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Department of Finance Canada
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Dear Sirs/Mesdames:

Response to Consultation Regarding 30% Rule for Pension Investment

We are lawyers with the Pensions & Benefits and Tax Departments of Osler, Hoskin & Harcourt LLP and write to provide our comments regarding the Consultation Document released by the Department of Finance on June 30, 2016 titled "Pension Plan Investment in Canada: The 30 Percent Rule" (the "**Consultation Document**"). Thank you for this opportunity to participate in the consultation.

Osler is a law firm with over 400 lawyers in Toronto, Montreal, Calgary, Ottawa, Vancouver and New York, which provides legal services to corporations in a wide variety of business law specialties. We provide advice to public and private sector pension plan sponsors and administrators on the legal and regulatory aspects of pension plans, including frequently advising plan administrators on all aspects of pension investments, including the federal pension investment rules in Schedule III to the *Pension Benefits Standards Regulations, 1985* (Canada) (**"Schedule III"**). We also provide advice to investment managers and entities contracting with pension plans regarding the investment restrictions applicable to pension plans.

Our Submissions

In our submission, the 30% rule does not continue to be useful as a means of regulating pension investment, if it ever was. In general, we are in favour of eliminating it in order to provide more flexibility to pension plan investors and eliminate impediments to efficient investment. However, we are also mindful of the fact that any changes to the 30% rule should be carefully considered and calibrated.

Further, any changes to the 30% rule, or that accompany its removal, should not put pension plans in a position that would be worse than the current status quo. In particular, we do not favour changes to the 30% rule if they are accompanied by ITA changes that would be detrimental to pension plan investors; nor do we favour changes that would complicate, rather than facilitate, negotiations with counterparties, investment managers and other investment partners (e.g. replacing the 30% rule with certain disclosure requirements at the investment level, as was suggested in Ontario's recent consultation on the same subject). Overall, the tax measures proposed in the Consultation Document would put pension plan investors (and, by extension, their sponsors and beneficiaries to the extent the funded status of plans is impacted by these measures) in a worse position than the status quo.

Prudential Considerations

In our submission, the 30% rule does not continue to be useful as a means of regulating pension investment, if it ever was. While we have not separately responded to the individual consultation questions, we do address the questions in the context of the submissions below in support of our view.

1. **Poorly Calibrated and Outdated**

As noted in the Consultation Document, the stated intent of the 30% rule was originally prudential in nature. Specifically, the rule sought to discourage active management of corporations by pension plans (and, at the time, other financial institutions), promoting passive investment and limiting exposure to a business should it fail.[1]

Current capital markets and opportunities in those markets have evolved since the 30% rule was first introduced and are increasingly complex; prescriptive quantitative rules, such as the 30% rule, are poorly suited to managing the risks presented by today's environment. In addition, infrastructure and private equity investments have become increasingly common for pension plans, as part of their diversification measures, and may not be as attractive on a passive basis. Many pension plans have highly sophisticated investment and risk management capabilities, developed as part of their duty of prudence, that allow them to respond to both capital market risks and specific investment risks effectively. Imposing prescriptive quantitative requirements on such plans impedes their ability to effectively manage risk rather than supporting that goal. For example, the 30% rule promotes a disconnect between equity ownership and voting control of a corporation, which is inconsistent with both good governance and prudential considerations. Specifically, as noted in the Consultation Document, pension plans can permissibly take a greater than 30% equity stake in a business, as long as they do not gain more than 30% voting control. In these circumstances, the limits on voting rights imposed by the 30% rule hinder the ability of pension plans to manage their risks through input into the governance of an organization. Structuring a pension plan's interests to comply with the 30% rule and allow it to provide adequate input into governance can be complex and leads to inefficiencies.

In our experience, those plans that do not have developed internal investment capacity (typically, smaller plans) rely on investment professionals (whether investment fund managers or segregated account managers) to invest the assets of their pension plans, in accordance with their fiduciary duties. Both because of their asset size and diversification requirements, their investments typically do not raise 30% rule issues, other than in respect

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1 See, for example, the following Department of Finance publications: "The Regulation of Canadian Financial Institutions: Proposals for Discussion", 1985, and technical supplement and "New Directions for the Financial Sector", 1986.

of ensuring that the rule is not breached inadvertently in the context of fund investments, as described below, which represents both an administrative burden and cost.

As outlined below, regulatory focus should shift to ensuring that the prudential framework for pension investment that already exists under all pension standards legislation in Canada is applied to both large and small plans, rather than requiring compliance with the 30% rule, which is not well suited to either circumstance.

Notably, the 30% rule applies a bright line test that targets a single risk that may or may not apply in any given circumstance of corporate voting share ownership by a pension plan. For example, although the rule is intended to prevent the operation of businesses, it is frequently confronted by pension plans (both large and small) in the context of their investments in various types of investment funds, i.e. precisely the passive types of investments that were originally viewed as appropriate. Many such investment funds, and the feeder entities for such funds, are established as limited partnerships or trusts that are managed by the promoter of the investment fund. Such funds and feeders for such funds invest in shares of various corporations and as a pension fund's ownership of units in the fund or feeder fluctuate as other investors purchase and dispose of shares of the fund, the pension plan's indirect ownership in the corporations in which the funds have invested fluctuate as well.[2] Such fluctuations could inadvertently cause a breach of the 30% rule. In such circumstances, while there may be a technical violation of the 30% rule, the fundamental character of the investment does not change or put the plan in the position of controlling or managing an operating company. However, because there is no cure period provided under Schedule III to remedy the breach, the pension fund is immediately offside Schedule III and in a revocable position under the ITA.

In addition to being poorly calibrated to address the stated policy purpose, the 30% rule is outdated and impedes pension funds in delivering on the benefit promise to beneficiaries (as further discussed below). Specifically, the 30% rule increases the costs of investment and may cause plans to forego certain investments at the expense of higher investment returns, as described below; this, in turn, has an impact on the funded status of plans and the cost of benefits paid by plan sponsors and plan members. The delivery of the benefit promise through sound and efficient investment practices is a goal that should be promoted by government policy as adequate retirement savings and the viability of defined benefit pension plans continues to be an issue of national scope and importance.

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[2] In addition, in many circumstances, Canadian pension plans are required to invest in feeder funds with other entities that are not resident in a particular jurisdiction (e.g. the United States). In such circumstances, the pension plan could have a much larger percentage ownership in the feeder then it would have in the main investment fund. We also note that some investment funds, particularly hedge funds, may themselves be structured as corporations, raising the issue of voting share ownership at the level of the fund investment, but not the types of issues that the 30% rule was intended to address.

2. **Inefficient and Out of Step with Other Jurisdictions**

In addition to being poorly calibrated and poorly suited to managing the risks of current capital markets, the rule is often faulted for imposing barriers to investment for Canadian pension funds, which must compete globally with other pension and sovereign wealth funds for investment opportunities. Negotiating protections and monitoring obligations to prevent the inadvertent breach of the 30% rule and/or structuring investments not to breach the 30% rule is administratively burdensome, costly and inefficient. Where such structuring could not be achieved or appropriate compliance protections negotiated, we have seen it be a barrier to otherwise prudent investments. Such foregone investments also represent a lost opportunity cost.

As noted in the Consultation Document, pension investments by non-Canadian pension plans are, generally speaking, not subject to similar quantitative restrictions. When competing for investments globally, the 30% rule places Canadian pension funds at a competitive disadvantage relative to foreign pension funds in that it can require both additional structuring and negotiation to ensure compliance, as described above.

3. **Unnecessary Because of Prudential Framework**

As noted above, a robust prudential framework applies to investment by pension funds under the *Pension Benefits Standards Act* (Canada) ("**PBSA**") and all other Canadian pension standards legislation. Such a framework makes quantitative rules such as the 30% rule unnecessary as the fiduciary duties applicable to pension fund investment are both broad and flexible enough to most effectively ensure prudent investment. Specifically, under the PBSA, plan administrators are subject to the duty of prudence, the duty to use specialized knowledge and skill and the duty to act in the best interests of the members of the pension plan. The PBSA also imposes a prudent portfolio standard to the evaluation of pension fund investments along with detailed requirements for statements of investment policies and procedures ("**SIPP**") to govern the investments of individual pension funds. In our view, these fiduciary duties and the prudential framework for investment under the PBSA generally should prevent plan administrators from operating a corporation where it was imprudent or not in the best interests of plan beneficiaries to do so or where the appropriate skills were not available to do so or it was inconsistent with the plan's SIPP.

If the 30% rule were to be eliminated, these legislated duties and requirements would continue to apply to pension plan investments. In addition, the Office of the Superintendent of Financial Institutions would continue to have powers that would allow it to investigate and confirm that prudent investment practices were being followed. Given this framework and our comments above regarding the investment practices of pension plans, in our submission, it should not be necessary to impose additional disclosure or other requirements on pension plans if the 30% rule is removed. That said, if such disclosure

requirements are imposed, they should only be imposed at the plan level. Based on our experience, mandating disclosure or undertaking requirements at the level of the corporate investment could introduce more barriers to investment. Specifically, investment funds, investment partners or the corporation in which the pension plan invests may not wish to be subject to the additional disclosure/undertaking requirements that would be imposed on them merely because an investor is a pension fund. Imposing such requirements would effectively negate the benefits of eliminating the 30% rule.

4. Any Changes Should Be Harmonized with ITA and Other Schedule III Rules

As noted above, changes to the 30% rule should work in harmony with ITA provisions for special purpose corporations, which will continue to be important to pension funds even where the 30% rule is eliminated, as well as with other investment rules in Schedule III (e.g. the investment (pooled) fund exception to the 10% rule under s. 9(3)(a) of Schedule III and the new investment fund exception to the related party rules under the amendments to s. 17(2)(a) of Schedule III, to take effect on July 1, 2016, both of which require compliance with the 30% rule by investments funds in order for them to qualify under the exceptions).

Income Tax Considerations

The Consultation Document asked certain questions including whether the tax policy concerns discussed in the Consultation Document relating to the ability of pension plans to acquire controlling positions are material in nature and if the potential relaxation or elimination of the 30% rule causes those concerns to be material in nature.

The Consultation Document states that it is estimated that in 2014, Canada's six largest pension plans held at least $22.25 billion of active investments in Canadian entities outside of the real estate and resource sector. In order to determine if that is a material number it must be compared to the total amount invested by Canadian defined benefit plans and the total amount invested by defined benefit plans outside the real estate and resource sectors in 2014. The 2014 Asset Mix Report proposed by the Pension Investment Association of Canada states that the total amount of investments by defined benefit plans in 2014 was $1,505.79 billion and of that amount, $197.28 billion was invested in private equity, venture capital and infrastructure. Therefore, the $22.25 billion referred to in the Consultation Document represents only 1.5% of the total investments made by defined benefit pension plans and only 11.3% of investments made by defined benefit pension plans in private equity, venture capital and infrastructure. As stated in the Consultation Document:

> In recent years, increasing longevity has raised the cost of expected payments for pension plans. At the same time, pension plans have seen increases in investible cash due to large contributions from baby

> boomers (currently 50-69 years old) in their peak earning years. Furthermore, low interest rates and volatility in global equity markets stemming from the global financial crisis of 2008 have diminished plans' ability to generate returns from passive investments such as long-term bonds to match their liabilities. As a result, pension plans are increasingly seeking investments that can provide strong and steady returns over a medium term horizon.

This has resulted in pension plans investing more of their funds in private equity, venture capital and infrastructure. In the Consultation Document it is noted that:

> According to the Pension Investment Association of Canada (PIAC), member pension plans reported in 2000 that only 1.5 per cent of their assets were invested in private corporations and infrastructure, which often involve a substantial ownership stake. In 2014, these investments (in and outside of Canada) accounted for approximately 13 per cent of pension plan assets.

It should be noted that only a small portion (11.3%) of that increased investment is as a result of active investments. So the active investments made by the largest six pension plans are not material in the context of the total investments made by defined benefit plans or the total investments made by defined benefit plans in private equity, venture capital and infrastructure.

The relaxation or elimination of the 30% rule should not cause these concerns to become material relative to the other concerns referred to above such as the impact on capital markets, liquidity, the availability of patient capital, capital for large scale projects. The 30% rule prevents a pension plan from holding more than 30% of the shares that vote for the election of directors. As noted in the Consultation Document, many of the large pension plans have developed strategies that comply with the 30% rule while permitting them to have an economic interest in excess of 50% of an entity as well as contractual rights that permit the pension plans to prudently protect their investment. Consequently, the relaxation or elimination of the 30% rule will not impact upon the ability of those plans to acquire more than a 50% economic interest in entities. Therefore, the principal result of relaxing or eliminating the 30% rule will likely be to simply reduce complexity and administration costs – rather than resulting in a material change in the investments of pension plans. If the 30% rule is relaxed or eliminated the other plans will still be subject to the 10% diversification test under the PBSA as well as the prudential and other fiduciary requirements under the PBSA. Thus, the relaxation or elimination of the 30% rule should not have a material impact upon their ability to own more than a 50% economic interest in entities.

The Consultation Document raised two potential tax measures (the "**Potential Tax Measures**"):

(i) potentially extending the entity level SIFT tax regime (the "**SIFT Extension Proposal**") which currently applies to publicly-traded flow-through entities so that it would also apply to certain private flow-through entities with pension plan investors; and

(ii) potentially extending the thin capitalization rules (the "**Thin Capital Extension Proposals**") which currently apply to certain debts owing to non-residents so that the rules would also apply to certain debts owing to pension plans.

The Potential Tax Measures would be detrimental to pension plan investors and to the sponsors and members of those pension plans, given their interest in the funded status of such plans. For example, if the SIFT Extension Proposal were implemented, then a large number of investment funds in which pension plans have invested would be considered SIFT Partnerships or Trusts. Consequently income (other than dividends) earned on all the non-portfolio property and all gains recognised by the fund on a disposition of non-portfolio property will be subject to tax in those funds. This will not only impact the pension plan investors in the fund, but also the taxable investors in the fund. In many cases, even though investors in such funds are taxable, they may not actually pay taxes on all of the income allocated to them by the fund. Those investors could have deductions such as interest expense or non-capital losses which could be used to offset income allocated to them by the fund or capital losses that could be utilised to offset any capital gains allocated to them by the fund. If the SIFT Extension Proposals are enacted, this could well prevent pension plans from acquiring interests in Canadian private equity and venture capital funds.

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 which own shares representing more than 25% of 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 votes or value. Since the thin capital rules deny an interest deduction to the corporation in which the pension plan has invested, the Thin Capital Extension Proposals will affect not only the pension plan but will also affect taxable investors in the corporation. Different types of businesses use different leverage ratios to finance investments. Therefore, implementing the Thin Capital Extension Proposals could result in pension plans not being able to invest in corporations undertaking certain types of activities.

Overall, the implementation of the Potential Tax Measures would result in pension plans (and, by extension, their sponsors and beneficiaries to the extent the funded status of plans is impacted by these measures) being in a worse position than the status quo.

We appreciate the opportunity to make submissions for your consideration. If you have any questions regarding our written submissions, please do not hesitate to contact Paul Litner (416.862.4730) or Anna Zalewski (416.862.5928) regarding the Prudential Submissions and Jack Silverson (416-862-5678) regarding the Tax Submissions.

Yours truly,

Osler, Hoskin & Harcourt LLP

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