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Finance Canada Consultation on Pension Plan Investment in Canada: the 30% Rule

Canadian Bar Association
Pensions and Benefits Law Section

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PREFACE

The Canadian Bar Association is a national association representing 36,000 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 CBA Pensions and Benefits Law Section, with assistance from the Legislation and Law Reform Directorate at the CBA office. The submission has been reviewed by the Legislation and Law Reform Committee and approved as a public statement of the CBA Pensions and Benefits Law Section.

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I. INTRODUCTION

The Pensions and Benefits Law Section of the Canadian Bar Association (CBA Section) is pleased to contribute to Finance Canada's consultation on the rule under section 11 of Schedule III to the *Pension Benefits Standards Regulations, 1985*. That rule restricts federally regulated pension plans from holding securities of a corporation to which are attached more than 30% of the votes to elect the directors of the corporation, subject to certain prescribed exceptions[1] (the 30% Rule).

The CBA Section consists of members involved in pensions and benefits law across the country, including counsel (private practice and in-house) who advise pension and benefit plan administrators, employers, unions, employees and employee groups, trust and insurance companies, pension and benefit consultants, and investment managers and advisors.

The CBA Section commends the government's continuing efforts to provide guidance on the important issue of prudent management of pension investments and to seek input on from pension industry stakeholders.

II. CONSIDERATIONS RAISED IN THE CONSULTATION

A. Overview

The CBA Section's general view is that the 30% Rule is an outdated restriction on pension plan investments that should be eliminated. The *Pension Benefits Standards Act, 1985* (the PBSA) and its regulations impose prudential and other requirements, above and beyond the 30% Rule, which have the effect of prohibiting pension plans from owning more than 30% of the voting shares of any corporation except where the plan is sufficiently sophisticated to prudently make such an investment.

1 See subsection 11(2) of Schedule III to the *Pension Benefits Standards Regulations, 1985*.

As the 30% Rule was never intended nor designed to serve as a tax policy tool, eliminating it should not result in consequential changes to the income tax treatment of pension plans or the investments held by pension plans.

B. Prudential considerations

The investment of a pension plan's assets is an important aspect of plan administration. A balanced approach is necessary in regulating pension investments to protect the interests of plan beneficiaries while providing flexibility in administering and investing plan assets.

The existing requirements of the PBSA, its regulations and regulatory guidelines governing the investment of plan assets are sufficient to ensure that pension plans acquire more than 30% of the voting shares of a corporation only where it is prudent and appropriate in the circumstances of the particular plan. Specifically:

- subsections 8(4) and 8(5) of the PBSA impose a fiduciary-like standard of care on plan administrators when administering the plan and the pension fund;
- subsection 8(4.1) of the PBSA expressly requires an administrator to invest the plan's assets "in a manner that a reasonable and prudent person would apply in respect of a portfolio of investments of a pension fund";
- subsection 8(10) of the PBSA guards against situations where there is a conflict of interest by requiring a plan administrator to act in the best interests of the plan members whenever a material conflict of interest arises;
- section 16 of Schedule III restricts investments in related parties, which provides an additional safeguard in prohibiting pension funds from acquiring shares of a corporation where doing so would constitute a related party transaction;
- the restriction on a pension fund investing more than 10% of its assets in a single person (including a corporation) (the 10% Limit), set out in section 9 of Schedule III, prohibits pension plans (most likely smaller pension plans) from acquiring more than 30% of the voting shares of a corporation where the value of that investment is greater than 10% of the market value of the plan's assets; and
- Guideline No. 6, "Pension Plan Prudent Investment Practices Guideline", issued by the Canadian Association of Pension Supervisory Authorities (CAPSA) includes the requirement for a plan administrator to exercise prudence in selecting investments for the plan.

In light of these restrictions and protections under the PBSA, Schedule III and CAPSA Guideline No. 6, continuing to impose the 30% Rule is unnecessary to ensure that pension assets are prudently invested and the interests of plan members protected.

The consultation document indicates that the 30% Rule was originally introduced to reflect the belief that pension plans should remain passive investors. While that may previously have been an appropriate approach, the CBA Section sees this as no longer always the case. The consultation document comments that various factors, including increased longevity, low interest rates and volatility in the global equity markets, have led pension plans to seek investments that can provide strong, stable returns. One way to achieve these objectives in some cases is by taking an active role in plan investments. In our experience, the number of pension plans taking such action has increased in recent years for a variety of reasons, including the development of structures for complying with the 30% Rule.

Eliminating the 30% Rule will not necessarily result in more pension plans becoming active investors. Sophisticated pension plans with established structures for complying with the 30% Rule, while at the same time exerting influence over a corporation as a shareholder, will continue to be active investors. Other, usually smaller, pension plans that are traditionally passive investors are likely to remain so, regardless of whether the 30% Rule is eliminated.

That said, some members of the CBA Section are of the view that the 30% Rule may continue to serve a purpose in the case of plans that have less sophisticated governance structures and compliance procedures in place.

III. INVESTMENT PERFORMANCE

Does the 30% Rule impede pension administrators from obtaining appropriate investment returns? If so, why?

It is possible for plan administrators to structure an investment in a corporation to comply with the 30% Rule while affording the plan considerable influence over the target corporation. In most cases, the structures involve costs to the plan that would not be incurred if the 30% Rule did not exist. Additional costs, while often immaterial to the overall size of the investment, still reduce the plan's rate of return on the investment, reduce the assets available to provide benefits under the plan and could result in higher contribution requirements under the plan.

The consultation document notes that many pension plans have recently increased investment holdings where they play an active role. In our experience over the last few years, the 30% Rule has not prevented sophisticated pension plans from making investments that they have determined to be prudent or from exercising a prudential level of control over those investments while complying with the 30% Rule. In today's investment environment, transactions often have complex structures for reasons other than the 30% Rule (e.g., for liability reasons or to permit different classes of investors to participate in the investment). The 30% Rule is one factor among many in structuring pension investments.

What are the costs, if any, that the 30% Rule imposes for pension plans seeking active investments?

The 30% Rule imposes additional transactional and administrative costs on pension plans that invest in a corporation in compliance with the 30% Rule while acquiring considerable influence over the target corporation. The costs include, for example, legal, tax and other professional advisory fees, as well as the costs associated with educating the target or any co-investors on the structure. However, in our experience, the costs associated with establishing and maintaining these structures are often relatively small compared to the size of the investment and would not alone cause the administrator not to proceed with the investment.

Does the 30% Rule create inequities between large and small pension plans? Conversely, could its removal do so? If so, why?

In our experience, the 30% Rule does not, in itself, create inequities between large and small pension plans because smaller plans would typically not invest in more than 30% of the voting shares of a corporation whether or not the 30% Rule applied. Smaller funds normally do not have the assets or expertise to make direct active investments in corporations. In most cases, such an investment by a smaller pension fund would simply not be prudent. Also, as mentioned above, the 10% Limit will in some cases preclude plans (most likely smaller plans) from making such an investment.

IV. TAX POLICY CONSIDERATIONS

The consultation document suggests that the principle underpinning the 30% Rule is that pension funds should be passive investors and that it is intended to reduce pension plans' exposure to risk should a controlled business fail. The 30% Rule was never intended or designed to serve as a tax policy tool. In the CBA Section's view, it is inappropriate to tie changes to the manner in which pension funds and their investments are taxed to the elimination of the 30% Rule.

The tax policy concerns expressed in the consultation document appear to be premised on the assumption that ownership of 30% of the voting shares of a corporation necessarily results in control of the corporation's business activities. This is simply inaccurate in many cases. Further, a 30% voting interest test is inconsistent with the tests for control of a corporation applied under the *Income Tax Act* (Canada) (the ITA).

Eliminating the 30% Rule may draw criticisms of there being an "uneven playing field" from other private sector investors that compete with pension funds for investment opportunities and, therefore, some may call for changes to the tax treatment of pension plans. The CBA Section believes that no changes are warranted and the important public policy objectives that underlie the current tax treatment of pension plans must continue to be respected.

We believe that eliminating the 30% Rule should ***not*** result in any consequential changes to the tax treatment of pension plans or the investments held by pension plans.

Nonetheless, should the federal government decide that eliminating the 30% Rule would require consequential income tax changes, we urge consideration of the following:

- Any proposed tax measures need to be developed with consideration to related provisions in the ITA and, accordingly, should be specifically proposed but not implemented prior to proper consultation with the pension industry, income tax experts and other interested stakeholders;
- Depending on the tax measures proposed, some stakeholders may conclude that the status quo (i.e., maintaining the 30% Rule) would be preferable and this option should remain open to consideration by the federal government;
- Any proposed tax measures should seek to respect the general principle that pension plan taxation is based on tax deferral, with taxation in the hands of the eventual recipient of benefits under the pension plan;
- Any new tax measures should avoid undue complexity so that pension plans are not driven to implementing complex structures to avoid double taxation that could result in additional administrative costs to the plan;
- New tax measures should not apply to entities that are currently exempt from the 30% Rule, such as real estate, investment and resource corporations, or to other existing investments (particularly long term investments) based on legitimate structures;
- The decision as to whether a pension plan invests within Canada or abroad should not be influenced by any new tax measures. For example,

any new tax measures should not serve as an incentive for Canadian pension funds to invest outside Canada, rather than within Canada;

- The income tax treatment of pension plans and their investments should not serve as a disincentive or obstacle for Canadian pension funds investing in infrastructure projects and should avoid placing Canadian pension plans at a competitive disadvantage with foreign pension funds and other investors, both in Canada and abroad; and
- Any new tax measures which are linked to the 30% Rule should take into consideration any variation in the 30% Rule among the provinces and territories applicable to pension plans that are not federally regulated.

V. CONCLUSION

The CBA Section appreciates the federal government's continuing efforts in providing guidance on various aspects of prudent management of pension investments. We trust that our comments are helpful and look forward to the opportunity for continued participation in the federal government's pension consultations.