CUPE

Submission

by the Canadian Union of Public Employees (CUPE)

to the

Department of Finance Canada Consultation on “The 30 Per Cent Rule”

September 23, 2016

Introduction

The Canadian Union of Public Employees (CUPE) is Canada's largest union, representing 639,000 workers. Our members deliver frontline services in municipalities, health care, social services, schools, universities and many other sectors. CUPE members take great pride in delivering quality public services – and with incomes close to the Canadian average depend crucially on quality public services to maintain their standard of living, as do all Canadians.

We would like to express our appreciation for this opportunity to share our views on "the 30 percent rule", and related pension regulatory issues raised by Pension Plan Investment in Canada: the 30 Percent Rule (hereinafter, "the Consultation Paper"). CUPE members participate in many pension plans subject to these federal jurisdiction regulations. Hundreds of thousands of our members participate in plans that could directly be affected by the changes contemplated in the Consultation Paper, given the incorporation of federal investment rules into the pension standards legislation of most provinces. Our members participate actively in pension plan governance, and in regular dialogue with federal and provincial pension regulators and policy-makers. We have a number of very serious concerns related to the current direction of pension fund investment practices, and this Finance Canada consultation process provides us with an opportunity to share these concerns.

We are aware that the Canadian Labour Congress (CLC), to which CUPE is affiliated, has submitted a written brief to this same consultation process. We would like to express our support for the CLC's brief, but we value this opportunity to share our own views as well. To simplify, we interpret this process and the several questions raised as boiling down to only one simple question: Should the federal government eliminate the 30 Percent Rule? If it were presented in this manner, CUPE's answer would be simply "no". While many pension funds remain underfunded, and pension costs have been under pressure, there is no evidence that this rule is somehow preventing regulated plans from generating sufficient returns in the financial markets. In fact, in our view, the pressures to eliminate this rule are emerging in particular from the very few large funds who have reconfigured their investment strategies around a relatively recent investment category: "private market" assets, composed of public infrastructure, private equity, and real estate. These funds are already in a process of pursuing these investments, and the largest among them are increasingly seeking large, controlling ownership stakes in the enterprises that operate the asset.

We are concerned about each of these three sub-categories, but we have particular concern about the public infrastructure component, which has become the latest hot trend among large financial investors. While the structures of pension fund investment in privately owned, operated, or financed infrastructure can vary, an increasingly popular approach involves the acquisition of controlling equity ownership of entities involved in the provision of public services or in the operation of public infrastructure assets. In some cases, this involves the outright privatization of already existing public assets (e.g. Ontario's ongoing sale of Hydro One). In others, it means so-called green field construction of new facilities to provide a service (e.g. the Caisse de Depot commuter rail project in Montreal). In another form, it requires the establishment of complex investment vehicles that are structured into “public private partnerships" or "P3s". In each of these cases, they involve forms of privatization that CUPE has always resisted as contrary to the public interest, and having negative consequences for workers, communities, and users of public services and infrastructure.

Insofar as the contemplated elimination of the 30 per cent rule would facilitate more of the same kinds of privatizations of public assets (by pension funds, or with their participation), CUPE is opposed to this proposal. While we are aware that some pension fund managers now view infrastructure as an emerging “asset class” with an attractive risk-return profile, our view is that the social costs of this asset class are unrecognized and unmeasured, particularly when it comes to earnings-focused investors who seek to hold and draw value from such assets for longer periods. Moreover, as with other recent examples of new asset classes promising high returns at minimal or managed risk (i.e. hedge funds), the new types of infrastructure investments have such limited track records that their risk profiles are in many cases not understood. Recent pressures to deregulate financial sector actors and markets have been followed by significant negative shocks, including most dramatically, the 2008 financial crisis. This experience offers strong evidence for a return to more cautious approaches to financial regulation, and much more skepticism about models resting on self-regulation. If anything, the experience of the past ten years may yet serve as a catalyst for a renewal and strengthening of prudential regulation of financial activity and actors, including in particular the established regulatory framework for tax assisted pension funds.

In support of these general views, and our rejection of the argument for elimination of the 30 per cent rule, the following text will begin, first, with an outline of our primary concerns with this proposal. We will describe the negative consequences that CUPE members and the general public have experienced as a consequence of large pension funds having become significant and active investors in the privatization and private management of public infrastructure. Secondly, we will discuss several of the technical issues identified in the Consultation Paper, with specific reference to risk mitigation/prudence and tax fairness issues. Third, we will conclude this submission with a very brief set of answers to the ten specific questions included in the Consultation Paper.

I. Pension Fund Investment in Infrastructure and Public Private Partnerships (P3s)

As the Consultation Paper makes clear, several of the large pension funds in Canada are themselves advocates for the elimination of the 30 per cent rule. They argue that this rule limits their options for holding larger equity and voting stakes in private corporations. While it is widely recognized that pension funds, especially the largest funds, have modified the composition of their investment portfolios into more complicated (and often, higher risk) investment vehicles and asset classes, there has not been significant public policy discussion of the cumulative social and economic effects of these changes. More specifically, the rise of increasingly large direct stakes in private market investments has resulted in what the Consultation Paper refers to as an overall shift in pension fund operations from that of a ‘passive’ to an ‘active’ investor.

The Consultation Paper notes the dramatic increase in pension fund holdings of “private corporations and infrastructure” from just 1.5% in 2000 to 13% in 2014. The specific emergence of public infrastructure as a relatively new[1] asset class for pension funds has become a subject of some interest in the business press and even the popular press. However, what is sometimes less obvious to a casual reader is the fact that this new type of "private equity" pension fund investment in infrastructure involves a substantive change away from public ownership and control – i.e. a kind of privatization. This is including many components of infrastructure that have historically been owned and operated by democratically accountable governments and public sector entities. Such public assets have become particular targets for acquisition and transformation into privately-owned, for-profit operations. The 1999 sale of the Bruce Nuclear generating facilities to a consortium, that includes the OMERS pension fund in Ontario, was an early and large-scale example of such a privatization. Clearly, when we consider this development alongside other recent shifts in pension fund investment practices (hedge funds, derivatives, complex debt instruments), it is clear that the role that pension funds are now playing in the economy in Canada and elsewhere, is shifting in qualitative terms. This is the context for this consultation process.

For CUPE members, these shifts in the character of pension funds from passive investor to active co-owner and operator of partially or fully controlled business operations represents a troubling development for two reasons. First and most immediately, the development of public infrastructure as a new asset class for private financial interests (including but not limited to pension funds) contributes to the construction of a private market for these important public assets, and it helps to legitimize the privatization of a wide range of public assets and public services. In our view, the experience of privatization and private ownership of public infrastructure assets has been a repeatedly proven public policy disaster.

[1] See: Boston Consulting Group, *Measuring Impact of Canadian Pension Funds*, October 2015

Privatizations of energy, water, and rail assets were pioneered by the UK government led by Thatcher in the 1980s. Significant research since that time has shown that these changes were damaging to the public interest. Broadly speaking, these privatizations produced widely observed increases in direct costs to public infrastructure users, deterioration of service levels and quality, declining transparency about operations, and downward pressure on the wages and compensation of the workers involved in service delivery and support. The most recent form of privatization to attract profile in UK - the so called Private Finance Initiative (PFI) used to involve private investment and ownership in parts of the National Health Service - has resulted in very similar and widely acknowledged negative outcomes for the general public.

These issues of public interest are not simply abstract and conceptual. They are of significant material relevance for future retirees, including the members of pension plans seeking to invest in these asset classes. A clear case in point is the example of energy privatization. Examples of such privatizations consistently show a pattern of increases in electricity rates paid by consumers; in some cases, very significant increases. Such new, above-inflation cost increases on electricity users have the potential to significantly erode retiree incomes, and even wipe out the value of the indexation provision of a pension benefit.

In Canada, this concern is not just theoretical. The Government of Ontario has recently taken steps to begin the privatization of the Hydro One Crown corporation that transmits electricity across the province. Pension funds have been enthusiastic buyers of the recently released shares, and it is quite possible that one such fund could seek a controlling (above 30 per cent of voting shares) interest in this service monopoly. The contemplated elimination of the 30 per cent rule would in fact increase this likelihood. Yet, the attractive rates of return that are sought in such deals are precisely the result of the consumer pricing structures that impose inflationary pressures on users – including the members of the pension plans on whose behalf such an actively-invested pension fund is operating.

If we extend this point to other types of service-assets used by retirees – toll highways, hospitals and other health care providers, privatized long term care facilities, retirement residences, water/wastewater facilities, airports, railways, postal services – the serious social costs of infrastructure privatization become clearer. As CUPE has shown repeatedly, some of this social cost is taking the form of government backstops and bailouts for P3 projects that were structured to leave the risk in the hands of the public sector. This helps explain why the decision to privatize such assets and services remains highly contentious and, in many instances, unpopular.

In our view, the historic conception and practice of pension funds as essentially passive investors had significant merits. Pension funds often played a role as helpful investors in publicly owned and operated infrastructure when they would purchase and hold government bonds issued for that purpose. Indeed, some funds were invested exclusively in low-risk, stable return government bonds and debt instruments. The Canada Pension Plan reserve fund, prior to its 1998 restructuring, was established in 1966 with the explicit mandate of providing loan capital to provincial governments at lower-cost federal bond interest rates, in order to help them build public infrastructure more quickly and more in expensively than they would have otherwise. The reserve fund generated reasonable real returns on this investment, and provincial taxpayers – and public infrastructure users – benefited significantly through either lower tax obligations (than they would otherwise face) or expanded public infrastructure and services. This was a form of social return that operated as a function of public ownership and management – and precisely the social benefits that are being quietly sacrificed as important public infrastructure assets are sold off. In a comprehensive 2014 report on P3s (called PPPs or PFI in the UK), David Hall observed:

> *Pension funds also have to be concerned about the negative social and economic impact of PPPs themselves. As shown elsewhere in this paper, PPPs increase the risk of corruption, distort public investment decisions, often require some sort of 'user pay' arrangement to provide the necessary profits, undermine democratic governance, increase the cost of infrastructure, undermine pay and conditions of workers, and have a much weaker commitment too good quality services. Many financial organisations such as private banks and hedge funds are not concerned with these issues, but pension funds aim to provide decent incomes and living conditions for retired workers. Investing in PPPs therefore undermines this objective. By investing in PPPs, pension funds are actively contributing to these problems.*[2]

CUPE members with tax-assisted pension funds understand the importance of the funds' role as investors, and want them to achieve decent rates of return on their investments. However, pension funds continue to achieve healthy returns in a wide and in fact growing range of financial securities and assets without recourse to involvement in this kind of privatization. As both public sector workers and significant users of public services and infrastructure, CUPE members have challenged the growing pressure to privatize and privately contract public service work, and regularly demonstrate the superiority of public ownership and management. Our members have also made it clear that they oppose the involvement of our own pension funds in privatization and P3s. The union's long-standing (1999) policy of opposition to pension investment in P3s was reaffirmed at our November 2015 National Convention, when delegates overwhelmingly adopted a resolution declaring the union's intention to "take a strong stand against the use of public pension funds in the development, building, ownership or operation of private infrastructure." Even where inflated

[2] Hall, D. PPPs, PSIRU (January, 2014), p. 87

returns are promised by the promoters of these schemes, CUPE members and growing numbers of pension plan members do not support them.

II. Prudential Regulation and Tax Fairness Issues

The Consultation Paper released by Finance Canada notes that the 30 per cent rule was originally established as a constraint to require not only passivity (as the owner-investor) but also prudence. Pension funds are structured to hold uniquely sensitive assets that underpin the basic material living standards of retired workers – including many with low incomes. For this reason, and unlike the large pools of financial assets owned by so called "high net worth individuals", the assets in the fund have been legally recognized as trust property requiring prudence and a degree of risk aversion in their management. The acquisition of controlling ownership positions in private corporations is understood to expose the investor to much higher levels of risk, specifically the risk of the complete failure of the business.

The sectors of interest for pension fund investors seeking to exceed the 30 per cent controlling interest level include in particular infrastructure (as above), private equity, and real estate ("private market investments"). While promoters of the investments in these sectors seek to highlight their low risk profile, there is significant evidence that pension fund investors – and beneficiaries – can be exposed to substantial risks in this category. The Financial Times reported[3] in 2012 on a court case that saw a group of pension funds sue a money manager that had invested the funds' placement into a single company, rather than distributing it among many. When the single company – a PFI/PPP intermediary investor in infrastructure – went bankrupt, the pension funds were exposed to substantial losses. The British court rejected their suit, leaving the fund beneficiaries suffering losses as a result of the risks to which concentrated private ownership had exposed them. These are the kinds of pension fund losses that may increase if ownership stakes above the 30 per cent threshold become normalized. To some degree, the pension fund losses suffered in this case reflect a larger pattern of pension fund trustees and their delegated investment managers being ill-equipped to analyze and evaluate the risks involved. Significant allocations to privately managed infrastructure and private equity holdings are still a relatively new phenomenon, and the risk analysis for these assets remain very undeveloped. This is even recognized by some of the advocates of privately financed infrastructure and P3s. For example, in a 2012 report on pension fund investment in infrastructure, the Organisation for Economic Co-operation and Development (OECD) acknowledged:

> *An additional issue for pension funds is the lack of objective, high-quality data on infrastructure investments and a clear and agreed benchmark.*

[3] Financial Times, November 16, 2012, "Pension funds lose PFI test case"

> *This makes it difficult to assess the risks of these investments and to understand correlations with the investment returns of other assets.*[4]

Very similar warnings and commentaries have appeared in recent years in respect of complex hedge fund investments – from which a number of large pension funds have recently begun to withdraw. We see the rapid shift of pension funds into private equity infrastructure showing similar dynamics. Yet, this is not the message being delivered to most pension fund trustees and decision-makers by many infrastructure investment managers. This underscores the key role played by existing diversification and risk-mitigation regulations, including the 30 per cent rule and other quantitative limits.

The Consultation Paper also quite rightly identifies the concern that the tax exempt status of pension funds (and subsidiary entities owned by pension funds) might lose its rationale if pension funds were to become controlling owners of majority or even 100% equity stakes in private companies. In our view, this concern is a serious one. The public policy rationale for the tax treatment of pension funds was, in the first instance, a sound one, and Canadian tax law has historically followed that of other jurisdictions. The interest earned by pension funds on government bond portfolios, as well as the dividend and capital gain incomes generated on equity holdings, have been exempt from the usual corporate income tax liabilities on the grounds that such treatment encourages the formation of pension plans (and funds) by reducing their cost – and extends the level of pension coverage across a broader demographic. As passive holders of government bonds, and some securities, pension funds were offered exemption from the usual tax liabilities in order to help establish and extend the "Pillar 2" employment based tier of the retirement income system.

The contemplated elimination of the 30 per cent rule, and the remaining formal limit to effective controlling ownership, would raise serious questions about this tax advantage being granted not just to passive pension investors with minority equity holdings but to entire companies – even large companies – that compete directly with other private companies with regular tax liabilities. CUPE has long been concerned with tax avoidance and aggressive tax management strategies and the effects of these practices on government revenues and capacity. Corporate income tax revenues have already been in long term relative decline (now a 70-year low as a share of GDP) as a result of generally regressive tax cuts and expanding tax expenditures. The result is a loss of some $50 billion per year in federal revenues since 2000.

In this context, CUPE is concerned that the outright ownership and management of a growing range of private companies by pension funds risks further eroding the tax base. While the Consultation Paper signals that this may be a concern,

[4] Della Croce, R. "Trends in Large Pension Fund Investment in Infrastructure", OECD Working Papers on Finance, Insurance and Private Pensions, No. 29., p. 13

we have not seen any research – from Finance Canada, Canada Revenue Agency, or any other sources, to offer assurance on this issue. We would again request that further research on this matter be carried out prior to the implementation of any changes to these rules. All Canadians, including pension plan members, should fully understand the impact of any expanded functions and roles for tax exempt pension fund companies.

III. Conclusion

We appreciate this opportunity to engage with this important consultation and we look forward to further development of this discussion. We conclude with a set of more specific answers to the ten Consultation Questions provided in the Consultation Paper.

1. *Does the philosophy that plan administrators should act as passive investors continue to be valid. If not, why?*

Yes. In our view, pension funds represent a special category of financial capital that should be invested and regulated, with a particular level of care and caution. While they have long term time horizons, recent economic shocks have underlined that short term fluctuations can very negatively affect pension sponsors and, by extension, beneficiaries. In that environment, a move to active, "controlling interest" ownership of private companies introduces significant new risks, most of which are very difficult to absorb or mitigate.

2. *What are the benefits and risks of pension plans taking on a dual role of providing benefits to members and taking an active role in the operations of a business?*

Pension funds should not own controlling interests in private businesses. Their key mandate is to deliver retirement income benefits to their beneficial owners. If they were to talk full ownership of private businesses, their risk profile, their reputational risk, and their sharper interest in public policy issues as they pertain to "their" subsidiary businesses, will necessarily shift their focus to operating active businesses – possibly many. We see basic conflicts of interest between these two roles.

3. *Are the prudent person and other PBSA standards sufficient to offset potential risks involved in pension plans acquiring a controlling stake in a corporation?*

No. In our view, the existing prudential standards are not sufficient. Recent financial market events, including the 2008-2009 crisis (centred around sub-prime mortgage lending), various hedge fund meltdowns, and the asset-backed commercial paper fiasco, underline the fact that even investors subject to PBSA and other prudential standards legislation can exercise poor judgement and become exposed to new categories of investment that they are unable to evaluate or risk-assess. These events should prompt serious consideration of a thoughtful strengthening of these standards – not their erosion. This is particularly true in light of the growing technical complexity of financial securities and investment strategies that rely on derivative instruments that make the real content (and economic impact) of a fund's portfolio opaque even for many finance professionals.

4. *If a pension plan’s investment exceeds a certain threshold, should the plan be subject to additional requirements? If so, what should those requirements consist of and what would be the appropriate threshold?*

The existing 30 per cent limit on voting equity should be maintained.

5. *Does the 30 per cent rule impede pension administrators from obtaining appropriate investment returns. If so, why?*

Many Canadian pension funds continue to operate as traditional, passive investors, and continue to deliver on their benefit promises. No evidence has been presented to suggest that appropriate investment returns are no longer available in traditional securities markets.

6. *What are the costs, if any, that the 30 per cent rule imposes for pension plans seeking active investments?*

We are not in a position to answer this with precision, but we do understand that some large pension funds are using creative so-called work-arounds in order to achieve controlling ownership interests in private companies, and these creative techniques incur costs. Our suggestion for avoiding these costs would be to respect, in spirit and substance, the existing prudential standards and all quantitative limits.. The Consultation Paper's acknowledgement that some plans are "circumventing" the rule through "elaborate structures" suggests a possible need for stronger or more proactive enforcement of the existing regulations. In our view, such an approach would have the additional benefit of exposing members' trust property to less risk.

7. *Does the 30 per cent rule create inequities between large and small pension plans? Conversely, could its removal do so. If so, why?*

It would seem likely that only the largest pension funds have been seeking controlling stakes of private companies, and the removal of the 30 per cent rule would make this practice somewhat easier and less costly. It is difficult to assess the extent to which this can be characterized as an inequity any different than the simple inequity produced by economies and diseconomies of scale.

8. *Are any of the tax policy concerns relating to the ability of tax-exempt pension plans to acquire controlling positions in taxable corporations (e.g., potential strategies to eliminate corporate-level taxation, which could provide an advantage to the plans or the businesses they control) material in nature?*

As we have indicated above, we consider this to be an important and little-examined question. We would urge Finance Canada to pursue this as a research question before implementing any of the contemplated changes.

9. *How does the potential relaxation or elimination of the 30 per cent rule impact any concerns described in respect of the previous question?*

CUPE is concerned that the elimination of the 30 per cent rule would facilitate an expansion of the outright ownership and operation of private companies in a manner that transforms them from vehicles established to passively invest workers' deferred wages in debt and equity markets into businesses with their own unique agendas and strategies, and for whom the delivery of pension benefits becomes a secondary function.

10. *Should the Government consider implementing tax measures (e.g., thin capitalization restrictions, application of the SIFT tax to pension-controlled trusts and partnerships) to limit the ability of pension plans to undertake tax planning strategies to reduce or eliminate entity-level income tax on business earnings? Are there other potential tax measures that the Government should consider in this regard? What considerations should be taken into account in the assessment of such potential measures?*

CUPE supports fair taxation levels for profitable private corporations, and does not support the use of the tax advantages extended to pension funds for any other purpose than securing and delivering pension benefits. A thoroughgoing analysis of the corporate tax revenue and other economic effects of a change to the 30 per cent rule should be conducted and shared for public comment prior to any changes to the pension regulatory standard in the PBSA.

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