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HOOPP
Healthcare of Ontario Pension Plan

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Department of Finance, Canada
Ottawa, Canada

Dear Sirs/Mesdames:

**RE: Pension Plan Investment in Canada: The 30 Per Cent Rule**

Healthcare of Ontario Pension Plan ("HOOPP") is pleased to have this opportunity to make a submission in response to the June 3, 2016 consultation document published by the Government of Canada (the "Consultation Document") on the usefulness of the 30 per cent pension investment rule (the "30% rule").

The 30% rule is a pension investment restriction set out in Schedule III of the *Pension Benefits Standards Regulations, 1985* (Canada) (altogether, the "federal investment rules"). Several provinces (including Ontario) have incorporated the federal investment rules by reference in their provincial pension legislation thereby making them effective in those provinces.

The Consultation Document states that the "the rule was intended to limit plans to a more passive role and to reduce the risk of exposure to business failure".

The 30% rule is narrow and prescriptive. It applies only where pension funds look to invest in securities of a corporation to which are attached more than 30% of the votes that may be cast to elect its directors. It does not restrict other investment structures, including limited partnerships and trusts. Moreover, the rule imposes a limit on voting control but does not constrain a pension fund's economic exposure to a corporation in which it invests. Accordingly, as the Consultation Document notes, some pension funds make investments not otherwise exempted under the federal investment rules in corporations through "elaborate financial, legal, and organizational structures which effectively allow for control of a corporation with less than 30 per cent of the voting shares". This reflects the reality that pension funds make their investment decisions based on their view of the value of a potential investment in relation to its price and the risk-adjusted return which the investment is expected to generate. When there is a compelling investment rationale, pension funds will try to be creative to find a compliant way to invest for their members.

Fundamental to regulating pension fund investing is the duty of prudence covered in both federal and provincial pension standards legislation which applies to all registered pension plan administrators and their employees and agents. The legislated duty of prudence is broad; it goes well beyond compliance with the federal investment rules and sets the standard of performance for pension fund managers for all their investment activities.

HOOPP's position is that the 30% rule is neither necessary nor appropriate to regulate pension funds because there is no clear or compelling policy reason for it; the duty of prudence is a meaningful and effective standard, the 30% rule is not. Simply because a pension fund seeks to invest in a corporation by acquiring more than 30% of its voting shares does not mean it would necessarily fail to meet the prudent investment standard. In fact, there are many investments that could be made by a pension fund in corporations above a 30% voting threshold which, were it not for the 30% rule, would be entirely in the best interests of the fund and plan members.

**Consultation Questions**

In the Consultation Document, there are a number of questions under each of the sections titled "Prudential Considerations", "Investment Performance" and "Tax Policy Considerations". HOOPP's position in respect to the various questions, grouped according to each section, is as follows:

"Prudential Considerations"

- Does the philosophy that plan administrators should act as passive investors continue to be valid. If not, why?
- 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?
- Are the prudent person and other PBSA standards sufficient to offset potential risks involved in pension plans acquiring a controlling stake in a corporation?
- 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?

Pension funds that make direct investments in business corporations must be prepared to manage the investment prudently, whether it involves ownership of 30% or less, or upwards of 100% of the voting shares. Prudent management of public or private equity investments requires adequate resources to undertake the diligence, supervision and governance appropriate for the particular investment. All else being equal, if 100% of a corporation's shares are owned by the pension fund, there is a call for greater diligence, supervision and governance than if the pension fund has invested in a 30% or smaller shareholding. However, the acquisition of a minority position in a closely held corporation can sometimes require a proportionately greater amount of time and effort to negotiate and supervise than a 100% investment, as the pension fund minority shareholder needs to ensure, as much as possible, that its interests are properly protected against actions by the corporation or its majority shareholder. Looked at in this way, a 30% holding in a business corporation is not always as passive an investment as the 100% interest is active.

Differences among particular corporations and among the different industries in which they operate can also present different challenges for pension fund investors, as much as the relative size of the pension fund's ownership stake.

It's not clear that direct investments in 30% shareholder positions are as passive as the stated rationale for the 30% rule would imply. The philosophy that plan administrators should act as passive investors by holding direct investments at up to a 30% voting interest was probably never entirely valid for this reason.

What is certain is that the larger the pension fund, the more likely they would be to have the necessary governance and resources to manage so-called active investments. There may be a particular size at which a pension fund grows large enough to have the internal capabilities to be an active investor but much also depends on the pension fund's particular investment portfolios and allocations, and the effectiveness of its governance to ensure that appropriate resources are dedicated, either internally or externally, to manage its portfolios of direct equity investments.

The largest pension fund organizations are all governed, structured and resourced to run sophisticated in house investment operations that enable them to actively manage investments, including private equity investments, prudently, just as many are also governed, structured and resourced to actively manage sophisticated pension administration operations.

There are many potential benefits of pension funds taking active positions in business corporations: for the pension fund and the pension plan members, for the corporation being acquired and for the economy more broadly. Having the opportunity to acquire control positions in business corporations gives pension funds greater advantages including the ability to make key decisions about how the corporation is managed such as the appointment and compensation of senior officers and the financing of the corporation and when and how the investment is divested. This greater level of control ought to enhance opportunities for successful financial outcomes.

For business corporations, there are clear advantages to having a broader universe of potential investors and to having a pension fund as a major or controlling shareholder. Advantages include the "patient capital" which pension funds and their investment philosophy represent as well as the greater opportunities for follow-on investments which may be available, if and when needed. As prudent investors, pension funds would also tend to bring a higher quality of corporate governance to bear on their investments, which can result in higher performing boards and management.

With improvements to the quality of governance and management for business corporations, there are likely to be more financially successful enterprises, along with other more indirect economic improvements including more stable job markets.

While there are risks associated with being a controlling shareholder, including potential liability to the other stakeholders of the corporation controlled by the pension fund, these risks are capable of being appropriately mitigated as part of the pension fund's prudent management of its investment.

The 30% rule may serve to reinforce the need for smaller pension funds to invest prudently: if such pension funds were inclined to directly invest in a controlling stake in a business corporation without appropriate governance and resources in place, the 30% rule may help to prevent it. However, as prudential regulation, we believe it serves no useful purpose for those pension funds that have appropriate internal capabilities.

The Consultation Document indicates that consideration is being given to replacing the 30% rule with other requirements if a pension fund invests in securities of an issuer above a given threshold. HOOPP's position is that the 30% rule should be eliminated entirely. We believe pension regulators already have the tools they need to access all the information they may require and that no other undertakings or disclosures are necessary.

"Investment Performance"

- Does the 30 per cent rule impede pension administrators from obtaining appropriate investment returns? If so, why?
- What are the costs, if any, that the 30 per cent rule imposes for pension plans seeking active investments?
- Does the 30 per cent rule create inequities between large and small pension plans? Conversely, could its removal do so? If so, why?

When negotiating the acquisition of an equity interest in a business corporation as a so-called passive investor to which the 30% rule applies, the pension fund is kept at a disadvantage for several reasons including the following:

i. The terms of its investment are invariably heavily negotiated with the majority shareholder who is motivated to limit the rights of the minority shareholder(s) to the maximum extent possible.
ii. If the 30% rule was eliminated, pension funds would have the ability to invest in majority shareholder positions and thereby act as an owner, affording them significantly improved control over these kinds of investments. As an owner, a pension fund would be very involved in key business decisions, including but not limited to employment and compensation decisions relating to the CEO and other senior officers, assisting with acquisitions (often initiating or at least assisting in the execution), and approving capital expenditures and the capital structure to support the business.
iii. The pension fund would also have control over the timing and terms of its exit from the investment, instead of this being determined by another shareholder.

More generally, the ability of pension funds to make direct ownership investments in business corporations, free from the 30% rule restriction, will mean broader investment opportunities for pension funds without the need to consider and create "elaborate financial, legal, and organizational structures" to achieve strict compliance with the restriction. For those funds with the resources and governance to make and manage such investments prudently, the more investment choices available at a lower cost, would likely increase investment returns and perhaps reduce risks from more favourable investment structures.

It is difficult to measure the cost of the disadvantages from the 30% rule on either an aggregate or investment-by-investment basis. For pension funds with sizeable private equity portfolio allocations that make and manage direct investments, the costs are likely to be fairly significant.

Ultimately, the types and sizes of investments, particularly equity investments, made by pension funds will be determined in large part by each fund's size. The larger the fund, the more likely it will be for the fund to have the risk and portfolio allocation room and resources to make and manage direct investments. Conversely, the assets of smaller funds will necessarily be invested in pooled investment structures and index funds rather than be made through direct equity investments. Any differences between pension funds based on their relative sizes have very little, if anything, to do with the 30 per cent rule. If the 30 per cent rule was eliminated, larger pension funds may take larger equity positions, perhaps even more 100% ownership stakes, because they have the scale and resources that would be necessary to do so. Smaller plans would continue to invest in pooled investment structures and index funds for their equity exposures because they generally would not have the scale and resources to do otherwise.

Any differences that may exist would not be as a result of the 30 per cent rule and could, perhaps, only be overcome through investments in pooled investment structures.

"Tax Policy Considerations"

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

The Consultation Document identifies a tax advantage available to pension funds from owning business corporations which the 30% rule has helped to discourage: "pension plans may in some circumstances be able to restructure their [direct] investments in [business corporations in which they acquire an ownership interest] so as to shift taxable income from the business entity to the [tax-exempt] pension plan." As part of a proposed elimination of the 30% rule, the Consultation Document presents two potential tax measures (the "Potential Tax Measures") to address this problem:

i. the first would involve extending the entity level SIFT tax regime (the "SIFT Extension Proposal") which currently applies to publicly-traded flow-through entities to private flow-through entities in which pension plans have significant interests. From certain statements in the Consultation Document, it would appear the SIFT Extension Proposal could apply where one or more pension plans have a non-controlling interest as low as 10%; and
ii. the second would involve extending the thin capital rules (the "Thin Capital Extension Proposals") that currently only apply to debts owing to certain non-residents, to apply to debts owing to pension plans.

As outlined below, if the Potential Tax Measures are introduced, the ability of pension funds like HOOPP to make investments in Canadian private equity and venture capital will be adversely impacted unless appropriate changes are made to mitigate such impacts.

1. SIFT Extension Proposals

Currently, the SIFT rules apply to partnerships and trusts, investments in which are listed or traded on a stock exchange or other public markets ("SIFT Partnerships and Trusts"). Under the SIFT rules, SIFT Partnerships and Trusts are subject to entity level tax to the extent that they earn income from carrying on a business in Canada, receive income (other than dividends) from a non-portfolio property or realize a gain on the disposition of non-portfolio property. Non-portfolio property is defined for this purpose to include:

a) securities of a Canadian resident corporation, trust or partnership (or a non-resident person or partnership the principal source of income of which is Canada) if the fair

a) securities of a Canadian resident corporation, trust or partnership (or a non-resident person or partnership the principal source of income of which is Canada) if the fair market value of such securities represent more than 10% of the equity value of the entity;
b) Canadian real property or resource property; and
c) property used by the SIFT Partnership or Trust or a person or partnership with which it does not deal at arm's length in carrying on business in Canada.

The SIFT Extension Proposals would have adverse tax implications for investments by pension funds like HOOPP in private equity and venture capital.

Rather than making direct majority ownership investments in private equity, HOOPP most frequently makes investments in funds that are organized as limited partnerships, the general partners of which are corporations controlled by the promoter of the relevant fund. Very often, these investments by HOOPP represent minority interests. The investors in such funds frequently include both taxable and tax-exempt investors. If the SIFT Extension Proposal was implemented, a large number of private equity funds in which HOOPP has a minority interest would be considered SIFT Partnerships or Trusts. If HOOPP was to make such investments in venture capital funds, the same impact would result. As a consequence, income (other than dividends) earned on all the non-portfolio property and all gains recognized by the fund on a disposition of non-portfolio property will be subject to tax in the fund. This will not only impact tax-exempt investors in the fund (pension funds like HOOPP) but also taxable investors in the fund.

Taxable investors in private equity and venture capital funds often do not pay taxes on all of the income allocated to them by the fund, since they typically have deductions such as interest expense or non-capital losses which are used to offset income allocated to them by the fund, or capital losses that are used to offset any capital gains allocated to them by the fund. If the SIFT Extension Proposals are enacted as proposed, the effect of the SIFT tax at the entity level would tend to reduce the size of returns for taxable investors and the result is likely to be that pension fund investors would taint these investments for other taxable investors. Given this adverse result for taxable investors, fund promoters may be very reluctant to offer these private equity and venture capital fund investments to pension funds at all. In addition, if the SIFT Extension Proposals are implemented without grandfathering rules, this could cause pension funds to dispose of their existing interests in Canadian private equity and any venture capital funds which would adversely impact the market for such funds and, perhaps, Canadian capital markets more generally.

2. Thin Capital Extension Proposals

The existing thin capital rules apply to reduce deductions for interest expense incurred by taxable Canadian corporations with one or more specified non-resident shareholders (generally non-residents that own shares representing more than 25% of the votes or value of a corporation) to the extent that the debt to equity ratio exceeds 1.5 to one. If the Thin Capital Extension Proposals are implemented, the thin capital rules would also apply in circumstances where a pension plan holds shares entitling it to more than 25% of the votes or value.

In the Consultation Document it is observed that, absent the Thin Capital Extension Proposal, interest would be deductible for the taxable Canadian corporation but would not be taxable when it is received by the pension plan. The Consultation Document describes the potential concern as follows:

> "It may be noted with respect to both examples that, while the business earnings are not taxed initially, they will eventually be taxed when the pension plan distributes the earnings to its members as pension income, which is subject to personal level tax. However, the potential policy concern stems from the fact that this taxable distribution may not take place until many years after the income is earned, resulting in a very considerable deferral, not available to taxable businesses."

The stated potential concern assumes that the tax deferral that would be available for pension funds and their pension plan members would be "very considerable" but no evidence or any studies are cited as proof of this. The tax deferral of particular investment income or gains earned by pension funds to pay pensions is a very difficult thing to measure. It is not at all clear that the amount of tax foregone on income at the entity level would be greater than the tax ultimately received on pension income at the retiree level. It should be noted that, while taxable investors may have available dividend tax credits on corporate earnings paid out in dividends, pension plan beneficiaries who receive deferred investment earnings in the form of pension payments do not. The validity of the stated tax deferral concern we believe is further complicated by the element of double taxation for pension plan members: tax being payable on income at the entity level as well as on the retirees' pension payments.

There are other problems with a blanket application of a thin capital rule to pension plan investments, particularly for those investments in which the pension fund does not hold 100% ownership, if the rule is applied in the case of an ownership threshold of less than 100%. Any taxable minority shareholder would be forced to accept the impact of a 1.5 to 1 debt to equity ratio/interest deductibility limit on the corporation in which it has invested alongside the pension fund.

Another of the problems with applying the thin capital rules to pension plans was referred to in a paper prepared by Vijag Jog and Jack Mintz entitled "The 30 Percent Limitation for Pension Investments in Companies: Policy Options" Vol. 60, No. 3, Canadian Tax Journal 567-608 (the "Mintz Paper"):

> "Different types of business use different leverage ratios to finance investments. Corporations with stable earnings (such as those in the utilities, real estate, and financial sectors) tend to use more leverage than corporations in more volatile industries. Finding the "right" statutory leverage threshold is not a simple matter."

The Thin Capital Extension Proposal is a "blunt instrument". It does not reflect the amount of leverage required by corporations in which pension funds have invested based on the industry in which they operate nor does it otherwise attempt to link the amount of leverage required to the particular level of stability of the corporations' earnings or their ability or need to have higher or lower leverage. The effect of this may be to taint pension funds for corporations in search of investors. As noted, the Thin Capital Extension Proposal may also discourage taxable investors from wanting to co-invest with pension funds.

If the Potential Tax Measures were implemented, a number of other tax measures need to be implemented in order to attempt to reduce the adverse consequences described above. These measures would include:

(i) a grandfathering rule such that the Potential Tax Measures would not apply to existing investments by pension funds. As noted above, the Potential Tax Measures

may affect both majority investments and minority investments. In addition, the Potential Tax Measures will cause partnerships and trusts in which pension funds have invested to be subject to tax. Absent grandfathering, the introduction of the Potential Tax Measures could result in HOOPP, or partnerships or trusts in which it has invested, being forced to dispose of their investments in Canadian private equity;

(ii) if the SIFT Extension Proposal is implemented, it should contain a safe harbour provision that would prevent it from applying unless a particular pension fund held more than 50% of the partnership or trust. Absent such a safe harbour provision, the SIFT Extension Proposals would prevent smaller pension plans and Pooled Investment Vehicles from investing in venture capital and private equity funds;

(iii) adjustments to the Thin Capital Extension Proposal that include a higher threshold of pension fund ownership before the thin capital rule would apply to the operating entity and that would allow for more variation in the applicable debt to equity ratio limit to reflect the particular industry and financing needs of the operating entity.

HOOPP shares the concerns expressed in the Consultation Document that a level playing field needs to be maintained for investors in capital markets and entities in operating business markets to ensure fairness and economic and capital market efficiency. HOOPP agrees that pension funds should not be permitted to restructure their active investments in businesses that would currently be restricted by the 30% rule "so as to shift taxable income from the business entity to the pension plan... to avoid federal and provincial corporate income taxes on income earned from these businesses." However, it would likewise be unfair and inefficient that pension funds be made subject to targeted and restrictive tax rules that would directly or indirectly constrain them and their legitimate investment activities both in Canada and globally.

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Once again, HOOPP appreciates the opportunity to provide our views in response to the regulatory posting on the 30% rule. If you have any questions or would like to discuss with us this submission, please do not hesitate to contact the undersigned.

Yours truly,
HEALTHCARE OF ONTARIO PENSION PLAN

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