OPSEU Pension Trust
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Finance Canada
90 Elgin Street
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Via email: FIN.Pensions-Pension.FIN@canada.ca

Re: Pension Plan Investment in Canada: The 30 Per Cent Rule

The purpose of this letter is to provide comments on the Consultation on Federally Regulated Pension Plans (the "Consultation Paper") released by the Department of Finance Canada on June 3, 2016. We thank the Department of Finance Canada for providing us with an opportunity to provide feedback on proposed changes to the 30 per cent rule.

The current system works

Canada has historically supported employer-sponsored retirement savings as the third pillar of its income support program by allowing retirement vehicles to earn income on a non-taxable basis and employees to contribute to retirement savings vehicles on a tax deferred basis. These vehicles include pension plans whose sole purpose is to provide retirement income for their members through a combination of contributions and investment earnings. Private pension plans benefit the economy as a whole by putting money in the pockets of retirees and reducing reliance on the public pillars of the retirement income system.

The Government of Canada has taken a number of steps to strengthen and modernize the pension system in Canada including the recently negotiated historic agreement to expand the Canada Pension Plan and updating the 10% rule to make it consistent with diversification requirements for other investment products, i.e., changing the test from book value to market value.

Value of Canadian model

Canadian pension plans are globally recognized for the high quality of their governance and for their investment expertise. After the 2008 financial crash, Canadian pension plans recovered more quickly than their US counterparts. The Deputy Governor of the Bank of Canada has said that "given their size and importance to the Canadian and global financial systems, pension funds

contribute meaningfully to financial stability by helping to maintain the diversity of market behaviour."[1]

A recent study conducted by the Boston Consulting Group determined that of the top ten pension plans in Canada (of which OPTrust is one) six are in the top 20 of global infrastructure investors, four are in the top 20 of real estate investors, eight are in the top 100 and three are in the top 20 in terms of overall size. These plans invest over $600 billion in various asset classes across Canada and are highly diversified across alternative asset classes. They employ approximately 11,000 people, attracting top talent to Canada and exporting our talent across the globe, while at the same time operating at costs comparable to passive indexing.

The Federal government has clearly indicated its desire to partner with Canadian pension plans by making "an attractive pitch for pension funds"[2] to invest in Canada – one example of which is a partnership with the *Caisse de depot et placement du Quebec* to develop an electric rail network in Montreal. However, increasing the potential tax burden on pension plans and their beneficiaries would appear at odds with this stated goal.

Tax changes would have negative impacts

Pension plans operate in a closed system, deriving revenue to pay our beneficiaries from two sources: investment returns and contributions. If downward pressure is placed on investment returns, then upward pressure may be placed on contributions. In the case of public sector pension plans, those contributions are paid for by Canadians and their employers, many of whom are sub-national levels of government.

Further, the proposed tax measures may have a chilling effect on the government's objective of promoting partnerships with pension plans to fund infrastructure projects, as pension plans have a fiduciary duty to manage their investments in the best interests of the members and therefore seek investments with the most favorable risk-return profile. From a more technical perspective, the proposed changes could impact the ability of tax-exempt investors to participate in leveraged co-investments in Canada since they would negatively impact all investors whether tax-exempt or taxable.

"Prudent person rule" sufficient to govern fiduciary responsibility

The prudent person rule is sufficient to ensure that plans only acquire more than 30% of the voting shares of a corporation where it is prudent and appropriate in the circumstances of the

[1] Remarks Lawrence Schembri - Deputy Governor, Pension Investment Association of Canada Québec, Québec, 15 May 2014
[2] Reuters June 8, 2016: http://ca.reuters.com/article/businessNews/idCAKCN0YU2LF

particular plan. When the prudent person approach to pension investing was implemented in Canada in the 1980s and early 1990s, the policy decision was made to retain certain specific limits despite the elimination of the "legal list" and other requirements. One such limit was the 10% diversification requirement. However, since the late 1980s and early 1990s when these limits were adopted, the investment and pension landscape has changed dramatically. For example, when the 30% rule was enacted, most plans only invested in public equities or corporate bonds. A few plans made direct investments in real estate but infrastructure investing was in its infancy.

As noted in the Consultation Paper, various factors, including increased longevity, low interest rates and volatility in the global equity markets, have led pension plans to seek investments that can provide strong, stable returns, such as. long-term investments in infrastructure.

It is our view that the 30% rule does not properly capture the complexities inherent in the modern rapidly-evolving pension and investment environment and may make it more difficult for plans to manage their investments in a prudent manner due to the mismatch between equity and beneficial ownership. The trust principles underpinning the prudent person and no-conflict rules are actually better suited in such an environment because they are specifically designed to evolve to accommodate changing circumstances.

Status quo

Pension plan administrators and their business partners are now much more experienced in working with the 30% rule. The additional costs imposed on pension plans because of the structuring required to comply with the 30% rule are, in our experience, not material and certainly would not prevent a plan from making an investment which it considered prudent. The reality is that the 30% rule is only one factor among many in the structuring of investments in the alternative space and there are many upfront costs associated with such investments, apart from the costs associated with the 30% rule (e.g., due diligence costs). If the trade-off is a tax which reduces investment returns or the retention of the 30% rule, we would prefer to retain the 30% rule.

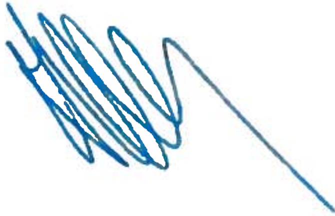
Understanding the purpose of pension plans

The sole purpose of Canadian pension plans is to deliver on the pension promise. Pension plans do not pay dividends, issue shares or engage in business practices unrelated to carrying on their core function. It is important for those who argue that the current system is not "level" to understand that the system is designed that way for a purpose. The "fairness" and "efficiency" of the system must be considered in the context of the policy considerations underlying employer-sponsored pension plans. Taxing pension plans for the purpose of creating a level playing would represent a significant departure from decades of pension policy.

Conclusion

Plans are subject to rules which require them to invest prudently. The strength of the prudent person rule is that it evolves with changes in the investment environment. In our view, the 30% rule no longer serves the purpose for which it was originally enacted, i.e., to promote prudence, and therefore we are in favour eliminating the rule. However, in our view taxing our pension plans, and ultimately the members that contribute to our plans, is a far worse public policy outcome than eliminating the 30% rule. In that regard, we would support the status quo.

Yours very truly,



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