THE CANADIAN BAR ASSOCIATION
L'ASSOCIATION DU BARREAU CANADIEN

# Strengthening the Legislative and Regulatory Framework for Private Pension Plans Subject to the *Pension Benefits Standards Act*, 1985

NATIONAL PENSIONS AND BENEFITS LAW SECTION
CANADIAN BAR ASSOCIATION

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## PREFACE

The Canadian Bar Association is a national association representing 37,000 jurists, including lawyers, notaries, law teachers and students across Canada. The Association's primary objectives include improvement in the law and in the administration of justice.

This submission was prepared by the National Pensions and Benefits Law Section of the Canadian Bar Association, with assistance from the Legislation and Law Reform Directorate at the National Office. The submission has been reviewed by the Legislation and Law Reform Committee and approved as a public statement of the National Pensions and Benefits Law Section of the Canadian Bar Association.

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# Strengthening the Legislative and Regulatory Framework for Private Pension Plans Subject to the *Pension Benefits Standards Act, 1985*

## I. INTRODUCTION

The National Pensions and Benefits Law Section of the Canadian Bar Association (CBA Section) is pleased to provide its views concerning the Department of Finance Consultation Paper, *Strengthening the Legislative and Regulatory Framework for Private Pension Plans Subject to the Pension Benefits Standards Act, 1985* (Consultation Paper). The CBA Section has approximately 600 members involved in pensions and benefits law from across the country, including counsel to pension and benefit plan administrators, employers, unions, employees and employee groups, trust and insurance companies, pension and benefit consultants, and investment managers and advisors.

It is important that the federal government consider reform of the *Pension Benefits Standards Act, 1985* (PBSA) and its regulations at this time because of current financial conditions and because several provinces have recently engaged in inquiries expected to lead to pension reforms. Reports have been issued by the Ontario Expert Commission on Pensions, the Nova Scotia Pension Review Panel and the Joint Expert Panel on Pension Standards of Alberta and British Columbia.[1]

## II. Issues for Discussion Pertaining to Defined Benefit Plans

### A. Solvency Measurements and Funding Rules

This is an appropriate time for the federal government to consider the solvency measurement mechanisms and funding rules in the PBSA, as financial and industry conditions have changed significantly since the date the current mechanisms and rules were enacted. The

[1] See, Ontario Expert Commission on Pensions, *A Fine Balance: Safe Pensions, Affordable Plans, Fair Rules* (Toronto: 2008); Nova Scotia Pensions Review Panel, *Promises to Keep* (Halifax: 2009); Joint Expert Panel on Pension Standards, *Getting our Acts Together: Pension Reform in Alberta and British Columbia* (Victoria and Edmonton: 2008).

CBA Section believes that changes should be directed toward providing more flexible pension funding while promoting pension security. Although temporary funding relief measures may be appropriate, they may not be appropriate as permanent legislative changes. We believe that to the extent possible solvency measurement and funding requirements across Canada should be uniform.

As a temporary relief measure, several Canadian jurisdictions have extended, or are considering extending solvency amortization from five years to ten years. Shortening the legislated amortization period at the federal level would be a significant departure from the trend in other jurisdictions, and would adversely affect legislative uniformity. Reduced solvency amortization would impose significant financial hardship on plan sponsors, particularly considering current financial market conditions. Plan sponsors would generally welcome an extension of the amortization period, to give plan sponsors more time for funding benefits. However, extensions may adversely affect the security of pension plan members. The best solution would allow for extending amortization while maintaining security for plan members.

**RECOMMENDATION:**

**The National Pensions and Benefits Law Section recommends that the legislated amortization period should be extended if it can be coupled with measures to adequately protect the security of pension benefits.**

One possibility might be to extend solvency amortization with the consent of plan members and retirees. While members who are active employees may have an incentive to consent, as it would provide relief to their employer as sponsor of the pension plan and help to keep jobs, retirees in particular would have less incentive to consent. In Quebec, for example, obtaining member consent for contribution holidays has not worked in practice. The deeming of member/retiree consent in the event of silence after notice has been provided (negative consent) might be practical, but may raise problems in terms of fairness.

Another possible solution is to offer extended solvency amortization in return for asset pledges. This solution is complicated though by issues such as the priority of pledges and

asset valuation. Further, the adverse effect of an asset pledge on an employer's ability to raise capital may negate the benefit of pension funding relief.

Another option might be to offer extended solvency amortization if a letter of credit is provided for security. This can be an appropriate safeguard where a plan sponsor is able to satisfy the credit requirements of the financial institution providing the letter of credit. Irrevocable letters of credit are currently a temporary funding relief option for federally-registered pension plans. The more permanent use of letters of credit in the context of solvency funding is consistent with developing trends in other jurisdictions and could help promote legislative uniformity. Provided that a letter of credit is properly structured and excluded from the employer's estate on bankruptcy or insolvency, it may be an appropriate alternative.

**RECOMMENDATION:**

**The National Pensions and Benefits Law Section recommends that properly structured letters of credit with appropriate safeguards be considered to extend the solvency amortization period and to help provide pension plan funding.**

The current requirement is that solvency of a pension plan is measured according to the standards of practice adopted by the Canadian Institute of Actuaries. The requirement is also subject to the Superintendent of Financial Institution's (Superintendent) discretion to grant adjustments in specific circumstances. The present method has the advantage of relying on professional actuarial expertise while reserving regulatory oversight with power to monitor and direct changes, where appropriate. However, there should be greater access to information and interaction amongst stakeholders.

**RECOMMENDATION:**

**The National Pensions and Benefits Law Section recommends that the current actuarial standards for solvency be retained, and consideration be given to:**

**(a) making the reasons behind the assumptions used in valuations more accessible**

**(b) including any promised benefits in solvency valuations**

**(c) ensuring that any proposal to prohibit asset smoothing[2] fully take into account the volatility of market conditions, and**

**(d) enhancing consultation between the federal government and actuaries to determine the appropriate discount rate to be applied in calculating plan liabilities.**

Actuarial reports are currently required to be filed every three years, subject to the Superintendent's discretion to require additional reports more frequently. Instead of leaving filing intervals to the discretion of the Superintendent, a plan with solvency liabilities falling below a specified threshold, set by regulation, should be required to perform and file annual valuations for more stringent oversight. The Superintendent should have the authority to order independent valuations in certain circumstances, such as where the Superintendent reasonably believes that the plan is at risk or if there is a material departure from accepted actuarial practices, provided there are clear guidelines for the Superintendent's discretion. More aggressive measures should be adopted to detect and discourage late filings of any required reports.

**RECOMMENDATION:**

**The National Pensions and Benefits Law Section recommends that:**

- **regulations should require plans with solvency liabilities below a determined threshold to perform and file annual valuations, rather than leaving filing intervals to the discretion of the Superintendent;**
- **subject to clear guidelines as to the exercise of discretion, the Superintendent should have authority to order independent valuations in certain circumstances; and**
- **increased steps should be adopted to detect and discourage late filings of required reports.**

In connection with the solvency measurements and funding rules, the federal government should consider the contribution limits imposed by the *Income Tax Act* (ITA) with a view to raising the limit of excess surplus permitted to remain in a pension plan as a cushion to protect against market downturn.

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[2] Asset smoothing is an averaging method that stabilizes short term fluctuations in market value of plan assets. The Office of the Superintendent of Financial Institutions (OSFI) has recently published a *Bulletin* on this subject – see, http://www.osfi-bsif.gc.ca/osfi/index_e.aspx?DetailID=244n

**RECOMMENDATION:**

**The National Pensions and Benefits Law Section recommends that contribution limits under the ITA be revised to raise the limit for excess surplus assets permitted to remain in a pension fund.**

Federal legislation has been amended recently to address plan funding in the context of a bankruptcy or insolvency[3]. The scope of these changes should be fully examined.

**RECOMMENDATION:**

**The National Pensions and Benefits Law Section recommends that the federal government examine the bankruptcy, insolvency, creditors' arrangement and pension legislation and the priority for special payments under a pension plan.**

## B. Requiring Full Funding on Voluntary Plan Termination

The CBA Section supports amendments to the *Pension Benefits Standards Act* regulations (PBSA regulations) to require full funding of pension benefits on plan termination. However, the full funding requirement should not apply to multi-employer pension plans or other target benefit or negotiated cost plans, because of their unique structure.

**RECOMMENDATION:**

**The National Pensions and Benefits Law Section recommends that full funding of pension benefits should be required for all plan terminations, except for multi-employer pension plans, target benefit plans, and negotiated cost plans.**

The Consultation Paper suggests that compliance with the full funding requirement could be modified or waived by a negotiated agreement between the plan sponsor and members. This exception would create flexibility but more details are required about the nature of a negotiated agreement. If members must agree unanimously, the exception may not be very helpful to employers, particularly if positive consent of pensioners and deferred

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[3] Bill C-12, *Bankruptcy and Insolvency Act, Companies' Creditors Arrangement Act and Wage Earner Protection Program Act* amendments received Royal Assent in December 2007 (S.C. 2007, c. 36).

vested members is also required. Negative consent, where member/retirees are deemed to consent in the event of silence, might work but may raise problems in terms of fairness. Also, where plan members are represented by a trade union, the union's consent should be considered sufficient.

**RECOMMENDATION:**

**The National Pensions and Benefits Law Section recommends that if unanimous or near unanimous member, pensioner and deferred vested member consent were required to avoid full funding on termination, the requirement should be in the form of negative consent to avoid administrative difficulties. Where members are represented by a trade union, then the union's consent should be considered sufficient member consent.**

As mentioned above, recent amendments to other federal legislation have addressed plan funding in the context of a bankruptcy or insolvency.[4] Again, the federal government should fully examine the scope of changes to bankruptcy, insolvency, creditors' arrangement and pension legislation in the context of deemed trust concepts and the priority of special payments on plan termination.

## C. Partial Termination and Immediate Vesting

No comment.

## D. Disclosure of Information

The CBA Section supports disclosure by electronic means at the option of the receiving member or beneficiary, but believes there should be an exception for smaller plan administrators with limited technological capabilities. The scope of information (e.g. member statements, current or historical plan documents) to be disseminated by electronic means should be clearly set out in the legislation.

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[4] *Ibid.*

We agree that the categories of members required to receive plan information should be expanded to include former members and retirees, where it is appropriate. As this may impose an undue administrative burden on plan administrators where former members have not provided up-to-date contact information, administrators should be deemed to comply when they provide the required information to last known addresses.

**RECOMMENDATION:**

> **The National Pensions and Benefits Law Section recommends that administrators be deemed to have complied with any expanded disclosure requirements by providing the required information to the last known addresses of former members and retirees. We further recommend that the information to be provided and to whom it is to be provided be clearly set out in legislation.**

## E. Contribution Holidays

The CBA Section supports the establishment of a formal Statement of Funding Policy, which should include any details on contribution holidays. We do not support requiring pension plans to have formal policies on contribution holidays but do support improved communication with plan members about contribution holidays.

**RECOMMENDATION:**

> **The National Pensions and Benefits Law Section recommends that a formal policy on contribution holidays is unnecessary provided that the PBSA mandates a formal funding policy.**

Contribution holidays may be legally permissible in certain circumstances so long as they do not compromise the solvency of the pension fund. A security margin could be established, and any funds in excess of this margin considered surplus. Measures should be introduced to prevent the initiation or continuation of contribution holidays based on a previous triennial valuation when plans have, in the meantime, become seriously under-funded. Such measures should take into account the possibility of rapid changes in a plan's funded status and the difficulty of estimating that status without subjecting the plan to a full valuation. They would need to be designed to trigger sensible action to preserve

the fund and to discourage deliberate or wilfully negligent disregard for its security. The regulator could establish targets for each plan, based on the Plan's annual financial statements to enable plan administrators to determine when contributions should cease or be resumed.

### F. Void Amendments

The CBA Section is of the view that an arbitrary solvency ratio for voiding amendments, without conditions and exceptions, would be too restrictive for plan sponsors and would penalize plan members by prohibiting them from negotiating mutually agreeable plan benefits. It would also prohibit employers and employees from negotiating mutually agreeable plan benefits.

**RECOMMENDATION:**

**The National Pensions and Benefits Law Section recommends that the solvency ratio applicable for voiding amendments be combined with certain conditions such as the adoption of reasonable minimum solvency funding standards, the establishment of priorities for retroactively voiding amendments which are not fully funded upon wind up, and clear disclosure to members regarding solvency deficiencies and benefits that may be at risk.**

## III. Issues for Discussion Pertaining to Defined Contribution Plans

### A. Safe Harbour for Qualified Default Investment Options

The Consultation Paper addresses only one area where safe harbour protection is under consideration: default investment options. In its *Pension Protection Act of 2006*, the United States enshrined the "safe harbour" principle, which entitles a plan sponsor to some protection against lawsuits or claims from members if the plan meets certain conditions. Canadian plan sponsors are also concerned with costly lawsuits involving defined benefit plans, and would seek comfort with respect to their defined contribution plans through a safe harbour. However, plan members may view a safe harbour protection as unjustly depriving them of their rights of action against plan sponsors or plan administrators in case of loss.

With respect to a default option, enshrining standards or obligations in legislation is difficult as many aspects of defined contribution plans allow members to choose between options for the investment of their accounts as matters of judgement. Much depends on the size and demographics of the workforce, and the size and ability of the employer both to contribute and to monitor members' investments. Smaller and midsize employers are often seeking a prepared "turnkey" plan. The similarity between defined contribution pension plans and Group registered retirement savings plans (RRSPs) should be noted. If the regulation of defined contribution plans is seen as too stringent, employers may turn to or convert their defined contribution plans to Group RRSPs, which lack some of the valuable protections of pension plans.

Moreover, pension legislation should clarify which aspects of a defined contribution plan are subject to a fiduciary duty of the employer/administrator (i.e. the selection and monitoring of investment options) and which are not. Provision should be made for some of the ongoing aspects of the administration of defined contribution plans to be shifted to service providers, once the design of the plan is established.

As to default options, a plan sponsor or administrator must provide a default investment option. Some factors involved in selecting a default option are:

- the availability of the option from the provider (all providers do not currently provide target date funds);
- the management expense ratio of the option (as compared to other options made available);
- the sophistication of the work force (the ability to understand the risks and rewards of the option);
- the ability and cost for members who wish to switch options;
- whether investment education and investment advice is provided; and
- the level of required and optional member contributions

The plan sponsor or administrator must communicate the risks and rewards of the default option both initially and periodically, with realistic return projections, in terms that plan members can understand.

Accordingly, the CBA Section would be concerned with legislation requiring a specific type of default option (i.e. a balanced fund, a target date fund or a GIC) rather than a checklist of matters required to take into consideration in selecting a default option. However, we strongly believe the legislation should expressly require a default fund and provide criteria that must be taken into account when establishing such a default fund. Emphasis should be placed on the information and the periodic communication that must be provided to participants regarding the consequences of relying on a default option which might or might not be appropriate for them.

Finally, although the Consultation Paper requests recommendations on a safe harbour with respect to the default option only, we stress that the PBSA should deal more broadly with information, education and advice that members in defined contribution plans should be entitled to receive.

**RECOMMENDATION:**

**The National Pensions and Benefits Law Section recommends that:**

**a) more specific criteria should be added to the PBSA concerning a greater number of aspects of defined contribution plans, including information to members, education and advice;**

**b) the PBSA should clearly identify which aspects of a defined contribution plan are subject to a fiduciary duty and who assumes such duty;**

**c) the PBSA should be amended to expressly require a default fund and provide the criteria that must be taken into account when establishing a default fund; and**

**d) emphasis in the PBSA should be on the information provided to participants.**

## B. Retirement Benefits Paid from the Pension Fund

Section 4B of the Consultation Paper proposes allowing payment of variable retirement benefits directly from members' defined contribution accounts held under a pension plan. The CBA Section strongly supports the proposal to allow Registered Retirement Income Fund (RRIF)-type benefits to be paid from members' defined contribution accounts in the manner permitted for "variable benefits" under the *Income Tax Regulations*. We expect this would be a plan design feature that would be optional for each plan sponsor, that is, it could

be incorporated by one plan sponsor and not by another. For plan sponsors who incorporate the feature, members would be allowed to leave their defined contribution accounts in the plan after termination of employment to receive variable benefits directly from their defined contribution accounts.

It is unclear what is meant by the reference in the Consultation Paper to the requirement for consent of the plan and the members. Also unclear is whether this would prevent a defined contribution plan administrator from making the variable benefit the default option for those members who do not complete their election form at the time of termination. While the flexibility to allow variable benefits to be paid from defined contribution accounts may not appeal to many plan sponsors, for example, those with small and medium sized plans, it may be a valuable design feature for some plan sponsors, such as those who wish to maintain ties with their former employees and who could offer certain incentives (most likely, investment selection and cost savings) for those former employees to leave their defined contribution accounts in the plan fund.

**RECOMMENDATION:**

**The National Pensions and Benefits Law Section recommends that the PBSA be amended to allow RRIF-type benefits to be paid from members' defined contribution accounts.**

## C. Standard of Care Changes

Section 4C of the Consultation Paper suggests that the standard of care for employers sponsoring defined contribution plans should be the standard of good faith. The standard of care for an employer sponsoring a defined contribution plan is a matter of legal debate. A plan sponsor’s role may be different from the plan administrator’s role, even though section 4C seems to use the terms interchangeably. It is not obvious why the focus on what the appropriate standard of care is and should be is limited to plan sponsors. The same should apply to other parties involved in the operation and administration of defined contribution plans. This is a complex area in need of clarity and definition under the PBSA. Under a defined contribution plan, an employer’s role once the plan is established is often very

limited. Service providers may have fiduciary responsibilities, depending on what they do in the particular circumstance and for whom.

These examples illustrate the need for the federal government to take a direct and concerted approach, first by defining the various roles and responsibilities in the operation of a defined contribution plan and then by assessing the appropriate standard that should apply. The federal government should also assess whether the legislation should be retrospective. We understand that a similar exercise of evaluating roles and duties of care is being undertaken by the Canadian Association of Pension Supervisory Authorities (CAPSA) in the context of its Model Law initiative, and it is appropriate for the federal government to also do this in relation to the PBSA.

**RECOMMENDATION:**

**The National Pensions and Benefits Law Section recommends that the PBSA be amended to define the various roles and responsibilities in the operation of a defined contribution plan and to assess the appropriate standards that should apply.**

## D. The Use of Surplus in Defined Contribution Plan Components

The use of defined benefit surplus to fund the employer's obligation under the defined contribution component of the plan raises the question of whether the defined contribution accounts should be proportionately decreased if the plan is wound up with a defined benefit deficit. It also raises the corollary issue of whether the defined contribution members have a right to share in the surplus of the defined benefit component if the plan is wound up with a defined benefit surplus. In hybrid plans, the defined contribution members have already assumed much of the investment risk, and we are not aware of a case where members have been informed that their accounts could be negatively impacted by a plan wind up by a deficit in the defined benefit component. If it became clear law that defined contribution members might have to assume the defined benefit investment and funding risk, there would be an immediate and powerful disincentive for defined contribution members to remain in the plan. Employers and administrators would have to inform defined contribution members

of that risk and in fairness to the defined contribution members, move them to a different plan or to a Group RRSP.

Any codification of the use of surplus in a defined contribution component must balance interests. In any event, the PBSA should be amended to explicitly address the wind up of hybrid plans in a deficit position to provide certainty in those circumstances.

**RECOMMENDATION:**

**The National Pensions and Benefits Law Section recommends that the PBSA be amended to address the wind-up of hybrid plans in both surplus and deficit positions.**

## E. Administration Procedures

Currently, the PBSA does not clearly allow the administrator to unilaterally transfer the account balances of defined contribution component members out of the plan upon termination of employment.

Employers remain responsible for the administration of the account balances of a terminated defined contribution component member. In some cases, this means the costs of maintaining the former member's account is assumed by other members of the plan. Further, it is difficult to maintain ongoing communication with former employees. The CBA Section supports clarifying the PBSA to provide that on termination of a defined contribution component member, the administrator may transfer the member's account into another retirement savings vehicle upon providing reasonable and appropriate notice to the member. Providing defined contribution component sponsors with this ability will limit the plan sponsor's liability in respect of the terminated member and provide terminated members with ongoing control and responsibility for the investment and maintenance of their accumulated assets.

The new rules should also prescribe what information is required in the notice. For example, the member should be informed when the transfer will occur and given the appropriate contact information for the holder of the retirement savings vehicle.

**RECOMMENDATION:**

> **The National Pensions and Benefits Law Section recommends that the PBSA be amended to clarify that on termination of a defined contribution component member, the administrators may transfer the member's account into another retirement savings vehicle upon providing reasonable and appropriate notice.**

# IV. Other Issues Respecting the Framework for Private Pension Plans

## A. Flexibility of the *Pension Benefits Standards Act, 1985*

Ideally, legislative change should provide greater flexibility for plan design. The CBA Section supports alternative plan designs and believes that added flexibility is likely to increase the number of individuals able to participate in a registered pension plan. Plan members should be required to play a much greater role in the administration of certain alternative plans, and if design change shifts risk from plan sponsors to plan members, there should be appropriate oversight and reporting obligations. Jointly trusteed plans, such as multi-employer pension plans, should also be encouraged.

**RECOMMENDATION:**

> **The National Pensions and Benefits Law Section recommends that the legislative framework accommodate alternative plan designs.**

## B. Multi-Employer Pension Plans

The CBA Section believes that several improvements could be made to the legislative framework to encourage multi-employer pension plans (MEPPs). Solvency requirements do not work for MEPPs that are funded through fixed negotiated contributions under multi-year collective agreements because of their unique nature. MEPP assets are permanently committed to participant benefits. If a MEPP is designed properly, regardless of the benefit promise, the total amount of assets available in the rare event of a MEPP wind-up should be distributed entirely to members and beneficiaries. As a wind-up is unlikely, it does not make sense to provide artificially low benefits in return for more security against possible wind-up in the future.

**RECOMMENDATION:**

> **The National Pension and Benefits Law Section recommends that like several provincial governments, the federal government should exempt MEPPs from solvency funding requirements. In return for solvency funding relief, MEPPs should be held to high communication standards to ensure members understand benefit reductions might apply on plan wind up.**

The computation of lump sum payments is normally based on the full wind-up liability for the participant as of the measurement date. Subject to certain limits, 100% of the commuted value is paid, even if the plan is not fully funded on a wind-up basis. This method may be appropriate for single employer plans, but does not make sense for MEPPs. Under the method, members who terminate might be treated more preferentially than continuing members of a MEPP. Instead, lump sums or other transfers should be paid based on the wind-up funded level of the most recently filed actuarial report (up to 100%).

**RECOMMENDATION:**

> **The National Pensions and Benefits Law Section recommends that for MEPPs, transfers should be paid based on the wind-up funded level of the most recently filed actuarial report without subsequent payment of the withheld amount.**

In keeping with the general purpose of pension plans, benefit payments from MEPPs should be used for retirement purposes. Therefore, we believe that a MEPP administrator should be provided with the broadest reasonable authority to suspend pensions when pensioners return to work. This will help to ensure that pension payments are used for retirement purposes, rather than to supplement wages.

**RECOMMENDATION:**

> **The National Pensions and Benefits Law Section recommends that a MEPP administrator should be provided with broad reasonable authority to suspend pensions when a pensioner returns to work.**

## C. Simplified Pension Plans

Under the PBSA regulations, simplified pension plans are defined contribution pension plans constituted by contract between a participating employer and a financial institution. There are two key differences between a defined contribution plan and a simplified pension plan. First, the simplified pension plan must be administered by a financial institution rather than the employer or another designated administrator. Second, the simplified pension plan permits a number of employers to participate in the plan.

The simplified plan model should be attractive to employers as it shifts the administrative risk to the financial institution. If there are other participating employers, it could reduce costs for the employer and plan members due to economies of scale. Simplified pension plans can also be attractive to smaller employers without the resources to administer a pension plan.

In Quebec, simplified pension plans have achieved some success mainly with small employers, although larger employers are also starting to show an interest. Simplified pension plans governed by the Quebec *Supplemental Pension Plans Act* are contracts issued by a financial institution in which several employers can participate. The simplified pension plan consists of two parts, one that sets out the provisions applying to all employers and another that deals with the provisions specific to each employer. As under the PBSA, the employer assumes a minimum of administrative tasks. The financial institution administers the plan and provides the required information to the members and supervisory authorities. However, the Quebec government has tried to combine the advantages of the group RRSP and DPSP and the registered pension plans. For example, the employer can opt for member contributions that are not locked-in or can decide that member contributions credited to a member's not locked-in account cannot be withdrawn before the member's active membership in the employer's simplified pension plan ends. The employer’s contributions are always locked-in. Further, even when the employer elects not to permit the members to withdraw their contributions during active membership, the members can still use their contributions to take advantage of a RRSP homebuyer's plan or lifelong learning plan, transfer their contributions to a locked-in retirement savings instrument as of the age of 55, or opt for a cash refund, in the case of a disability that reduces life expectancy.

Finally, under the Quebec *Supplemental Pension Plans Act*, members must withdraw all amounts from their accounts at the end of membership in a simplified pension plan. This avoids the issue raised in section 4E of the Consultation Paper concerning inactive members who do not transfer the assets to an alternative vehicle.

We believe that the flexibility of the Quebec simplified pension plan has contributed to the decision of Quebec employers to set up a simplified pension plan rather than other types of retirement or pension vehicles.

**RECOMMENDATION:**

**The National Pension and Benefits Law Section recommends that to make simplified pension plans more attractive to employers, the PBSA be amended to provide greater flexibility to plan sponsors wishing to establish such a plan.**

## D. Distinction Between Defined Contribution and Defined Benefit Plans Under the Act

The CBA Section supports added clarity regarding the differing treatment of defined benefit and defined contribution plans under the PBSA. At present, the intermingling of disparate concepts and rules within discrete sections of the PBSA and its regulations makes them difficult to read, interpret and apply.

Guidance from the Superintendent concerning which provisions of the PBSA apply exclusively to either defined benefit or defined contribution plans may be helpful. However, unlike legislation, the Superintendent's policy directives and guidance would more easily be subject to judicial override.

We support the current PBSA approach that distinguishes between provisions applicable to defined benefit and defined contribution plans. However, we believe that greater clarity would be helpful in distinctions about provisions for plan funding rules (filing of actuarial valuation reports and cost certificates), pre- and post-retirement death benefits, portability rights, member statement requirements, and items for the Statement of Investment Policies and Procedures.

**RECOMMENDATION:**

**The National Pensions and Benefits Law Section recommends that the PBSA clearly identify which provisions apply to defined benefit plans (including hybrid plans or plans with a historic defined benefit component) and which apply to plans offering strictly a defined contribution component. Where there is significant divergence between the rules applicable to defined benefit versus defined contribution plans, separate sections within the Act would promote clarity.**

## E. Investment Rules

The CBA Section believes that a review of the investment rules under Schedule III is timely. The Consultation Paper notes that these investment rules have not been modified in a material way since the move away from the concept of a “legal list” of permitted investments about 15 years ago. Within the last four months, commissions established by the governments of Alberta, British Columbia, Ontario and Nova Scotia to review pensions have all commented on the pension investment rules. In addition, recent financial and economic developments are bringing pressure on pension funds and sponsoring employers to review investment strategies. The CBA Section believes the first step in determining the most effective regulation of pension fund investments is to evaluate existing and proposed regulatory regimes against the objectives of investment regulation.

For defined benefit plans, funding for registered plans is required primarily to increase the likelihood that pension benefits will be paid as promised. Similar considerations apply to “target” benefit plans. For both, the primary purpose of pension investment regulation is to enhance the prospect that pension fund assets will be accumulated sufficient to pay the promised or target benefits. This appears to have also been the intention underlying the existing federal investment regulations.

**RECOMMENDATION:**

**The National Pensions and Benefits Law Section recommends that, for Defined Benefit and Target Benefit Plans Funding, the primary objective of**

**investment rules should be that sufficient pension fund assets will be accumulated to fund benefits.**

Where a pension plan permits members to make investment decisions, investment regulations should protect the members as investors by facilitating prudent decision-making without dictating investment choices. The CBA Section believes the existing investment rules under Schedule III do not achieve this objective.[5] In 2004, CAPSA adopted the Guidelines for Capital Accumulation Plans (Cap Guidelines). Those guidelines do not have the force of law but are generally considered to be "best practices" by plan sponsors and service providers. They provide information and tools that members should have to make appropriate decisions on how their account balances will be invested.

**RECOMMENDATION:**

**The National Pensions and Benefits Law Section recommends that to facilitate member investment decisions in capital accumulation plans (CAPs), investment rules should be expanded to provide legislative support to protect the members as investors by facilitating prudent decision-making and promoting the CAP Guidelines.**

The Office of the Superintendent of Financial Institutions (OSFI) has also published guidelines for developing investment policies and procedures.[6] The CBA Section believes it is appropriate to base investment rules on the criteria developed by OSFI and CAPSA, and for OSFI to develop expanded guidelines and commentary from time to time, preferably with provincial regulators through CAPSA.

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5 We note though that OSFI, working with provincial pension regulators, federal and provincial insurance regulators and provincial securities regulators, has attempted to introduce these considerations into the regulatory framework for defined contribution pension plans through the adoption of the Capital Accumulation Plan - CAP -Guidelines.

6 Section I.3.2, Guideline for the *Development of Investment Policies and Procedures for Federally Regulated Pension Plans*, April 2000.

**RECOMMENDATION:**

**The National Pensions and Benefits Law Section recommends that the investment rules be modified to address pension plans that permit members to make investment decisions, based on the principles set out in OSFI's guideline for developing investment policies and procedures and the CAP Guidelines.**

Investment regulation also attempts to control self-interested actions of the employer and other participants in the pension investment process, through restrictions on related party transactions in Schedule III and the investments prohibited by regulations under the ITA. While the restrictions in Schedule III merit review, the CBA Section submits that controlling self-interested actions remains an important objective of pension investment regulation.

**RECOMMENDATION:**

**The National Pensions and Benefits Law Section recommends that control of self-interested transactions of the employer and other participants remain an important objective of pension investment regulation.**

Investment regulation may also include regulation of pension funds as institutional investors with the potential to affect capital markets and the Canadian economy. For example, the existing 30% limit on voting shares appears to have been intended to prevent pension funds from controlling the companies in which they invest, rather than ensuring the funding of pension benefits.

Pension funds play a significant role in Canadian capital markets. Internationally, some commentators have called for reform of the way in which pension funds invest to enhance the operation of capital markets generally. However, few commentators have called for specific investment rules for pension funds. Rather, they generally propose improved governance processes and reporting.

Considering that other participants in capital markets are subject to less regulation than pension funds, it is not obvious that regulation of pension funds as institutional investors is necessary or desirable. Pension funds are already subject to regulation under applicable

securities regulation regarding their interests in public companies. We note that securities regulators across Canada have taken the particular concerns of pension funds into account in developing National Instrument 62-103 (The Early Warning System and Related Take-Over Bid and Insider Reporting Issues).

**RECOMMENDATION:**

**The National Pensions and Benefits Law Section recommends reliance on securities regulation to regulate pension funds as institutional investors, rather than the PBSA regulating pension funds as institutional investors.**

Despite the patchwork of provincial and federal regulation of pension plans, considerable uniformity has developed in the regulation of pension fund investment. Of the nine provinces that regulate pension fund investment,[7] seven have adopted investment rules substantially the same as the federal rules. The other two provinces, Quebec and New Brunswick, have adopted investment rules that are mostly similar. As several provinces are now considering proposals to modify pension investment rules, uniformity is in jeopardy. For multi-jurisdictional pension plans, the prospect of material differences in investment rules across Canada is daunting.

**RECOMMENDATION:**

**The National Pensions and Benefits Law Section recommends that uniformity of pension investment rules across Canada should be an objective of investment regulation to facilitate effective plan administration.**

During the 1990s pension investment regulation across Canada shifted from the use of lists of permitted investments to a prudent investment approach with a few specific rules. The prudent investment approach is currently reflected in subsections 8(4) and (4.1) of the PBSA.

This approach has allowed pension plans considerable flexibility to adapt pension investment strategies as financial markets have evolved. Not only have new financial instruments arisen, but as those instruments have grown more familiar, their use by pension

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7 Prince Edward Island does not have pension legislation.

funds has become increasingly accepted as prudent. With the rapid development of these changes, the flexibility of the prudent investment approach has been particularly valuable. A few quantitative limits are unlikely to be the basis for meaningful regulation of investment. If more refined investment rules were developed, it would be difficult and expensive for a pension regulator to maintain sufficient financial and investment expertise to proactively provide meaningful investment oversight generally to pension plans within its jurisdiction. We suggest instead guidance be offered by OSFI regarding investment issues that arise occasionally, and investigations of any complaints as they arise.

**RECOMMENDATION:**

> **The National Pensions and Benefits Law Section recommends that an effective use of limited regulatory resources would be to develop guidance regarding investment issues that arise from time to time, and to investigate pension funding issues in response to complaints.**

The general prudence principle is sometimes seen as vague and requiring more explicit guidance. This concern may be exacerbated if the quantitative limits set out in the existing Schedule III are eliminated. However, every pension plan is required to prepare and review at least annually a written statement of investment policies and procedures to flesh out the prudent investment principle in the context of a particular pension plan. OSFI already provides valuable guidance on the development of such policies and procedures.

**RECOMMENDATION:**

> **The National Pensions and Benefits Law Section recommends that the prudent investment standard continue to be the principal rule for pension fund investment, and that each pension plan administrator continue to be required to prepare and maintain a written statement of investment policies and procedures tailored to that plan.**

If the prudent investment standard alone is considered too vague, section 7.1 of the PBSA regulations provides for matters to be addressed in a plan's statement of investment policies and procedures. Diversification of investment risk would be an important criterion in developing a portfolio strategy and must be addressed in the statement of investment policies

and procedures. Other important matters to be considered are set out in the OSFI's guideline for developing investment policies and procedures.

**RECOMMENDATION:**

**The National Pensions and Benefits Law Section recommends that OSFI publish redacted examples of statements of investment policies and procedures that it considers appropriate, particularly for the benefit of smaller plans.**

The development of general investment commentary gives guidance to pension plan administrators, without restricting investment flexibility. OSFI has already provided such guidance on some issues.[8]

**RECOMMENDATION:**

**The National Pensions and Benefits Law Section recommends that OSFI continue to provide guidance to pension plans in response to issues of concern, and work jointly with provincial pension regulators through CAPSA to develop additional investment guidelines and information to help pension plan administrators fulfill their prudent investment obligations.**

Section 9 of Schedule III prohibits loans or investments greater than 10 percent of the total value book value of the plan's assets to any one person, two or more associated persons or two or more affiliated corporations, subject to a few prescribed exceptions. As pension fund investing has evolved in recent years, this limit is both too generous and too restrictive.

The limit is too generous as it may suggest it is prudent to invest up to 10% of a plan's assets in securities of a single company. This limit is far higher than would actually be considered prudent by most pension investment advisors.

The limit is too restrictive for purposes of investments in funds or funds of funds, which may be cost effective for smaller pension funds and have become common in recent years. There is an exception for an investment in a fund that itself complies with Schedule III.

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[8] See the February 1992 Guideline regarding *Securities Lending* and the May 1997 Guideline on *Derivatives Best Practices.*

Even for domestic funds, the investment rules applicable to funds under securities legislation do not exactly match the requirements of Schedule III. For example, the 10% rule in Schedule III is based on the book value of the plan's assets. The rules for most funds are based on market value rather than book value. If the exception in section 9(3)(a) of Schedule III is not available, then tracing of a pension fund's indirect interest in a particular company through funds and funds of funds becomes impractical to monitor, let alone control.

Since the plan administrator is required to exercise prudence in selecting an investment fund, the 10% rule does not appear to be necessary or appropriate. Quebec deleted the 10% limit from its investment rules in 2000 (except with respect to securities of the employer and affiliates), and instead adopted a general diversification requirement.[9]

**RECOMMENDATION:**

**The National Pensions and Benefits Law Section recommends eliminating the 10% limit in section 9 of Schedule III.**

Section 10 of Schedule III limits investment in real property and Canadian resource properties. The limits are arbitrary and sometimes more restrictive for Canadian investments than for foreign investments. The general prudent investment standard is sufficient to address investment issues regardless of asset class.

**RECOMMENDATION:**

**The National Pensions and Benefits Law Section recommends eliminating the limits for real property and Canadian resource property investments in section 10 of Schedule III.**

Section 11 of Schedule III prohibits a pension fund from investing in securities of a corporation to which more than 30% of the votes that may be cast to elect directors of the corporation are attached. This seems intended to limit the impact of pension funds on capital markets, rather than to protect the interests of plan members.

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[9] "Unless it is reasonable in the circumstances to act otherwise, the pension committee must endeavour to constitute a diversified portfolio so as to minimize the risk of major losses" (Section 171.1 of the Quebec *Supplemental Pension Plans Act*.

If it was previously appropriate to limit pension funds to passive investments, that is no longer the case. Generally, shareholder activism has increased over the last 15 years. A number of large sophisticated pension plans look for more active investment to achieve desired rates of return and are prepared to be involved in supervising management.

In any event, the 30% limit does not prevent pension funds from exercising significant influence over the companies in which they invest. Sophisticated pension plans now establish structures that comply with the wording of section 11 and afford the pension fund considerable influence over the target company, as was quite publicly acknowledged in connection with the abortive takeover bid by the Ontario Teachers' Pension Plan for BCE. The 30% limit might be viewed as restricting self-interested transactions by preventing use of a pension fund to control target companies for the benefit of the employer. However, the current rule is ineffective for that purpose as well.

**RECOMMENDATION:**

> **The National Pensions and Benefits Law Section recommends eliminating the 30% limit on voting shares in section 11 of Schedule III.**

Sections 12, 13 and 14 of Schedule III provide exceptions to the 30% limit for real estate corporations, resource corporations and investment corporations established by pension funds for investment purposes. If the restrictions in section 11 are eliminated, the exceptions in sections 12, 13 and 14 would no longer be necessary.

Any corporations established by pension funds for investment purposes should be subject to the same rules as the pension funds regarding the holding of investments and their assets. Results should be appropriately included by the pension funds for reporting purposes.

**RECOMMENDATION:**

> **The National Pensions and Benefits Law Section recommends that the restrictions regarding real estate corporations, resource corporations and investment corporations in sections 12, 13 and 14 of Schedule III be eliminated.**

One area that merits continued regulation beyond the general prudent investment rule relates to self-interested actions of the employer and other participants in the pension investment process. When an employer is under financial pressure, it may be tempting to push the limits of prudence for personal benefit. The employer's own employees administering the pension plan are not well-positioned to resist pressure from their employer. Restrictions and bright line tests are appropriate to control self-interested actions.

Regulations under the ITA prohibit certain investments in related parties. Those regulations apply to all pension plans in Canada, whether subject to federal or provincial regulation. Those prohibitions apply to different parties than the restrictions on investments in related parties contained in Schedule III. To ease regulatory compliance it would be preferable to define one set of related parties in which investments are to be restricted.

**RECOMMENDATION:**

**The National Pensions and Benefits Law Section recommends that investments in related parties continue to be prohibited pursuant to the ITA and, with some exceptions, not by restrictions in investment rules.**

Regulations under the ITA permit unlimited investment in shares listed on a designated stock exchange, as well as bonds, debentures, notes and similar obligations of corporations with listed shares. If the 10% limit on investments generally is eliminated, it would be appropriate to maintain a bright line test regarding investment in securities of the employer and affiliates, as Quebec has done. Consideration should be given to setting the limit lower than 10%, in line with current views as to prudent diversification. To allow practical administration of investments, this limit should not restrict investment in arm's length funds that comply with National Instrument 81-102 or similar rules or in foreign arm's length funds. To avoid creating complicated compliance issues, holdings of securities of the employer and affiliates by such funds should not be counted for purposes of the new limit.

**RECOMMENDATION:**

**The National Pensions and Benefits Law Section recommends that the investment rules set a limit below 10% on investment by a pension fund in**

**securities of participating employers and affiliates, other than indirect investment through arm's length funds.**

Self-interest may arise in different types of transactions. For example, a director of the plan administrator may be a principal of an investment management firm that could be retained to manage pension fund assets. We note that corporate law imposes rules regarding conflicts of interest typically requiring disclosure to the board or committee, and restricting voting.[10] Adopting corporate rules as a model would be beneficial in that directors and officers are generally familiar with corporate rules. If further protections are required for pension investment issues, disclosure in periodic reports to the pension regulator made available to plan members would permit flexibility while allowing for oversight.

**RECOMMENDATION:**

**The National Pensions and Benefits Law Section recommends that apart from the restrictions on investments in related parties, the conflict of interest rules for pension funds be modeled substantially on those applicable to directors and officers of corporations.**

It has recently been suggested that pension fund investment should take into account environmental, social and/or governance issues. The CBA Section believes that the general prudent investment standard allows consideration of environmental, social and/or governance issues for the purpose of analysing potential investment returns. However, we note that considerations independent of objectives of pension investment have the potential of creating conflicts of interest with plan members and confusion regarding the duties of the plan administrator. If reference to environmental, social and/or governance issues is considered essential in the investment rules, those issues should be in the context of evaluating potential investment returns rather than as independent objectives.

**RECOMMENDATION:**

**The National Pensions and Benefits Law Section recommends that for pension investment purposes, consideration of environmental, social and/or**

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[10] See section 120 of the *Canada Business Corporations Act*.

**governance issues be permitted for the purpose of analyzing potential investment returns rather than as independent investment objectives.**

## V. Conclusion

The CBA Section appreciates this opportunity to respond to the issues pertaining to the PBSA in the Consultation Paper. We trust that our feedback will be helpful, and we look forward to ongoing opportunities to provide further input to improve this important legislation.