August 2001

A Submission to the
CAPSA Investment Policy Committee

Recommendations for Modifications to Pension Plan Investment Rules

Submitted by the Pension Investment Regulations Task Force comprising representatives of:

ACPM
The Association of Canadian Pension Management

Pension Investment Association of Canada

Canadian Life
and Health Insurance
Association Inc.

ICAC

To: Glenn McAllister
Chair, Investment Policy Committee, CAPSA
c/o Office of the Superintendent of Financial Institutions
Private Pension Plans Division
255 Albert Street
12th Floor
Ottawa, Ontario
K1A 0H2

Dear Mr. McAllister:

Following the recent adoption of the federal investment rules (FIR) by Ontario, as part of the harmonization initiatives of the Canadian Association of Pension Supervisory Authorities (CAPSA), a broad-based group of pension organizations formed the Pension Investment Regulations Task Force (the "Task Force").

The objectives of the Task Force were to review the key principles of the regulations, and to identify the practical issues and problems in monitoring compliance with these regulations. While the majority of the Task Force participants are familiar with the operations of Ontario pension plans, it is our understanding that the issues addressed are pertinent to all federally-regulated pension plans, and to plans registered in provinces that have adopted the FIR.

The Pension Investment Regulations Task Force comprises representatives from:

- The Association of Canadian Pension Management (ACPM);
- Pension Investment Association of Canada (PIAC);
- Canadian Life and Health Insurance Association (CLHIA); and
- Investment Counsel Association of Canada (ICAC).

The ACPM's mission is "to promote the growth and health of Canada's retirement income system by championing the following principles: clarity in pension legislation, regulations and arrangements; good governance and administration; and balanced consideration of stakeholder interests".

The ACPM represents private and public sector pension plans, administrators and all stakeholders in promoting these principles. The Association has 750 members, representing 400 pension plans having aggregate assets exceeding $300 billion.

The PIAC is the representative organization for pension funds in matters relating to pension investment. The PIAC requires that its member pension funds be at least $200 million in size. At the end of 2000, collectively, its 138 Members were responsible for over $1/2 trillion in assets. PIAC's mission is "to promote the financial security of pension fund beneficiaries through sound investment policy and practices".

The CLHIA, established in 1894, represents 79 life and health insurers in Canada. The Association's membership accounts for some 98 per cent of the life and health insurance in force in Canada and administers about two-thirds of Canada's pension plans.

The ICAC represents professional money management firms in Canada that are registered in the adviser category as investment counsel/portfolio manager. The 64 Member firms manage an aggregate of $400 billion in assets of institutional and individual clients. The mission of the ICAC is "to advocate the highest standards of unbiased portfolio management in the interest of the investors served by Members".

At the outset of these comments, Task Force participants and their colleagues in the pension industry wish to commend CAPSA for its recent initiatives, including:

- harmonizing the pension investment rules across most provinces;
- participating in the Joint Forum of Financial Market Regulators, which has already published Proposed Regulatory Principles for Capital Accumulation Plans;
- publishing draft Pension Governance Guidelines;
- establishing the Investment Policy Committee to review and recommend changes to pension investment rules;
- sponsoring a seminar in April 2001, part of which allowed industry representatives to review what they consider to be the current status and trends in the pension industry; and
- considering the establishment of an Industry Advisory Group, to provide confidential consultation to the Investment Policy Committee.

The benefits of many of these initiatives are obvious to the Task Force participants. In particular, the opportunity for industry participants to communicate with CAPSA on matters of policy and regulation and greater uniformity are welcomed. We trust that CAPSA also values the benefit of greater dialogue with the industry.

Regarding the federal investment rules, the Task Force presents the attached submission to the CAPSA Investment Policy Committee - *Recommendations for Modifications to Pension Plan Investment Rules*. This submission has been reviewed by Boards of the ACPM, PIAC, and ICAC, and the committee responsible for pension matters of the CLHIA, and each of these organizations supports the recommendations.

The submission reviews the principal pension investment rules and their purpose. It also summarizes the Task Force's concerns about the difficulty in complying with them. Given the developments in pension investment management and its regulation over the last few years, the Task Force strongly suggests that it is most appropriate to adopt a prudent person approach to investment management. The benefit of this approach is that it creates a higher standard of diversification than quantitative rules do and allows CAPSA members to focus only on prudential regulation.

The Task Force recommends that the CAPSA Investment Policy Committee initiate a process to review changes to pension legislation and the FIR, with the objective of fully adopting prudent person standards – a concept that was partially introduced in the federal regulations in 1993. Such a change would require a review of the processes used by regulators in carrying out their prudential oversight responsibilities. The CAPSA Investment Policy Committee could then make the necessary recommendations to the appropriate regulators.

While it is our understanding that the CAPSA Investment Policy Committee is establishing an Industry Advisory Group for confidential consultation purposes, the Task Force is prepared and would welcome the opportunity to discuss further any of the issues raised in the submission.

Respectfully submitted on behalf of the Task Force,

David W. Ireson, Task Force Chair

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Glossary

ACPM	Association of Canadian Pension Management
CAPSA	Canadian Association of Pension Supervisory Authorities
CLHIA	Canadian Life and Health Insurance Association
DB	Defined Benefit pension plans
DC	Defined Contribution pension plans
ERISA	Employee Retirement Income Security Act (U.S.)
FIR	Federal Investment Rules, as defined in Schedule III of the PBSA
ICAC	Investment Counsel Association of Canada
IFIC	Investment Funds Institute of Canada
Investment Funds	Includes mutual funds, pooled funds, and segregated funds:
Mutual Funds	Funds regulated by securities administrators through National Instrument # 81-102
Pooled Funds	Funds, if formal trusts, regulated by the ITA
Segregated Funds	Funds regulated by insurance legislation
ITA	Income Tax Act (Canada)
OSFI	Office of the Superintendent of Financial Institutions
Passive Investment	Investment in shares of a company, with no management responsibilities
PBSA	Pension Benefits Standards Act, 1985 (Canada)
PBA (Ontario)	Pension Benefits Act (Ontario)
PIAC	Pension Investment Association of Canada
Private Placement and Merchant Banking	Investments made directly with the issuer of a security
Quantified Constraints	The 10%, 5/15/25%, and 30% rules
SPPA	Supplemental Pension Plan Act (Quebec)
Task Force	The Pension Investment Regulations Task Force

Executive Summary

Since the enactment of the FIR in the PBSA, the nature of pension plans and investment management have changed significantly. In particular:

- the scope and type of pension arrangements have changed (e.g., the growth of DC plans);
- more sophisticated investment management tools are now available, and continue to develop; and
- one or several external investment managers are used by all but the very large pension plans who have developed sophisticated internal investment management infrastructures.

These changes have resulted in significant problems for the administrators of today's DB and DC pension plans in complying with the FIR.

In addition, initiatives to harmonize the investment rules for pension plans across Canada, and the recent adoption of the FIR by Ontario in the PBA, have resulted in plan administrators questioning the practical application of the Quantified Constraints defined in the legislation. In fact, the need for Quantified Constraints is being challenged by plan administrators, since there is an expectation that these same administrators are bound by prudent person standards, which can potentially conflict with the Quantified Constraints.

This paper summarizes each of the principal rules in the FIR and outlines the challenges associated with applying them in today's pension investment environment. The rules are:

- portfolio diversification, the 10% direct and "look-through" rules;
- industry concentration, the 5/15/25% rules;
- passive investment, the 30% rule; and
- related party transaction rules.

The paper then reviews and discusses the prudent person standards, as applied to pension investment management, with reference to precedents both within Canada and internationally, as evidence that many jurisdictions have moved towards such a regulatory model.

The Task Force concludes that regulators should take the forward-looking, global approach, and fully adopt the prudent person standards for investing pension plan assets and eliminate the Quantified Constraints. The expectations for prudent processes should be defined, should be applicable to the wide range of pension plans in Canada, and should provide the flexibility to be adaptable to the future evolution of the industry.

In addition, the Task Force believes that rules for related party transactions are required, but the technical drafting of the rules could be improved.

The elimination of Quantified Constraints will require that pension regulators review the processes used to carry out their oversight responsibilities. OFSI's approach, as outlined in its paper *Risk-Based Supervision of Private Pension Plans*, would be a useful starting point for this review. The Task Force would welcome the opportunity to work with the regulators in developing the processes used to assess prudent investment management.

Recommendations

To attempt to modify specific rules in the FIR, such as the quantified rules for portfolio diversification and industry concentration, will not solve the longer-term issues of prudent management of investments held in pension plans. The complexities associated with prudently investing pension assets are such that it is unlikely that any defined rules (i.e., Quantified Constraints) could be created that effectively contemplate all current and future investment structures.

The key for plan administrators is to develop and monitor what is considered to be an effective investment management process that assesses, on an ongoing basis, the prudence of individual security investments within the overall structure of the investment portfolios. This is the primary, and should be the only true investment obligation of the plan administrator. The courts can determine and apply the prudent person standards over time in a way that reflects the markets, the investment structures of the day, and the tools available to plan administrators to fulfill their prudence obligation.

Unnecessary technical constraints are now imposed by rules designed to limit pension funds to Passive Investments. For those plans that are now active in the Private Placement and Merchant Banking markets, or those with subsidiary infrastructures, the rules force the search for technical solutions in order to comply with the regulations. These technical solutions often create situations that could be considered detrimental to the prudent management of the investment.

We believe that it is important that rules to limit conflict of interest resulting from related party transactions continue to be included in the FIR. The current rules, however, are not sufficiently clear or precise enough to adequately provide the guidance or regulatory oversight necessary.

The Pension Investment Regulations Task Force recommends that:

1. The CAPSA Investment Policy Committee initiates a process, with appropriate stakeholders, to implement the full adoption of the prudent person standards and define the prudent process expectations, rather than consider short-term technical adjustments to the existing rules.
2. The FIR continue to include restrictions for related party transactions, but the CAPSA Investment Policy Committee should review the existing rules to clarify definitions and ensure that they reflect current industry practices.
3. The processes used by regulators to carry out their oversight responsibilities be reviewed, and enhanced, in order to provide the framework required to effectively assess the application of prudent investment management principles.

The proposed changes to the PBSA and provincial pension legislation could then be submitted to the federal and provincial regulators for action.

Scope

The scope of this submission is to review the regulatory principles and specific investment rules defined in the PBSA, as they apply to both DB and DC pension plans. It does not address issues that have been raised regarding other forms of capital accumulation plans such as group RRSPs and deferred or employee profit sharing plans. These issues have been addressed in the ACPM/PIAC Joint Task Force Report to Joint Forum Working Committee on Investment Disclosure in Defined Contribution Plans, and the Report by the Joint Forum of Financial Market Regulators' Working Committee on Investment Disclosure in Capital Accumulation Plans.

Firstly, this submission summarizes the regulatory principles and rules in the PBSA, namely:

- prudent person standards, as defined in subsections 8(4)-(5) of the PBSA;
- portfolio diversification rules, as defined in sections 9 and 2 of the FIR;
- industry concentration rules, as defined in section 10 of the FIR;
- passive investment rules, as defined in sections 11 through 14 of the FIR; and
- restrictions on related party transactions, as defined in section 17 of the FIR.

For each of the rules in the FIR, the issue with the rule is summarized, and the problems in applying the rule in today's pension plan environment are discussed (Review of Specific Federal Investment Rules and Industry Comments, page 12). The issues and problems highlighted are based on detailed comments from a wide range of industry participants familiar with the management and operations of all types and sizes of both DB and DC pension plans. Where appropriate, reference is made to specific issues resulting from Ontario adopting the FIR in March 2000, as part of the national harmonization initiatives of CAPSA.

The submission then reviews the context of the FIR in relation to the requirements in the PBSA to administer a pension plan based on prudent person standards (Prudent Person Approach, page 19). For reference, this section of the paper summarizes the application of these standards in other jurisdictions, both within Canada and internationally.

Finally, the submission discusses what the Task Force suggests are the Principles of a Prudent Process, page 24, and the implications for the processes used by regulators to monitor pension plans, in order to provide a framework for future discussions with regulators.

Summary of Regulatory Principles and Rules

Prudent Person Standards

The prudent person standards are set out in subsections 8 (4)-(5) of the PBSA, as follows:

(4) In the administration of the pension plan and pension fund, the administrator shall exercise the degree of care that a person of ordinary prudence would exercise in dealing with the property of another person.

(4.1) The administrator shall invest the assets of a pension fund in accordance with the regulations and in a manner that a reasonable and prudent person would apply in respect of a portfolio of investments of a pension fund.

(5) Without limiting the generality of subsection (4), an administrator who in fact possesses, or by reason of profession or business ought to possess, a particular level of knowledge or skill relevant to the administration of a pension plan or pension fund shall employ that particular level of knowledge or skill in the administration of the pension plan or pension fund.

Similarly, subsection 22 (1) of the PBA (Ontario) defines the expectation for a pension administrator to act as a prudent person. Further, in subsection (2), it is expected that the administrator will use all the relevant knowledge and skill in the administration of the plan and investment of the pension fund.

Other provinces have similar wording in their legislation.

Specific Rules as set out in the FIR

Portfolio Diversification:

The purpose of the 10% rule is to set a minimum standard for diversification.

Subsection 9 (1) of the FIR prohibits a plan administrator from directly or indirectly lending or investing more than 10% of the book value of the plan's assets in "any one person, or group of associated or affiliated persons". Subsections 9 (2) and (3) define permitted exemptions.

Section 2 of the FIR defines the application of the term "indirectly", and contains what is referred to in this paper as the "look-through" rule.

Industry Concentration:

The purpose of the 5/15/25% rules is to limit the concentration of a plan's investments in either real properties or Canadian resource properties.

Section 10 of the FIR states that a plan cannot invest monies, directly or indirectly, at the time the investment is made, representing more than:

(a) 5% of the book value of the plan's assets in any one parcel of real property or Canadian resource property;
(b) 15% of the aggregate book value of the plan's assets in Canadian resource properties; and
(c) 25% of the book value of the plan's assets in all investments in real property and Canadian resource properties.

Passive Investment:

The purpose of this rule is to prohibit pension plans from owning a controlling interest in private sector corporations, and having the responsibility to participate in the day-to-day management of the organization (i.e., limiting the pension fund to passive investment risk), subject to defined exceptions.

Section 11 of the FIR prohibits a pension plan from owning more than 30% of the shares eligible to elect the board of directors of a company ("voting shares"). Three exemptions are permitted under subsection (2):

(i) Resource Corporations;
(ii) Real Estate Corporations; and
(iii) Investment Corporations.

For those corporations qualifying under the exemptions, it is necessary for the pension plan to file undertakings:

- Section 12 for real estate corporations;
- Section 13 for resource corporations; and
- Section 14 for investment corporations.

Related Party Transactions:

Section 17 of the FIR defines the conditions under which a plan may enter into transactions with related parties:

Subsection 17 (1) permits a related party transaction if it is required for the operation or administration of the plan, and if the transaction is at market terms and conditions;

Subsection 17 (2) allows the transaction if the securities are acquired at a public exchange (the list of permitted public exchanges is defined in Section 1); and

Subsection 17 (3) allows a related party transaction if it is deemed to be nominal or immaterial to the plan.

Review of Specific Federal Investment Rules and Industry Comments

Part A: Portfolio Diversification, the 10% Direct and "Look-Through" Rules

Issue:

The 10% rule, as currently written, is not a comprehensive yardstick for determining if an investment portfolio is adequately diversified. Furthermore, the rule presents a number of practical problems in managing the investment portfolios of pension plans, and in monitoring compliance.

Discussion:

- Monitoring Investments at Book Value

  The market value of a portfolio's securities is the best measure of its diversification for direct investments and pension plans utilizing Investment Funds. Plan administrators look at market values, not book values, when assessing risk associated with lack of diversification. For example, in 2000, Nortel exceeded 30% of the TSE Index, but many pension plans were compliant with the book value tests, especially those that had acquired Nortel before the price appreciation. Therefore, book value is not the right yardstick to meet the rule's intent.

  Applying a book value test to DC plans creates additional problems. The book value of a DC plan assets in total will not equal the book value of any given participant's account, because the book value in each case is derived based on different transactions. Participants' book values are a function of their own contributions, withdrawals and transfers, while the plan's book value reflects the aggregate buys and sells of all participants. Where Investment Funds are concerned, neither the plan book value nor the participant book value bears any relation to the book value of the underlying securities in an Investment Fund.

  Monitoring participant-level book values is not practical and, for employee-choice DC plans, it is virtually impossible. To do so, the book value of every security in an Investment Fund would have to be determined for each participant. This would require costly new systems, which would increase fees payable by DC plan members. Moving to a market value test at the Investment Fund level would provide a better measure of adequate diversification while keeping costs in check.

- The “Look-Through” Rule:

  Numerous problems have been highlighted by industry participants with the application of the “look-through” rule, as defined in Section 2 of the FIR.

  The use of book value measurement for the “look-through” rule is unworkable due to the following:

  - Pension plans do not currently have the methodology or systems to calculate the cost to a plan of any given security held by Investment Funds. As examples of the potential complexity involved:
    - pension plans investing in Investment Funds do not acquire their interests in a fund at one time;
    - Investment Funds do not acquire all of their portfolio holdings at one time, and reconstructing book value information back to the inception of the investment is not practicable at best, and, at worst, the data may not be available;
    - employee contributions to a pension plan are not made at one time, and it would be virtually impossible to monitor the indirect holdings of contributions made to employee-choice DC plans; and
    - there is no apparent limit to where the “look-through” rule stops.
  - For investments in “associated persons” or “affiliated corporations”, e.g., conglomerate infrastructures, there is no centralized source of data that summarizes and updates the national and international holdings of conglomerates, which are constantly changing. This implies that each pension plan would have to develop manual, *ad hoc*, monitoring procedures for those conglomerates in which the pension plan invests, based on information that becomes public knowledge sometime after holdings change.
  - The use of book value in monitoring diversification also discriminates against plan participants of newly created plan structures. The book value of investments purchased by new plans will reflect recent market prices, whereas the book value of investments in a mature plan, purchased several years earlier, will be expected to be lower. This could result in inequitable treatment of newer plan participants relative to participants of a mature plan structure. The investment opportunities will not be comparable.

- The recent adoption of the FIR by Ontario has resulted in a number of concerns being expressed by Ontario plan administrators. While these concerns have been raised in Ontario they are also of concern elsewhere. The concerns include:
  - confusion regarding the interpretation of the “look-through” rule;
  - possible non-compliance of existing plans;
  - a need for costly new monitoring systems; and
  - it is unclear as to how plan administrators should deal with member contributions, if the plan itself has exceeded the 10% limit.
- Concerns specific to Ontario include:
  - Ontario transition rules require that plan investments be brought into compliance, or be disposed of, by January 1, 2005. However, given the uncertain interpretation of the rules as currently defined, plan administrators are unable to determine if their plans are compliant or not, and are therefore unsure of how to bring them into compliance.
  - The previous Ontario rules did not have the requirement to monitor indirect holdings, and there were no apparent problems. The result of the adoption of the FIR by Ontario is that some plan investments that were previously compliant are potentially no longer compliant, depending on the specific interpretation of the rules, which, as noted above, are unclear.

- Conflicting plan compliance requirements – lack of uniformity:

  With the wide variation of pension plan sizes and types being subject to the requirements of the FIR, specific problems arise. Plans may use one or several Investment Funds, offered by one or several investment managers, for a variety of reasons. The Investment Funds chosen, if Mutual Funds, are subject to securities laws; if Pooled Funds, are subject to securities laws but not the same laws as Mutual Funds are subject to; and if Segregated Funds, are subject to insurance laws.

  - Mutual Funds, other than index funds, are subject to a diversification rule, which is a quasi-market value 10% limit (i.e., market value at the time the investment is made).
  - Pooled Funds are not subject to any prescribed diversification limits (except for those which are “pooled fund trusts”, as defined in the ITA, which are subject to a book value 10% diversification rule).

- Segregated Funds presently have no prescribed diversification limits, either at book or market value.

However, if a plan wants to invest more than 10% of its assets in any Investment Fund, the Investment Fund is also required to comply with the FIR, and the 10% book value test.

As IFIC have noted in their recent submission to the Standing Investment Policy Committee of CAPSA: “It is impractical and inefficient for a mutual fund to have to comply with two regulatory regimes, particularly since there are no significant differences between the two regimes”.

Part B: Industry Concentration, the 5/15/25% Rules

Issue:

The 5/15/25% rules address two specific industries: real estate and Canadian resource corporations. Is there a continuing need to isolate these two industries so as to require special attention by the regulators?

Discussion:

These rules probably reflected concern over which industries were deemed to have either higher volatility or higher risk at the time the regulations were drafted. Industries that may exhibit these characteristics at any given time will change. Based on the recent experiences in the North American markets, the technology, media, and telecommunications sectors may fall into this category.

Presuming that investment managers adopt prudent person standards in managing their portfolios, ongoing monitoring and assessment of investments in the portfolios would preclude any undue risk being incurred by over-concentration in any selected industry or sector.

Since these rules also incorporate the concepts of monitoring direct and indirect investments (the “look-through” rule) at book value, similar problems are experienced by the industry as outlined in the diversification section, Part A (see page 12).

Part C: Passive Investment, the 30% Rule

Issue:

Is there a continuing need for a Passive Investment limit? In other words, should pension plans be prohibited from playing an active role in the management of certain types of investments?

In addition, several practical questions have been raised with regard to the detailed rules for the exemptions permitted (real estate, resource, and investment corporations), and the undertakings required for exempted investments.

Discussion:

The purpose behind this rule is to limit pension funds to Passive Investments. However, the rationale behind this is not apparent, particularly in view of modern notions of prudence, which require pension plan administrators to actively monitor their investments to ensure that the interests of plan beneficiaries are protected. Moreover, evolving capital markets have led pension plans to become more active investors, often participating in venture capital opportunities (previously recognized as an exemption in Ontario). Private Placement or Merchant Banking activities by large pension plans with specialized investment management capabilities are now commonplace.

To unnecessarily limit the activities of large plans through technical rules could be detrimental to the availability of venture capital.

Industry stakeholders are concerned that particular investment transactions, about which there is no issue of prudence, must sometimes be deliberately structured in ways alien to their true business purposes and nature solely to meet the technical requirements of the 30% rule. This not only obscures the true business purpose and nature of the transaction, but can also sometimes work against it. An example would be the use of non-voting shares simply to comply with the requirements of the 30% rule. This may ultimately lead to greater risk being undertaken by the pension fund and its beneficiaries due to loss of control over the right to elect directors of the corporation.

We believe that 30% is an arbitrary limit. In today's market, it is possible to exhibit *de facto* control of (widely held) corporations by owning less than 30% of the voting shares.

The Trustee Act (Ontario) regulates the investment of trust funds (institutional investors similar to pension funds) through prudent person standards. It can be noted that no Passive Investment limit exists in the Trustee Act (Ontario).

Problems with Specific Rule Restrictions

- Investment corporations are prohibited from issuing debt.

  The interpretation of the requirement for an investment corporation to have not issued debt has been questioned in terms of whether this includes debt issued to a parent corporation, or whether it only refers to the issuing of debt to third parties.

  Industry participants have noted that using a debt/equity capital structure at the time a "subsidiary" is incorporated, is effective for tax planning purposes. It is uncertain as to the reason behind this restriction. The rule should be clarified, and re-drafted, to address any particular concerns the regulators may have.

- The undertakings that have to be filed for exempt corporations require that there be no more than two tiers of "subsidiaries" in each category (e.g., real estate corporations).

  Some large pension plans have developed multi-tiered investment infrastructures, especially in real estate holdings. These tiered structures (as many as five levels) were created, and were compliant with the Ontario rules that existed up to March 2000. Restructuring these investments to meet the new requirements will be complicated and costly. Moreover, there is no apparent policy justification for limiting subsidiaries to two tiers.

Part D: Related Party Transaction Rules

Issue:

The industry believes that it is prudent for the regulators to impose specific limitations on a plan's dealings with related parties; however, some of the specific rules, are unclear or outdated.

Discussion:

For transactions "that are required for the operation or administration of the plan", it is unclear as to what "required" means in this context, e.g., outsourcing may be prudent, but not required. Also, do these requirements extend to investment of the pension fund, or just the administration of the plan? Better definitions of the exemptions are required.

The list of "public exchanges" is incomplete, and does not reflect either the range of exchanges that are currently used, nor acknowledge the growing practice of Private Placement and Merchant Banking investments made by large pension plans, which, by definition, are not traded on public exchanges.

The acceptable list of "public exchanges", as currently structured, does not take into consideration:

(a) bond transactions, which are conducted through the dealer network;
(b) initial public offerings, which are made through either individual dealers or a consortium of dealers; and
(c) Private Placement and Merchant Banking transactions.

In cases (a) and (b) above, the transactions are in fact conducted through public exchanges, and fairly reflect the market value of the investment.

For corporations that are exempt from the 30% rule (i.e., those that are required to file undertakings in accordance with Sections 12 to 14 of the FIR), an exempt subsidiary cannot conduct transactions with related parties. It is inconsistent that exemptions under Section 17 are available to the pension plan, but not available to wholly owned subsidiaries.

Prudent Person Approach

While industry participants have commented on specific rules in the FIR and their application, a more general question has been raised as to the need for any Quantified Constraints, within the concept of the application of prudent person standards to regulating pension plan investments.

Issue:

If a pension administrator is expected to adopt prudent person standards (including the prudent portfolio rules), and be held accountable for applying the standards, why should there be any Quantified Constraints?

Discussion:

The existing rules in the FIR only go a limited way to defining appropriate diversification, i.e., the 10% rule. While there is an absolute limit on the direct and indirect holdings in “any one person”, no account is taken of sector or industry concentration. (Could a fund have 11 investments – i.e., less than 10% in each investment – but all investments in “hi-tech” stocks?) As well, investment quality is not considered. (Could all investments be in “penny” stocks, for example?)

If one were to contemplate regulating diversification in today’s markets, it would be necessary to set specific limits for:

- concentration of a fund in any “one person” (i.e., the 10% rule);
- diversification across industries and business sectors;
- diversification by geographic region in Canada;
- diversification by country and geographic region globally; and
- combinations of constraints nationally and internationally (e.g., an industry, worldwide).

For those industries deemed more volatile than others (in the existing legislation, real estate and resource corporations, and now, potentially "hi-tech" industries), what constraints would be appropriate? What industries in the future will exhibit higher volatility and risk?

The range of specific limits would become unwieldy and impractical.

One of the challenges to developing future regulations and policies will be to acknowledge the range of pension plans being administered. Very large plans have sophisticated in-house investment management teams, and use external investment managers for specialized mandates. The majority of plans, because of their limited size and the need to control costs (over 90% of pension plans have assets of less than $3 million), hire external investment expertise using Investment Funds. A plan, depending on its size, may hire one, or several, investment managers, and utilize one, or several, Investment Funds, to provide for an appropriate asset mix with suitable diversification.

An alternative is to adopt, totally, the prudent person standards. Precedents exist for this approach, and the Task Force views this approach as an extension of the process started in the early eighties, resulting in the current FIR.

In applying the prudent person standards, the selection of investments is made with consideration given to the overall context of the investment portfolio, without undue risk. This is an approach to investment that emphasizes the overall prudence of the portfolio for the purpose of satisfying the objectives of the pension plan.

The investor of a pension plan will be required to exercise prudence in the selection of individual investments within the overall context of the investment portfolio. No particular investment must meet the test of prudence independently of the other investments. Rather, the prudence of any particular investment will be judged in the context of the entire portfolio. An investment that might be considered too risky on its own, might be prudent if balanced against a particularly conservative investment held in the portfolio.

Unlike the Quantified Constraints, the prudent person standards have proved to be a very flexible standard, capable of adapting to changing markets and changing investment practices. We recommend that such standards be retained and extended, as in many other jurisdictions (e.g., Quebec).

- Elimination of Quantified Constraints is a natural progression

  In the previous amendments to the FIR in 1993 (and similar amendments to the investment regulations in Ontario, effective January 1, 1988), the regulation of pension fund investments was substantially changed from a “legal list” approach to a prudent person/prudent portfolio approach to pension fund investment.

For example, the regulatory impact analysis statement published with the enactment of the FIR in 1993 described the amendments to the FIR as being put in place to deal with "the implementation of the prudent person approach to investments of pension plans". Significantly, it also stated the following:

> *The amended regulations dealing with the level of prudence focus on the standard of care, the requirement to have a "written" investment policy and the selection of investments in accordance with the policy. Consideration was also given to the legal concepts associated with the prudent person approach. More specifically, the Office's position has been to focus on the process associated with the prudent person approach as opposed to the investment or portfolio of investments.*
>
> *The regulations will put federal pension plans on an even keel with Ontario and Quebec plans which have been under the prudent person approach for the past several years. This harmonization will assist pension plan administrators who are responsible for the investment policy of several pension plans under different jurisdictions.*
>
> *(Emphasis added)*

The retention of Quantified Constraints on investment is a holdover from the old regime, which the Task Force submits is no longer necessary in today's environment.

A natural and logical extension of regulating investments through prudent person standards would be to judge all facets of pension fund investment by these standards, without the retention of any Quantified Constraints. As discussed below, this is a principle that has been embraced by other jurisdictions. These jurisdictions have recognized that the existence of Quantified Constraints with prudent person standards is inherently inconsistent.

- Prudent Person Standards Precedents

There are precedents for fully adopting the prudent person standards:

Canada:

- The *Trustee Act* (Ontario) was amended in 1998 to incorporate prudent person standards, with no Quantified Constraints. Other provinces have also made such amendments to their trustee acts.
- Quebec's Bill 102, enacted in 2000, made a number of changes to the SPPA. As part of these amendments, the investment regulations were modified to eliminate the quantified constraints for diversification. Section 171.1 now reads:

> *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.*

United States:

ERISA defines the legal duties of a fiduciary of a pension plan. Specifically, subsection 404 (a)(1) states:

> *…a fiduciary shall discharge his duties with respect to the plan solely in the interest of the participants and beneficiaries…*
>
> *(B) with the care, skill, prudence, and diligence under the circumstances prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;*
>
> *(C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so…*

United Kingdom:

In the U.K. the Pension Act 1995 (c.26), Sections 33 to 36, require that:

> *…the trustees or fund manager must have regard:*
>
> *(a) to the need for diversification of investments, in so far as appropriate to the circumstances of the scheme; and*
>
> *(b) to the suitability to the scheme of investments of the description of investment proposed and of the investment proposed as an investment of that description.*

Australia:

The diversification principles outlined by the Australian Prudential Regulation Authority are:

> *Diversification of investments is useful to distribute and control risk, and minimises the variability of investment returns. It involves spreading investments over a number of individual assets, asset classes (i.e. shares, property, fixed interest, cash, international equities) countries or investment managers. Further diversification can be achieved by spreading investments within each asset class such as investing in commercial and residential property, long and short term fixed interest investments etc. The desirable level of diversification and the manner in which it is achieved will depend on the size and circumstances of the fund…*

Principles of a Prudent Process

Over the years, it has become a well-articulated principle of law that the prudence of an investment is to be judged, not only in the context of the overall portfolio of investments, but also be based upon the process employed by the person in selecting the investments, rather than the result. Consider the following:

> [the prudent person rule] *…is an extremely flexible standard capable of adoption to current economic conditions and contemporary understanding of markets and investments. For example, investments which were imprudent in the days of the gold standard may be sound and sensible in times of high inflation. Modern trustees acting within their investment powers are entitled to be judged by the standards of current portfolio theory which emphasises the risk level of the entire portfolio rather than the risk attaching to each investment action taken in isolation.* [Taken from a decision of the Chancery Division of the High Court in the United Kingdom in the case *Nestle vs. National Westminster Bank PLC* (June 29, 1988).]

> *…prudence is a test of conduct and not of performance… Neither the overall performance of the portfolio nor the performance of individual investments should be viewed as central to the inquiry. Prudence should be measured principally by the process through which investment strategies and tactics are developed, adopted, implemented and monitored… Investment products and techniques are essentially neutral; none should be classified prudent or imprudent* per se. *It is the way in which they are used, and how decisions as to the use are made that should be examined to determine whether the prudent standard has been met.* [Bevis Longstreth, *Modern Investment Management and the Prudent Man Rule* (1986, Oxford University Press, New York)]

Much like the case with the old “legal lists”, the retention of certain quantified constraints on investments has not proven to be an effective tool for regulating pension fund investment activity. Whether one is judged by prudent person standards, or by specified limits in the legislation, makes no difference in the way in which the legislation is enforced. Pension regulators in Canada have traditionally only had the ability to monitor pension fund investment activity by responding to any complaints initiated by members or other parties with respect to investment actions already taken by pension fund administrators and investment managers. In that regard, the ability of the regulator to enforce its legislation is no further impaired by replacing Quantified Constraints with prudent person standards.

However, the Task Force strongly advocates that, for the protection of all interested parties and stakeholders, the concept of prudence be further elaborated in the context of pension plans, to provide guidance on what constitutes a prudent process.

The examples of the legislation above can provide a guide as to how the prudent person standards and the FIR could be modified to suit Canadian needs. Regulators would not be creating a precedent in adopting such an approach. Rather CAPSA would be building on existing precedents and, in fact, continuing the initiative of moving to the prudent person standards started in 1993.

The Task Force urges that pension regulators adopt a set of prudent process standards to govern pension fund investments. Our recommendation regarding these standards is that they should include the following:

1) discharging duties solely in the interest of plan participants and beneficiaries;
2) acting with the care, skill, prudence and diligence under the circumstances prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims (which implies acting relative to best practices prevailing at the time);
3) diversifying the investments of the plan so as to minimize the risk of large losses;
4) disclosing key information to the appropriate stakeholders and regulators; and
5) defining governance structure and guidelines.

In this regard the regulators could have reference to recent changes to legislation governing trusts and to changes to the rules in other jurisdictions, as discussed above, for example:

- in Quebec the recent amendments to the SPPA brought about by Bill 102 removed the reference to a 10% restriction and replaced it with a duty of prudent diversification, to minimize the risk of major losses to the pension fund (Section 171.1);
- under the *Trustee Act* (Ontario), the provisions of Section 27 are relevant to the determination of what is a prudent process for investment purposes; and
- the regulations in the U.S. (ERISA), U.K., and Australia, provide useful examples of how this could be achieved.

The Task Force submits that similar statements in the legislation and the FIR would help to clarify the elements of a prudent process, providing better certainty and protection to all stakeholders affected by pension plan investment rules. To complement these changes, the regulators could also consider issuing guidelines, with emphasis on the recommended principles and practices of a prudent process.

The Task Force recognizes that one of the results of eliminating specific Quantified Constraints is that regulators will need to review the processes required to carry out their oversight responsibilities. The OSFI “CAMERA” model, as outlined in its paper *Risk-Based Supervision of Private Pension Plans*, April 30, 1998, would be a useful starting point for this review. The Task Force would welcome the opportunity to participate in any discussions addressing the development of practical processes that provide the framework for pension regulators to assess prudent investment management.

Conclusions

The Task Force believes that it is timely to review the principles and specific rules incorporated in the legislation to ensure that they are still valid relative to today's realities. These principles should also provide the flexibility to be appropriate as investment markets evolve.

This submission has highlighted specific problems with the existing FIR, based on what would be considered to be effective investment management of pension plans, in the best interests of plan participants and beneficiaries.

The Task Force believes that the preferred direction for resolving the problems identified is for regulators to take a forward-looking, global approach, and continue moving to prudent person standards in regulating pension plan investments.

In this regard, the Task Force strongly recommends that the regulators should actively pursue the full adoption of prudent person standards, and define the expectations for what would be considered to be a "prudent process". This would mean the elimination of Quantified Constraints.

The Task Force believes that the legislation should continue to set limits on related party transactions. However, the regulators should:

- clarify what is considered to be "required" for the operation or administration of the plan;
- re-define the list of "public exchanges"; and
- allow subsidiaries to have the same opportunities as the parent corporation in conducting related party transactions.

The elimination of Quantified Constraints will require that pension regulators review the processes used to carry out their oversight responsibilities. OFSI's approach, as outlined in its paper *Risk-Based Supervision of Private Pension Plans*, would be a useful starting point for this review. The Task Force would welcome the opportunity to work with the regulators in developing the processes used to assess prudent investment management.

Attachment

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