pension plans are more complex than needed. There is also a lack of uniformity among federal and provincial rules applicable to DC pension plans, and there is a need to modernize the administration of retirement savings plans through the use of e-commerce. Employers in some jurisdictions are also currently unable to end the DC pension plan relationship when the employment relationship ends. These issues add additional cost to the operation, and discourage the adoption of retirement savings plans.

The ACPM believes that particularly in an environment in which the creation of retirement savings plans is voluntary, it is of paramount importance that the administrative requirements for plan sponsors be simple and affordable.

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Suggestions for improvement:

- (a) **Automatic Enrolment with Opt Out:** For new hires, mandatory participation in a retirement savings plan can be made a term of employment. For those already employed at plan commencement, however, current statutes prohibit the deduction of contributions from wages without express consent.⁵ Further, U.S. experience indicates that some employers who prefer to offer voluntary retirement savings plans are still willing to “encourage” plan participation by using automatic enrolment as a plan default. In Canada, however, if the plan is not mandated as a term of employment, the deduction of contributions without consent is prohibited.

These statutory prohibitions have the potential to limit pension coverage. To reverse this result, ACPM recommends that they be eliminated for retirement savings plans that provide for automatic enrolment, but with an employee “opt out”. This model has recently been adopted in U.S. pension legislation. It gives each employee the freedom not to participate. The employee who does nothing, however, is automatically enrolled and makes contributions at the plan's default rate.

A recent study of U.S. plans⁶ indicates dramatically higher enrolment rates for new hires under automatic enrolment designs than for employees

⁵ See for example, s. 13 of the Employment Standards Act (Ontario) which is replicated to varying degrees in most other provinces.

⁶ Measuring the Effectiveness of Automatic Enrolment, Vanguard Centre for Retirement Research, Volume 31, December, 2007

hired under voluntary enrolment designs (86% versus 45%). Importantly, low income and younger plan members enjoyed the largest impact of this result.

- (b) **Multi-Employer/Association Savings Plans:** We suggest that multi-employer retirement savings plans be encouraged in order to provide expanded options for retirement saving. These could be available to employers and could provide a group savings ability for employees whose employer does not offer a retirement savings plan. Both Sweden and the Netherlands have versions of multi-employer savings plans that have contributed to the high levels of coverage in both countries. In Canada, these could be structured on national, regional or industry lines or under a particular financial institution. Legislation should ensure that there are not disincentives to establishing such plans. In particular, the administrator of such a plan should be shielded from legal liability provided it followed specific requirements.
- (c) **Simpler Laws:** Pension benefits statutes are generally more focused on DB pension plans than DC pension plans. Because of this failure to consider DC plans, the rules are unnecessarily complex for DC plans. This makes DC pension plans significantly less attractive than Group RRSPs, although arguably both have the same purpose. We recommend simplifying the rules that apply to DC pension plans to create a more level playing field with Group RRSPs. By way of example, the rules applicable to DC pension plans in the event of marriage breakdown could be much simplified to the benefit of all. An example of a simpler overall plan is the Quebec simplified pension plan, which is described in Appendix B.
- (d) **Uniform Laws:** A significant element of the complexity of retirement savings plans arises from the lack of uniformity among federal and provincial pension benefits statutes. For example, differences in locking-in requirements and different definitions of spousal relationships result in unnecessarily complex plan terms and processes. Many of these differences are minor and do not go to the heart of the retirement savings system.

A significant element of the complexity of retirement savings plans arises from the lack of uniformity among federal and provincial pension benefits statutes.

To address the issues raised in the two previous paragraphs, we suggest the following options, in descending order of desirability:

- (i) Create a single, simple statute applicable in all jurisdictions that applies to all retirement savings plans, that codifies only what is necessary and relies on the CAP Guidelines for the application of best practices and flexibility;
- (ii) Amend the pension benefits statute of each jurisdiction to provide regulators with rule making powers, together with a mandate to pursue uniform national rules. This might follow the model of national instruments under securities laws;

(iii) Expand uniform national guidelines, such as the CAP Guidelines.

- (e) **Safe Harbour:** In a perfect world a “safe harbour” would be unnecessary. A standard of care would be an acceptable governing model for decisions made in good faith and with proper diligence, and the Courts would support decisions meeting the standard. However this is not the current situation. The concept of a “safe harbour” is widely misunderstood. It is not a panacea or a complete release of liability for a person with legal responsibilities in relation to a retirement savings plan. Instead, a “safe harbour” provides legal protection from claims made against a stakeholder in respect of a particular plan design feature if the stakeholder has complied with all of its prescribed obligations under statute or regulation. For example, if the relevant rules provide that a balanced mutual fund is an appropriate default fund for a retirement savings plan, a “safe harbour” provision might provide that an employer who selects such a mutual fund as the default fund for the plan cannot be liable to plan members who suffer loss by virtue of that choice (vs. a money market fund, for example). But the employer would still remain responsible for its other legal duties in relation to the plan (e.g., to prudently select and monitor fund options/managers).

The ACPM recommends adopting the concept of a safe harbour for certain design features of retirement savings plans that meet criteria prescribed by legislation/regulation.

The ACPM recommends adopting the concept of a safe harbour for certain design features of retirement savings plans that meet criteria prescribed by legislation/regulation. Provided that a stakeholder (be it an employer, plan administrator or service provider) complies with a clear set of requirements, the stakeholder should have protection from legal liability in respect of those requirements. Taking a page from the U.S. experience, we recommend that the criteria be at the level of broad based rules thereby allowing the flexibility needed for the myriad of existing and to be developed retirement savings plans. The certainty and protection of a safe harbour will encourage the adoption of retirement savings plans. This could be included in the simplified statute referred to above.

- (f) **Terminated Members:** DC pension plans generally have members who are former employees. These former employees no longer have a relationship with the sponsoring employer, but the employer remains responsible for the administration of the plan in respect of those former employees while they remain in the plan. This can often result in the former employer or the remaining plan members assuming the costs associated with maintaining the former employee’s assets in the plan, and, the logistical difficulties of trying to communicate with a person with whom the employer is no longer in contact. This is a problem for DC pension plans but not for Group RRSPs. We believe that a plan sponsor’s legal and financial obligations to the member should terminate at the end of the employment relationship. Accordingly, DC pension plan administrators should be given the ability to transfer former employees’ benefits out of the plan into an individual retirement savings arrangement, upon appropriate notice to the member. In some jurisdictions, pension law does not clearly permit this to occur

for a DC pension plan, though all jurisdictions permit DB pension plans to transfer the obligation to pay the member's benefits to a third party, if the member does not exercise his/her portability rights by a certain point (that is, to annuitize the deferred pension benefit).

- (g) **Administrative Simplicity:** The ACPM recommends that legislation be modernized to reflect the electronic commerce capabilities that now exist. In particular, allowing plan members to opt out of receipt of formerly mandatory disclosure items and to designate beneficiaries electronically would help to ease administration and lower cost. In addition, simplifying and harmonizing the rules around locking-in, vesting, membership and marriage breakdown should be a top priority.

2. Adequacy of Retirement Income

There is concern that the design of certain existing retirement savings plans does not facilitate the creation of an adequate retirement income. The presumption in such cases is that it is the expectation of both the plan sponsor and more importantly the plan member that the plan is meant to fulfill this purpose. That may not be the case universally but it is a reasonable presumption in many such cases in that retirement savings plans enjoy features such as tax deferral and locking in that are clearly meant to ensure they play a role in funding a person's retirement.

There is concern that the design of certain existing retirement savings plans does not facilitate the creation of an adequate retirement income.

Where this is the expectation, commonly cited issues with the current design of these plans include the following:

- They do not address the now widely accepted issue of plan member inertia;
- They may provide too much investment choice thereby exacerbating that inertia;
- The investment management fees applied are beyond what is charged to a typical DB pension plan;
- The investment expertise required is beyond the capabilities of many plan members;
- The statutorily prescribed contribution limits are insufficient to allow the plan member to create adequate retirement income.

The ACPM believes that the design and regulatory changes suggested below will facilitate their ability to contribute towards an adequate income in retirement.

Suggested Design Improvements:

(a) **Retirement Income Purpose:** Where a sponsor establishes a retirement savings plan to contribute significantly to a plan member's adequate income in retirement, the ACPM believes that having this goal as the express purpose of the plan will improve the plan's chance at meeting that goal. Currently the purpose of many plans is to act as a savings vehicle to create capital for retirement or some less defined purpose. Re-focusing on the contribution to adequate retirement income will lead to decision making designed to fulfill that goal. The CAP Guidelines expect this focused decision-making. Further communications will be created with that goal in mind, thereby setting that expectation for plan members when making their own decisions.

Plans should enable or at least assist plan members to estimate a target retirement income, with appropriate disclaimers to clarify that the estimate is not a "promise".

(b) **Target Retirement Income:** Plans should enable or at least assist plan members to estimate a target retirement income, with appropriate disclaimers to clarify that the estimate is not a "promise". This will focus the plan on the desired result, namely, the creation of an amount of retirement income, and reinforce the purpose of the plan in the mind of the plan member while allowing him or her more knowledgeably to make adjustments to inputs such as contributions, asset allocation and retirement date in order to attain that goal. Such clarity should also better engage the plan members and may increase members' appreciation of the plan. The plan's income goal need not be a person's total retirement income expectation since they should have other sources of retirement income, but the member should be able to determine during the accumulation phase the effect of his or her decisions on the ultimate income that can be produced by the plan.

(c) **Automatic Escalation:** The ACPM believes that an adequate contribution level is fundamental to contributing towards an adequate retirement income. Providing a target retirement income will encourage some plan members to make sufficient contributions but the prevalence of inertia among plan members means that automated solutions of the type now used in the U.S. will lead to more realistic contribution levels (although the recent Vanguard study⁷ indicated that the auto escalation percentages, if set too low for instance to comply with a safe harbour, can act as an inhibitor to larger contributions that an employee might otherwise make). The ACPM therefore advocates changes in employment standards legislation across Canada in order to enable plan sponsors to automatically deduct contributions to retirement savings plans from the pay of plan members and to periodically increase contribution amounts in order to assist the plan member to reach the target retirement income.

(d) **Focus on Fees:** There is no doubt that over the long term, even a modest reduction in the fees charged to a plan member's account in a retirement

⁷ Ibid

savings plan can result in a substantially increased balance. Plan sponsors need to understand the effect of fees and take steps to ensure the fees for the plan are reasonable, even if paid by the plan members. By assessing whether all services are necessary, ensuring a competitive bidding process whenever possible and designing the plan to be as administratively effective as possible, plan sponsors can affect lower fees for their plan members. Reducing the number of fund options, making available lower cost alternatives such as passive asset management and maximizing contributions are three practical means by which fees might be lowered. Certain plan sponsors may also be able to access multi-employer/association type plans which may have additional buying power.

Plan members also need to understand these fees. Disclosure of the fee level and the relativity of these fees (compared to investments available outside their plan) is necessary information in order for plan members to make knowledgeable investment decisions.

- (e) **Optimize Investment Choices:** American experience suggests that when plan members are faced with an excessive menu of investment choices, they tend to procrastinate and not make any choice. Further, where plan membership is voluntary, there is evidence that excessive choice can actually reduce plan participation. Where a retirement savings plan requires its members to make investment choices, timely and sound investment decisions by members are critical. The ACPM therefore recommends that the number of investment choices typically offered by retirement savings plans today should be reduced to an optimal number corresponding with the plan's purpose and situation. An optimum menu of investment options should offer few enough choices to encourage and improve member decision-making, but a sufficient number to enable members to structure appropriately balanced and diversified portfolios. We do not favour specific regulation in this area. The optimum number of investment choices will vary with the plan's design, the investment knowledge of the plan's membership and whether investment advice is provided to members. The ACPM believes, therefore, that the best results will be obtained if plan sponsors have the flexibility to determine the optimum level of investment choice for their retirement savings plan, given its intended purpose, situation and design.
- (f) **Appropriate Default Funds:** Traditionally, plan sponsors have emphasized liquidity and safety when selecting the default investment option for those plan members who have not yet provided an investment instruction. Such goals of liquidity and safety, while reasonable, result in the sacrifice of potential returns in the long term with the result that plan members who remain in the default fund for extensive periods, do not enjoy sufficient investment growth to contribute to an adequate retirement income. Recognizing that many plan members will not take regular action to review their investment fund holdings, the ACPM endorses the approach, recently approved by the Department of Labor in the U.S., of using default funds that will potentially

The ACPM believes that the best results will be obtained if plan sponsors have the flexibility to determine the optimum level of investment choice for their retirement savings plan, given its intended purpose, situation and design.

yield more substantive investment growth. In doing so, regulators in the U.S. have recognized that the value of such growth outweighs the additional risk that must be assumed through the use of these investments, particularly when faced with the issue of long term inertia by plan members. Instead of mandating a particular variety of investment fund for use as a default investment option, the ACPM believes that the preferred route is to allow flexibility in selecting a default option that has an investment structure consistent with the retirement income goal of the plan.

(g) **Contribution Limits:** As stated above, adequate contributions are probably the single most important element in creating an adequate retirement income. The ACPM believes that the contribution limits for retirement savings plans currently in the federal Income Tax Act are insufficient to allow the build up of a capital base to enable an adequate retirement income. Those limits are also uncompetitive in relation to the limits allowed in DB pension plans, and the limits allowed by our major trading partners, including the U.S. and the U.K. The ACPM therefore recommends that the federal government raise the contribution limits to a level sufficient to allow for an adequate retirement income, as discussed in more detail above. The limits should also be indexed to inflation.

(h) **Advice:** Many see access to quality, professional investment advice as key to addressing the issue of the investment capability of many plan members. Indeed, the U.S. has created a safe harbour for plan sponsors that make investment advice available to their plan members in accordance with the terms set out by the Department of Labor.

Weighed against the advantages of providing advice are:

- The cost of providing quality investment advice which can result in a substantial increase in the fees charged to plan members;
- The evidence of the lack of use of such advice by members of plans that currently make it available;⁸
- The difficulty in monitoring the activities of the advice service providers;
- The lack of safe harbour to protect plan sponsors from exposure in the event that the advice does not work to the member's advantage;

The ACPM believes that the contribution limits for retirement savings plans currently in the federal Income Tax Act are insufficient to allow the build up of a capital base to enable an adequate retirement income.

⁸ The 2007 Employee Benefit Research Institute (EBRI) Retirement Confidence Survey indicates that approximately half of workers surveyed would take advantage of advice offered through their employer, however 11% indicated they would not implement advice, while 66% said they would implement advice only if in line with their own ideas.

-
- The apparent lack of availability of fee for service financial planning alternatives;
 - Whether there is the same need for such advice in a retirement savings plan that adopts some of the auto features and design improvements discussed above.

The ACPM believes that the decision of whether to make investment advice available to plan members during the accumulation phase of the plan member's career should be left to the individual plan sponsor.

While its impact on facilitating the adequacy of retirement income is not as clear, the ACPM does see merit in offering investment advice in the period prior to the conversion of the capital within the plan to a source of retirement income.

- (i) **Financial Literacy:** Financial literacy of Canadians continues to be a concern. The ACPM urges governments to use their policy-making influence over primary and secondary public education to ensure school-aged Canadians are taught the skills required to make good personal financial decisions, including those related to saving and investing over their working lives. Public awareness can also be created by governments regarding the importance of financial literacy much like their successful efforts in the areas of seat belt use, smoking cessation, fitness and environmental sustainability.

The ACPM urges governments to use their policy-making influence over primary and secondary public education to ensure school-aged Canadians are taught the skills required to make good personal financial decisions, including those related to saving and investing over their working lives.

3. Availability of Retirement Income Alternatives

Plan members nearing retirement are faced with one of the most important decisions of their lives: namely, in what form do they create retirement income. Retirement savings plans are perceived to be weak in facilitating an easy transition from accumulation to a stream of secure retirement income. However pension and taxation legislation make available many product alternatives to members of retirement savings plans such as life annuities and market based alternatives under Registered Retirement Income Funds (RIF) and Life Income Funds (LIF) to enable a stream of income in retirement. The ACPM believes that improvements need to be made to those products and the current regulatory environment in order to better prepare prospective retirees and to serve existing retirees.

Suggested Design Improvements:

- (a) **Sequence of Returns Risk:** The effect on a balance in a retirement savings plan of converting to an annuity during a period of low interest rates or to an individual LIF/RIF during a period of low market values can be very significant. The retiree may not recoup the losses arising from these circumstances. As this is a risk that is beyond the control of plan members, the ACPM endorses the creation of more and better products that mitigate

this sequence of returns risk either by enabling the periodic annuitization of plan balances, providing minimum capital or income guarantees or some other means. Plan sponsors who wish to help plan members manage this risk should have the flexibility under pension legislation to do so. It should be noted that this risk also affects members of DB pension plans who leave the plan and thus any such products would have more general application.

By way of example, in the U.S., financial institutions now offer products such as a fixed in-plan annuity and a variable in-plan annuity. With the former, a plan member may periodically purchase a deferred life annuity with some portion of his/her retirement savings plan balance. The periodic nature of the purchases allows “dollar cost averaging” of interest rates thereby removing sequence of returns risk. The annuities purchased can be aggregated leading to one, secure stream of retirement income.

The ACPM endorses the removal of any fetters that unnecessarily inhibit the creation of new retirement products for former retirement savings plan members.

With variable in-plan annuities the plan member periodically transfers a portion of the retirement savings plan balance into a notional market based account. In return, the member receives a promised minimum retirement income based on an agreed mortality table together with an increase in the market value of the account. In this instance the retirement income ultimately created may vary in amount but will never fall below the minimum. A slight variation on this theme is a feature called the guaranteed minimum withdrawal benefit which allows the plan member to receive at least some agreed stream of retirement income for life while continuing to remain invested in the market.

- (b) **Need for Flexibility/Options:** The long term nature of modern retirement and the infinite variety of needs to be addressed for individual retirees means that the regulatory system must allow for flexibility in product design. As referred to above, the U.S. market is currently seeing growth in the use of variable payment annuities with income guarantees. These products may not be acceptable under current Canadian taxation legislation. The ACPM endorses the removal of any fetters that unnecessarily inhibit the creation of new retirement products for former retirement savings plan members.

In addition, the ACPM endorses the concept that in all jurisdictions, the payment of a variable benefit be permitted directly from a DC pension plan. To date, this option is permitted, under the Income Tax Act and the pension legislation for the four western provinces only. This change would allow DC pension plans to pay pension benefits directly to their retired members, subject to an annual minimum payment after age 71 and subject to the same annual maximum withdrawal limit applicable to locked in retirement accounts under applicable pension legislation. Where a plan sponsor offers a variable retirement income benefit, members are able to remain in their pension plan after retirement, without having to assume greater responsibility for investment decisions or to pay higher investment fees that are typically charged within individual plan arrangements. Plan

sponsors and members alike also stand to benefit in situations where the retention of additional assets within the DC pension plan results in a lower management expense ratio.

Retiring plan members who prefer to purchase annuities or other options with all or a portion of their accumulated balance can continue to do so. This allows all members to choose the option which best suits their needs.

- (c) **Unlocking:** The issue of whether retirement savings should be locked-in and subject to spending limits is important to both retirement savings plan members and sponsors. The lock-in rules in many jurisdictions across Canada have recently been changed, but in a disappointingly disparate fashion. To establish a uniform and balanced position on this issue, ACPM is currently surveying its membership. In order not to preempt this process, a further discussion of unlocking is not included in this paper. A separate document outlining ACPM's position will be provided in due course.

- (d) **Information about Retirement Income Options:** Much of the focus in retirement savings plans relates to the investment of plan assets. Far less attention is given to the phase at which the member seeks to convert the account balance into a stream of retirement income. One of the major perceived weaknesses of DC pension plans when compared to DB pension plans is the inability of plan members to easily convert their plan balances into a guaranteed stream of retirement income. That perception is of course based on a fallacy given that the purchase of a life annuity remains one of the statutorily required options for retirees. This misperception points to the need for greater awareness of all retirement system stakeholders including plan members, plan sponsors and service providers to the availability of retirement income options. The ACPM encourages retirement plan administrators and service providers to improve the information available to members regarding this crucial phase of the member's life. The ACPM also encourages providers of financial products to continue in the development of retirement income product alternatives.

The ACPM encourages retirement plan administrators and service providers to improve the information available to members regarding this crucial phase of the member's life.

F. IMPROVING THE RETIREMENT SAVINGS PLAN SYSTEM

This final part of the Report summarizes the ACPM's recommendations for improvements to the Canadian retirement savings plan system. Our goal is a system in which barriers to retirement savings plan coverage are eliminated, and sponsors and members have retirement savings plans that efficiently deliver desired levels of retirement income.

For ease of reference, the recommendations have been listed in two categories, those that require regulatory or other intervention, and those that can be implemented immediately.

Our goal is a system in which barriers to retirement savings plan coverage are eliminated, and sponsors and members have retirement savings plans that efficiently deliver desired levels of retirement income.

I. Recommendations Requiring Regulatory Changes

- (a) **Simpler laws.** The laws applicable to DC pension plans should be simplified so that they can operate on a level playing field with Group RRSPs;
- (b) **Uniform laws.** The laws applicable to retirement savings plans should be harmonized across Canadian jurisdictions;
- (c) **Safe harbour.** Plan sponsors and service providers should have protection from legal liability if they comply with specific rules;
- (d) **Administrative simplicity.** Legislation should facilitate administrative efficiencies, such as e-commerce;
- (e) **Need for flexibility and options in retirement.** The regulatory system should allow flexibility in product design to accommodate the need for retirement income alternatives;
- (f) **Terminated members.** Sponsors of DC pension plans should be able to require terminated members to leave the plan;
- (g) **Automatic enrolment.** Plan sponsors should be permitted to enrol members in the plan without their consent, subject to the right of the member to opt out of the plan;
- (h) **Automatic escalation of contributions.** Sponsors should be allowed to increase contribution levels without express member consent;
- (i) **Contribution limits.** Tax-assisted contribution limits should be increased so as to allow accumulation of adequate retirement income.

2. Recommendations That Can Be Implemented Now

- (a) Retirement income purpose. Encouraging plan sponsors to articulate a stated “purpose” for the plan as a vehicle to generate retirement income;
- (b) Focus on fees. Sponsors and members need to have increased awareness of fees payable in the plan and their effect on savings;
- (c) Default funds. Default funds that are more appropriate to long term investing should be supported;
- (d) Target retirement income. Plans should enable or assist members to create a target retirement income, which would drive contribution levels and investment strategy;
- (e) Information about retirement income options. Plan members need greater information regarding the availability of retirement income options;
- (f) Sequence of returns risk. Plan members should have greater information on options to assist them in managing the risks surrounding the conversion of retirement savings into retirement income;
- (g) Multi-employer/association savings plans. Multi-employer/association savings plans should be encouraged;
- (h) Optimized investment choices. Plan design should avoid excessive investment choice, while still maintaining an appropriate selection of investment options. Innovation in determining investment choices should be encouraged;
- (i) Investment advice. Provision of investment advice should generally be at the discretion of the plan sponsor, although there is a greater need for advice in the period just prior to retirement;
- (j) Financial literacy. Governments should use their policy-making influence over primary and secondary public education to ensure school-aged Canadians are taught the skills required to make good personal financial decisions, including those related to saving and investing over their working lives.

If these recommendations are followed, the ACPM believes that the result will be stronger and more effective retirement savings plans and an environment in which plan sponsors will be encouraged to maintain existing plans and establish new ones.

Retirement savings plans are an increasingly important part of Canadians’ retirement planning. Retirement savings plans are not, however, delivering their full potential. This Report has attempted to identify issues relating to retirement savings plans that need fixing or further dialogue. To this end the Report has made a number of recommendations. If these recommendations are followed, the ACPM believes that the result will be stronger and more effective retirement savings plans and an environment in which plan sponsors will be encouraged to maintain existing plans and establish new ones.

Many of the recommendations in this Report can be implemented under the current legislative regime. The ACPM urges plan sponsors and service providers to consider these recommendations and implement them.

Many of the recommendations will, however, require changes to the regulatory scheme. The ACPM urges governments to consider the recommendations in this Report and to make appropriate changes. Other stakeholders cannot, by themselves, make significant progress in resolving these issues without legislative change. The ACPM encourages its members and other retirement savings plan stakeholders to work together to turn these recommendations into actions.

*Many of the
recommendations in
this Report can be
implemented under
the current legislative
regime.*

Appendix A

International Experience

Retirement savings plans present challenges in most parts of the world. An examination of some of the better known jurisdictions reveals commonalities of concerns (insufficient coverage, insufficient retirement savings, longevity risk).

1. United States

Beginning with Canada's largest neighbour to the south, the U.S. recently introduced massive reform to its retirement system through the Pension Protection Act 2006. Features such as automatic enrolment and automatic escalation of contribution levels with member opt-out available were designed to increase participation and savings rates in retirement plans. Safe harbour will be granted to sponsors if the plan follows these prescribed practices together with the existing ERISA requirements regarding eligible investment options. Approved default options have been described and safe harbour is provided to plan sponsors who offer such option(s). Investment advice is possible through the "eligible investment advice arrangement". This describes a series of requirements to which a sponsor must adhere in order to provide investment advice to plan members. Again, safe harbour will be granted to those sponsors that fulfill these requirements.

2. United Kingdom

In an effort to increase coverage the United Kingdom recently introduced "Personal Pension Accounts" for employees not participating in a pension scheme. Enrolment is automatic and accounts follow the employee between employers. Employees pay contributions of around 4% of earnings, with earnings bands to increase with wage increases. Employer contributions are mandated at 3% together with 1% normal tax relief. Employers offering a comparable scheme can be exempted from the application of this regime. Investment choice and a default fund will be offered and fees may not exceed 30 basis points.

3. Sweden

The Swedish pension system went through reform in the early 2000's. The first pillar of this system (state pension system) was rebuilt into three tiers. The first tier is essentially social assistance. The second and third tiers are financed equally by employers and employees through payroll. The second tier is a notional defined contribution account that is converted to an indexed annuity at retirement. The third tier consists of a defined contribution account that is invested at the direction of the employee from a specified list of mutual funds. The default option is a state run Premium Savings Fund. The second pillar consists of mostly DC plans requiring between 2-5% of wages and involves various levels of matching. The third pillar consists of private and voluntary

plans and is only supported implicitly by the government through preferential tax treatment.

The United Kingdom and Sweden have similar payout options that include lump sum payments, a life annuity, phased withdrawal and installment payments over a fixed period or ad hoc distributions.

4. Netherlands

The Netherlands retirement system also consists of three pillars - mandatory basic old age pension under a statutory insurance scheme (AOW), occupational pension schemes (quasi-mandatory) and individual savings through personal annuities or endowments offered by insurance providers. Over 90% of those employed in Netherlands participate in an occupational pension scheme. These are considered supplementary to the AOW and the combination of the two should provide 70% replacement income in retirement. It is legally required that occupational pension plans be fully funded and that a reserve is put in place determined by the level of investment risk assumed by the plan. The Financial Assessment Framework (FTK) introduced in 2007 brought in requirements of marking to market value both assets and liabilities (previously only assets were marked to market), tests to determine the ability of pension funds to meet their obligations (a continuity test, a minimum test and a solvency test) and the requirement that pension funds inform members of their policy on indexation. The third pillar of the Dutch system is voluntary and financed solely by the individual through insurance contracts (annuity or endowment).

5. Australia

Australian legislation mandates a universal, compulsory DC pension system. All employers must pay at least 9% of regular earnings for all full-time, part-time and casual employees into individual Superannuation accounts. Individuals are free to select the Superannuation plan to which they wish to contribute. Superannuation plans are organized and administered by single employers, by industry associations, by state governments and by the financial sector. Superannuation contributions are tax assisted but not fully deductible. Earnings are subject to 15% tax. Withdrawals from these plans are tax free and may begin at age 60. Most plans offer investment choice and some offer advice. The Superannuation system is also available to self-employed individuals. Accumulations are available as a lump sum at retirement.

6. New Zealand

New Zealand has recently introduced an optional, universal defined contribution system called KiwiSaver. The system became effective in 2007. KiwiSaver provides automatic enrolment of all employees whenever they start a new job. The employee has 8 weeks to opt out. Currently only employee contributions may be made to these plans. But 2008 legislation will require 1% employer matching contributions rising to 4% by 2011. This new legislation will also provide that contributors receive an annual tax credit

of \$20 per week and a fee subsidy of \$40 per year. Investment choice is available to members. Contributions are not deductible; earnings are taxed at 33%; withdrawals are tax free. Funds are accessible at age 65 as a lump sum – earlier for hardship cases. Employers may not offer advice.

Appendix B

Simplified Pension Plan (SPP) – referred to as a SIPP by the Régie des rentes du Québec

There has been much debate over the merits of a Group RRSP over a traditional DC plan, however in the province of Quebec this debate has been rendered somewhat irrelevant with the improvements introduced to the Simplified Pension Plan in 2004. SPPs combine many of the design elements of a Group RRSP and a traditional DC pension plan and can represent significant savings for an employer over an RRSP. The SPP eliminates much of the administrative burden associated with a traditional DC pension plan.

The SPP is similar to a Group RRSP in the following ways:

- Offered by financial institutions who fulfill role of plan administrator
- Single plan registration by financial institution with many participating employers
- Financial institution maintains registration and files necessary reports
- Members make investment choice amongst list of available investment options selected by the employer
- No need to establish a pension committee who acts in a fiduciary capacity
- May transfer to an RRSP to take advantage of Home Buyers Plan or Lifelong Learning Plan

The SPP is similar to a DC pension plan in the following ways:

- Governed by the Supplemental Pension Plans Act (Quebec)
- Employer contributes directly
- Subject to same contribution limits
- Benefits under the plan may not be seized
- Contributions are not subject to payroll taxes
- Employer's option to unlock member contributions, employer contributions are locked-in
- Option to establish an information committee

The SPP presents a more cost effective alternative over both the traditional DC pension plan and Group RRSP. A lack of similar legislation across all jurisdictions in Canada represents the most significant challenge to its adoption and use.

Appendix C

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