



NOVEMBER 1997

**PENSION INVESTMENT ASSOCIATION OF CANADA SUBMISSION TO THE SENATE
COMMITTEE ON BANKING, TRADE AND COMMERCE**

**IN THE MATTER OF THE COMMITTEE'S HEARINGS ON THE ROLE OF INSTITUTIONAL
INVESTORS**

INTRODUCTION

The Pension Investment Association of Canada (PIAC) is the Association which represents pension fund organizations in Canada in matters concerning pension investment and related issues. The mission of PIAC is:

"to promote the financial security of pension fund beneficiaries through sound investment policy and practices."

From the name and mission of the Association, it is clear that PIAC's focus is entirely on asset management and the structures and processes necessary to facilitate effective investment so that the value of assets entrusted to its Members can increase and that the pension promise may be kept. It is natural, therefore, that PIAC should also be interested in the governance of pension funds and the corporations in which they invest. It is for these reasons that PIAC wishes to provide your Committee with information which will assist in putting the examination of the role of institutional investors in context.

PIAC now represents 123 Member pension fund organizations which collectively manage over \$365 billion of pension assets on behalf over 6.5 million beneficiaries. Membership criteria restricts Member funds to those with assets in excess of \$200 million. There are 155 Member representatives active in PIAC, all of whom are involved in the investment process. In keeping with PIAC's mission, semi-annual conferences of Members are held in which specific investment issues are discussed and participants are able to network on matters of importance to them. As well, PIAC pursues its mission through the activities of its standing committees which include Government Relations, Industry Practices, Corporate Governance and Membership and Member Services. This structure allows the Association to keep Members up to date on issues which affect their day to day activities.

Of the PIAC Member fund organizations, 47 represent public pension funds and 76 sponsor corporate funds in Canada. Of all funds managed by PIAC Member organizations, 313 are for defined benefit plans, 30 are for defined contribution plans and 11 are for hybrid plans. Member firms are situated across Canada. Fourteen fund organizations are managed internally, 81 employ external portfolio managers to manage assets and 28 employ a mix of these styles. Public pension funds account for 76% of total Member assets. These statistics are summarized in the PIAC profile we have provided to you. They illustrate that the largest number of Member funds are private funds which manage their assets externally and that public funds, while smaller in number are responsible for the largest portion of assets and, for the most part, manage assets internally.

Plan members and retirees are ordinary Canadians such as teachers, civil servants and employees in major Canadian corporations. Because the preponderance of Member funds are defined benefit in nature, that is they pay pensions based on a formula computed by reference to

years of service and earnings, these ordinary Canadians rely heavily on those governing the plan to ensure that it is adequately funded to meet its obligations to retirees. Moreover, this constituency of plan members does not, by and large, have access to other substantial resources to enhance their retirement income. It is for these reasons that people responsible for the effective investment of pension fund assets take their responsibilities very seriously. It is estimated that more than 85% of every pension cheque is funded from investment returns as opposed to contributions. It is for this reason that the effective investment of assets is vital over the long term.

PENSION PLAN GOVERNANCE

In mid-March of this year, PIAC provided Committee members and researchers with copies of its governance model titled Effective Pension Plan Governance. Work on this project began in May of 1996 in response to an obvious vacuum in authoritative guidelines for the governance of pension funds. Most pension funds are, in fact, organized along the lines suggested by the PIAC model but without the detail set out in the model. Throughout its development, we were impressed by the amount of interest in PIAC's work expressed by pension professionals throughout the world. We came to the realization, early in the development of the model, that this was the only work of its kind being undertaken in the world. Following publication, the Council of Institutional Investors in Washington, a large and influential organization of public and private funds in the U.S. which focuses on corporate governance issues, ordered 500 copies of the model for use by its members.

Effective Pension Plan Governance is based on the belief that a governance structure is based on the pension promise and that the pension promise differs in defined benefit and defined contribution plans. The main principle underlying the structure is that pension plans are businesses, the objective of which is to manage assets to meet liabilities. As businesses, they have well defined products and services and they require attention to clearly defined objectives over the long term in order to meet the pension promise.

The governing body, whether it is known as the Board of Trustees, the Board of Directors or the Pension Committee, owes a fiduciary duty to the plan's beneficiaries. This body is responsible for the assets and the individuals which comprise the body must exercise the care and skill of a prudent person in fulfilling their responsibilities on behalf of beneficiaries. The selection of people to be appointed to the governing body is critical. Each must be knowledgeable, be willing to accept the responsibilities of fiduciary duty and be independent from the management of the pension fund.

The model sets out the basis on which the Trustees should share responsibilities with those responsible for active management. The critical points are that the Trustees set policy and provide oversight while management expedites all operational functions within policy parameters. Key to this process is the establishment of a strategic plan through which the objectives of the plan can be achieved.

Once established, the structure must be monitored to ensure that it is effective in meeting the objectives of the fund. This involves two processes: monitoring management and assessing the performance of the governance process. In monitoring management, it is essential that there be a timely transfer of information such as audit results, actuarial reports and investment performance. As well, access of Trustees to management executives is important in order to resolve conflicts and verify the accuracy of information. In assessing the performance of the governance process itself, both Trustees and management review the effectiveness of the structure in allowing the plan to meet the pension promise - the reason for which the structure was created.

PIAC believes that this structure can be effective in recognizing the interests of all stakeholders and ensuring an appropriate division of duties to allow prudent oversight by responsible,

knowledgeable individuals who accept the fiduciary duty they owe plan beneficiaries. From responses PIAC has already received from its Members, it is clear that compliance with the major elements of the model already exists and that their respective Boards of Trustees will be actively reviewing plan structures to ensure that the more detailed elements are also included in their various organizations.

PIAC is confident that its Members take the issues raised by the model seriously. In a structure consistent with PIAC's Effective Pension Plan Governance model, we believe that the problem which arose in the Enfield case, where company shares were purchased by the pension fund to increase management's control in a takeover, should not be possible because of its requirement for independent oversight.

In addition to making members of your Committee aware of PIAC's governance initiative, we have also provided copies of the model to policy advisors in the Office of the Superintendent of Financial Institutions who have expressed an interest in how pension plans ought to be governed. PIAC is interested in working with all those who have a policy interest in the governance of pension plans to the end that Canadians can have confidence in the process established to provide them with their promised pension.

CORPORATE GOVERNANCE

Included with this submission is a copy of the Corporate Governance Standards of the Pension Investment Association of Canada. Published first in 1993, these Standards were the result of intense work of PIAC's Corporate Governance Committee to codify the standards institutional investors believe corporations in Canada should be held to.

The genesis of these Standards lies in the responsibility of pension funds to generate the investment returns necessary to fulfill the pension promise to beneficiaries. As noted earlier, fully 85% or more of pension payments is funded by investment returns and, consequently, institutional investors focus on the creation of shareholder value in the companies in which they invest. It is this principle of improved shareholder value which is fundamental to the corporate governance activities of pension funds.

The only reason pension funds encourage improved corporate governance is to realize improved corporate performance and the resultant improved shareholder value.

BACKGROUND

How a pension fund invests its assets depends upon its liability structure. Those pension funds, whose retired beneficiaries greatly outnumber employed plan members, must restrict investments in equities to a much greater extent than plans where the plan membership is largely made up of younger employees. Therefore, investment policy and asset mix are dictated by the composition of the plan's membership. It is important to remember that the motivation of pension funds in determining how to invest assets is solely based upon the interests of the beneficiaries.

The increase in institutional investors' focus on corporate governance has resulted from the concomitant increase in the size of their holdings in individual companies. Pension funds have grown in value at a rapid rate in recent years and they own an increasing proportion of the available shares of Canadian companies.

The statistics which follow demonstrate the circumstances of PIAC Member funds.

- Total assets of Member funds have grown from \$209 billion at December 31, 1991 to over \$365 billion at December 31, 1996 - a mere five years later.

- During the same period, the number of Member organizations has grown from 93 to 123
- Canadian equity investments of member funds have grown from \$ 52 billion in 1991 to \$ 121 billion in 1996.
- Of this growth, approximately \$2.6 billion is attributable to net new Members in the period. Thus, new equity investments made by existing Members and market value increases account for approximately a \$67 billion or a 129% increase in the period.
- By way of comparison, the increase in stock market capitalization in Canada in the same period has been on the order of 67% ¹. In the period from 1991 to 1996, the book value of stocks held by trustee pension funds increased by just over 100% ². This occurred despite the increase in the foreign property limit and the greater use of derivatives.
- From some of these statistics, it is clear that institutional investor involvement in Canada's equity markets has affected the ownership structure of a number of Canadian companies.
- Canadian equities in Members' pension portfolios generated an average unweighted return in 1996 of 29.3% compared with the TSE total return index of 28.35% in the same period.

CORPORATE GOVERNANCE ACTIVITIES

With this background, one can understand the dilemma facing institutional investors holding large amounts of the share capital of a company. Not many years ago it was an easy decision for such investors dissatisfied with corporate performance - they simply sold the shares into a liquid market. Today, it is not as simple as "voting with their feet" and many pension funds find themselves in the position of working with the company in an effort to improve long-term corporate performance. This is the force behind institutional investor activism.

A great many PIAC Member funds still find that they can effectively dispose of their investments in underperforming companies and this is the usual procedure for a large portion of PIAC's membership. But as the size of individual holdings in actively-managed portfolios increases, the influence of relational investing, described by Professor MacIntosh, also increases as pension funds attempt to solve corporate underperformance by improving corporate governance and increasing shareholder value.

¹ This statistic is based on the observed increase in the capitalization of the Toronto Stock Exchange. Given the duplication of the major issuers on the TSE and the Montreal Exchange, and the fact that the vast majority of the major Canadian issuers are listed on the TSE, this statistic can be considered a valid proxy for the growth of the Canadian market.

² Statistics Canada, Quarterly Estimates of Trusteed Pension Assets: Estimates are based on those trustee pension funds having assets of \$200 million or more; at the end of the fourth quarter 1996, they held 87% of total assets.

In order to present as clear a picture as possible of the attitudes of PIAC's Members, we summarize below the results of a recent Member survey on Corporate Governance and Proxy Voting. The Survey was completed in January and the results released in April 1997.

- Responses were received from 70 Members, a 57.4% response rate.

- 51% of respondents were from funds under \$1 billion in size.
33% represented funds between \$1 billion and \$5 billion.
16% represented funds over \$5 billion in size.
- Of respondents:
66% represented externally-managed funds.
30% represented funds managed both externally and internally.
4% represented internally-managed funds.
- 81% of Members responding have their proxies voted by their external managers.
- 66% of Members responding stated they have a proxy voting policy, whether specific or general.
- While 64% of respondents maintain a record of how proxies are voted internally, 87% of respondents do not maintain a record of how proxies are voted by external managers.
- Only 26% of respondents said they analyzed proxy material internally while 50% believe such material is analyzed by external managers.
- 71% of respondents do not provide specific instructions to portfolio managers on proxy issues.
- The key governance issues reported by respondents are:

(a score of 5 is very important)

- Accountability of management to the Board 4.7
- Accountability of the Board to shareholders 4.7
- Private agreement exemptions 4.6
- Golden parachutes 4.4
- Independent Directors on Compensation and Audit Committees 4.4
- Crown jewel defenses 4.4
- Executive compensation linked to performance 4.4
- Director independence from management 4.3
- Poison pills 4.3
- Director independence from a controlling shareholder 4.2
- Unequal or subordinate voting shares 4.2
- Blank cheque preferences 4.2
- Greenmail 4.0
- Unlimited share issues 4.0
- Excessive executive compensation 4.0
- Detailed disclosure of executive compensation 4.0
- Stock option plans 4.0
- Lock-up arrangements 4.0
- Self-assessment of corporate governance effectiveness 4.0

The remaining nine issues scored less than 4.0 and included issues such as the Chairman of the Board also acting as CEO - 3.5, Confidential voting - 3.4, Loans to management to buy stock or options - 3.6 and Board size - 2.9. The remaining issues are, generally, either less significant or occur less-frequently.

The importance of these results is that they define the comparative importance of governance issues in the proxy voting practices of a fairly large and diverse constituency of institutional

investors. Much publicity has been given to corporate governance activism in recent years and PIAC believes such publicity has focused on the governance initiatives of a few large and, generally, public pension funds. While it is true that such funds may have more at stake and are usually less inhibited in asserting their views, it is not appropriate to attribute their interests and sophistication in governance to the entire pension business as these Survey results reveal.

In addition to its Corporate Governance Standards, PIAC has, for the last four years, provided an overnight Proxy Calendar service by fax to Members. The Proxy Calendar identifies up-coming corporate meetings, the Agenda of each and notes issues which are non-routine. By understanding basic corporate governance principles and knowing "what's hot and what's not" in each prospective meeting agenda, PIAC hopes that its Members can focus on important issues and take initiative in proxy voting by discussing them with their external managers.

Despite the fact that 86% of respondents to the Survey state that they are notified of important issues by Proxy Calendar compared with 55% by external managers and 35% by newspapers, as can be seen in the summary of the results above, 71% of respondents do not provide specific instructions to external managers on proxy issues. However, this latter percentage includes those Members who provide general instructions or those who ask to be consulted only on significant questions. PIAC believes, however, that despite the variety of modalities in providing instructions for the voting of proxies, the remaining Members believe that their proxies are being voted in the best interests of the pension plan. Furthermore, there is good reason to be sanguine about the motives of institutional investors in corporate governance issues when one understands that improved corporate performance and increased shareholder value are their main objectives. Sixty-nine percent of respondents to PIAC's Survey believe they would vote against a slate of directors in a company which demonstrated inadequate corporate governance.

Finally, PIAC believes that co-option, as described by Professor MacIntosh, is less of an issue than anecdotal reports may have one believe. In fact, PIAC has no evidence whatsoever that co-option has occurred and understands, from reports from its Members, that proxies are voted without duress. As for external managers, the influence of a corporate client on the manager's ability to vote proxies of that company is secondary to an extant bias in favour of management arising from their selection of the stock in the first place. They bought the shares, thus they are not likely to vote against the management in whom they have expressed confidence.

SUMMARY

PIAC represents a large and diverse group of institutional investors and its perception is different to those who have focused solely on the notable corporate governance initiatives which have received public attention in recent years. PIAC maintains that the collective attitude of its Members in governance matters represents a different reality than the actions of a few, large public funds. PIAC cannot speak for individual pension funds or discuss the merits of any specific initiative they may have undertaken. Many of such funds will also be appearing before you and can provide the necessary detail in specific matters. PIAC has believed, and will continue to believe, that the motive of institutional investors, large or small, public or private is to vote proxies in support of good corporate governance practices which they trust will yield improved corporate performance and increased shareholder value for the beneficiaries to whom they owe a fiduciary duty.

CONCLUSION

In pursuing its mission "to promote the financial security of pension fund beneficiaries through sound investment policy and practices" PIAC provides informational forums, research, analysis, communications and guidance to its Members to the end that their performance as fiduciaries is maintained at the highest level possible. In advocacy, PIAC aggressively speaks out and informs solely to improve return on investment which is the keystone of fulfilling the pension promise. It is for these reasons that PIAC developed Effective Pension Plan Governance, its model for the

governance of pension plans, and its Corporate Governance Standards. It is also for these reasons that PIAC provides its Proxy Calendar service to facilitate proxy voting and to promote greater awareness of, and interest in, corporate governance among its Members.

Corporate governance activism is not an issue which should be regarded with concern but rather one which focuses the attention of corporate management on activities which promote improved corporate performance. That, after all, ought to be the common goal, both of corporations and their shareholders.

Respectfully submitted,

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Chair, Government Relations Committee