September 15, 2016

The Honourable William Morneau, P.C., M.P.
Minister of Finance
Department of Finance Canada
90 Elgin Street
Ottawa, Ontario
K1A 0G5

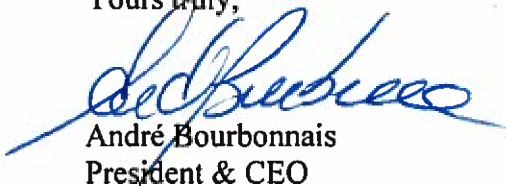
Re: *30% RULE FEDERAL CONSULTATION SUBMISSION*

Dear Minister:

We are pleased to provide our submission in response to the Department of Finance's consultation on the ongoing usefulness of the 30% rule for pension investments. Although Public Sector Pension Investment Board is not subject to the investment provisions of the *Pension Benefits Standards Act, 1985* (Canada) and the accompanying Regulations, the investment rules regarding quantitative limits outlined in the *Public Sector Pension Investment Board Regulations* (Canada) are very similar. For this reason, to the extent that changes to the 30% rule may impact the corresponding provisions of the PSPIB Regulations, we consider it appropriate to provide our submission.

We appreciate the opportunity to make submissions for your consideration and look forward to participating in upcoming discussions with the Department of Finance. If you have any questions regarding our written submission, please do not hesitate to contact Ms. Alison Breen, Vice President, Corporate Secretary and Chief Regulatory Officer by telephone at (514) 925-5482 or by email at abreen@investpsp.ca

Yours truly,



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30% RULE FEDERAL CONSULTATION SUBMISSION

INTRODUCTION

We are pleased to provide our submission in response to the Department of Finance's consultation on the ongoing usefulness of the 30% rule for pension investments, as expressed in Schedule III of the *Pension Benefits Standards Regulations, 1985* (Canada) ("**Schedule III**"). Although PSPIB is not subject to the investment provisions of the *Pension Benefits Standards Act, 1985* (Canada) ("**PBSA**") and the accompanying Regulations ("**PBSR**"), the investment rules outlined in the *Public Sector Pension Investment Board Regulations* (Canada) ("**PSPIB Regulations**") with which PSPIB must comply, mirror closely the investment provisions found in Schedule III. For this reason, to the extent that changes to Schedule III may impact the corresponding provisions of the PSPIB Regulations, we consider it appropriate to provide our submission. Thank you for the opportunity to participate in the consultation.

The Public Sector Pension Investment Board ("**PSPIB**") is a Crown corporation that was created in 1999 by the *Public Sector Pension Investment Board Act* (Canada) ("**PSPIB Act**") to manage and invest the net contributions received after April 1, 2000 from the pension plans of the Public Service, the Canadian Forces, and the Royal Canadian Mounted Police, along with the net contributions received after March 1, 2007 from the pension plan of the Reserve Force. To achieve its investment mandate, PSPIB makes investments in public and private assets. As at March 31, 2016, PSPIB's assets under management were valued at over $116 billion.

We do not aim in our submission to address each question posed in the federal consultation paper. Instead, our submission regarding the 30% rule will focus on the reasons why this 30% rule is outdated and should be eliminated. From a prudential perspective, as discussed in Part A of our submission, we believe that the most appropriate way to reform the regulatory framework governing pension investments is to replace the 30% rule with a principles-based approach to regulation that is aligned with the "prudent person" standard that governs the investment of pension funds pursuant to the provisions of federal and Ontario pension standards legislation. We are of the view that a principles-based approach to regulation grounded in the "prudent person" standard is best suited to ensure the investment risk management objectives of PSPIB and other similar pension funds.

The consultation paper also addresses tax issues. PSPIB's comments regarding the *Income Tax Act* (Canada) ("**ITA**") considerations are in Part B of this submission. Again, in this part of our submission, we do not aim to address each question posed in the consultation paper. Instead, we have formulated our response aimed at the broader policy considerations at stake. We provide input addressing the general concepts found in the consultation paper, considering them within the basic tax and regulatory framework that currently exists.

SUMMARY OF SUBMISSION

With respect to the prudential considerations discussed in Part A of our submission, we are of the view that the 30% rule is outdated for the following reasons:

- The policy objectives that led to the creation of the 30% rule are no longer relevant given the way in which Canadian Pension Funds[1] (**"Pension Funds"**) now approach their investment activities;
- The 30% rule is not aligned with the sophisticated governance and risk management structures in place in many of today's Pension Funds and pension investment managers, such as PSPIB;
- The 30% rule places many Pension Funds and pension investment managers, including PSPIB, at a competitive disadvantage relative to foreign pension funds; and
- The concern that Pension Funds might seek to control and operate Canadian enterprises is anachronistic.

Based on our review of these factors, we recommend that the 30% rule be abolished and replaced with principles-based regulation.

With respect to the taxation considerations discussed in more detail in Part B of our submission, Pension Funds are provided with a special exemption from income tax given their purpose. The maximization of tax-exempt earnings by Pension Funds is a government policy goal, except where it conflicts with other, more significant policy objectives. In this context and balancing it with concerns of fairness, the following should be considered in developing any legislative changes to the *Act* applicable to Pension Funds:

- Tax (and other) rules governing investments by Canadian Pension Funds should not seek to establish artificial parity among larger and smaller Pension Funds; they should provide all funds with the most favourable structural framework that is consistent with broader policy considerations so that each fund is able to invest for optimal returns.
- Consideration should be given to whether the existing exemption for Pension Funds investing in real estate and resource property should be expanded to include a similar exemption for infrastructure and other natural resource[2] investing, which has many similar features and which would support a long-term reinvestment in such asset classes to benefit Canadians.
- The introduction of a thin capitalization rule would be an acceptable policy approach, if properly structured. Financing provided by Pension Funds in parallel with, or

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[1] Formed by private employers or different levels of government as a semi-mandatory system to encourage eligible employees to save for retirement.

[2] i.e. timber, agriculture and mining for resources not included in "Canadian resource properties".

substitution for, arm's length commercial financing should be excluded from any such rule. This result is most consistent with the effect of the existing thin capitalization rules.

- The taxation of Pension Fund income from flow-through investing in commercial activities also is a reasonable policy objective. The need for an initiative in this regard should be validated quantitatively given past policy choices, and should be undertaken in a way that does not interfere with permitted flow-through investment (real estate and resource) or effective transaction structuring (the use of pooling vehicles for commercial reasons).
- Any tax policy initiative to limit the unintended extension of the Pension Funds' tax exempt status to commercial activities should be undertaken carefully as the potential downside from over-broad or incorrectly conceived rules could result in financial impact. We encourage continued active consultation in this regard. Initiatives should be clearly focused on their intended target of domestic investing in order not to needlessly disadvantage Canadian funds in competition with international capital pools or in international investing more generally.

PART A – PRUDENTIAL CONSIDERATIONS

Overview of the 30% Rule

The 30% rule is expressed in section 14 of Schedule III and prohibits Pension Funds from holding more than 30% of the voting shares of a corporation. Resource corporations, real estate corporations and investment corporations are exempt from the 30% rule, subject to specific undertakings and disclosure requirements. The impact of the 30% rule and other investment restrictions in Schedule III is far-reaching because the PBSR govern not only the investments of federally registered pension plans, but also the investments of Pension Funds registered in most Canadian provinces which have incorporated Schedule III by reference in their respective pension provincial regulations.[3]

Origins of the 30% Rule

An informed discussion about the continued relevance of the 30% rule must take into account the policy rationales for which the rule was initially adopted. Several government technical reports[4] from the late 1980s, when the 30% rule was initially contemplated, indicate that the main policy reason for implementing the rule was to ensure that Pension Funds and other financial institutions would not take an active role in managing the day-to-day operations of corporations.

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[3] The following jurisdictions adopt the federal investment rules in Schedule III: Alberta, British Columbia, Manitoba, Ontario, Newfoundland and Saskatchewan.

[4] When Schedule III was enacted in 1993, the Office of the Superintendent of Financial Institutions published a regulatory impact analysis statement which referred to a document from 1985 entitled "The Regulation of Canadian Financial Institutions: Proposals for Discussion" and a related technical supplement as well as a document from 1986 entitled "New Directions for the Financial Sector". The technical supplement contains some analysis of the rationales behind the 30% rule. See Department of Finance, Technical Supplement (1985), p. 51.

At the time the 30% rule was introduced, there was also a concern that alternative or illiquid investments are not an ideal match for most of the liabilities of such financial institutions. This view has evolved over time. It is now recognized that real estate and infrastructure projects, as well as other long term less liquid investments, can be appropriate matches for the long-term liabilities of Pension Funds.

A second rationale for the introduction of the 30% rule was based on the view that Pension Funds, and, in particular, public sector pension funds, should not control commercial enterprises in the Canadian economy. The view was that Pension Funds are not commercial businesses, they are funds responsible for the provision of pension benefits to plan beneficiaries.

The 30% Rule is Outdated

We submit that the public policy goals the 30% rule was intended to achieve are outdated. Capital markets are dynamic, and opportunities and risks are constantly evolving and changing. Given the fluidity of the current investment environment, the rules governing pension investments should be based on principles rather than antiquated quantitative restrictions.

Moreover, given modern notions of prudence which are now incorporated in pension standards legislation, and which require pension plan administrators to actively monitor their investments to ensure that the interests of plan beneficiaries are protected, the rationales underlying the 30% rule at the time of its implementation are anachronistic. The 30% restriction itself is an arbitrary limit that is increasingly irrelevant in today's market, in which it is possible to secure rights that can amount to *de facto* control of a public corporation even when owning less than 30% of its voting shares.[5]

In light of a Pension Fund's cardinal purpose, which is to secure retirement savings for plan participants, we are of the view that the regulatory framework for pension plan investment should focus on enabling pension investors to find investments that will earn sufficient returns at an acceptable degree of market risk in order to satisfy the long-term obligations of the pension plan. The main focus of the regulation should therefore be to ensure that Pension Funds adopt a prudent and reliable risk management framework that will govern their approach to making investment decisions.

As explained above, the policy rationales underlying the implementation of the 30% rule are difficult to defend in this day and age and do not correspond to modern investment realities. There are numerous reasons to conclude both that the 30% rule reflects an outdated approach to pension fund regulation, and that it should be replaced with principles-based investment regulations.

First, the quantitative restrictions, including the 30% rule, were implemented at a time when Pension Funds were much smaller in size and largely invested in publicly listed securities. The 30% rule presumes that Pension Funds will remain passive investors with little exposure to alternative and illiquid private investments, a strategy that is no longer effective in producing the

[5] There are several ways in which *de facto* control can be accomplished while holding less than 30% of the voting shares of a company, as pointed out by Vijay Jog and Jack Mintz in "The 30% Limitation for Pension Investment in Companies: Policy Options", *Canadian Tax Journal* (2012) 60:3, pp. 567-608.

returns needed to safeguard the pension promise. This is especially true in light of the growth in size of Canadian public sector plans, their increased diversification in a number of private asset classes (private equity, infrastructure, real estate, natural resources and private debt) and their global outreach with investments around the world. The asset class and geography diversification has allowed Canadian public sector pension plans to provide higher returns with reduced market risk.

Second, the 30% rule is not aligned with the governance and risk management structures of today's Pension Funds or pension investment managers, such as PSPIB, many of which maintain sophisticated in house investment and risk management expertise, operations and capabilities. As an example, we have included in Appendix "A" to our submission a summary of the investment risk management and governance framework in place at PSPIB. Given the sophistication of risk management strategies with which PSPIB complies, the 30% rule is not only unduly restrictive but it is not focused on what is truly relevant to the effective management of risk: ensuring that Canadian pension plans and pension investment managers have adopted robust risk management practices.

Third, as discussed in more detail in the "International Experience" section below, other OECD countries with which Canada's pension rules are often compared, i.e., United States, United Kingdom and Australia, do not impose an investment quantitative restriction such as the 30% rule. Therefore, when competing for investments on a global basis, the 30% rule places Canadian Pension Funds, and pension investment managers like PSPIB, at a competitive disadvantage relative to foreign pension funds.

Fourth, by separating equity ownership from voting power, the 30% rule risks creating a serious corporate governance problem, as pointed out by at least one commentator.[6] The ability of a shareholder to vote to elect or remove the directors is a critical corporate governance mechanism that acts to ensure that directors and professional managers whom they oversee fulfill their duties and responsibilities. The 30% rule currently prevents this convergence of interests between directors, managers and shareholders. Eliminating the 30% rule would enhance the oversight, accountability and transparency of public and private companies and allow for more effective risk management by Canadian funds, ultimately benefiting plan members, employers and retirees in Canada.

Finally, the concern about Pension Funds coming to control and operate Canadian enterprises is also anachronistic. With regard to public companies, PSPIB would not typically take a significant stake in a public company. With regard to private companies, PSPIB does not seek to run the business when it has a significant equity stake in the company.

In the case of publicly listed companies, limitation on liquidity is the primary reason for not taking a significant stake in a company or seeking Board representation at such company. One of the primary reasons for investing in publicly listed companies is to ensure an appropriate level of liquidity at the total fund level. As large investment blocks in a public company or investments subject to insider trading restrictions are quite illiquid, it is frequently very difficult

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[6] Poonam Puri, *A Matter of Voice: The Case for Abolishing the 30 Percent Rule for Pension Fund Investments*, C.D. Howe Institute Commentary, No. 283 (February 2009), p. 5.

to unwind a significant position in a public company in a manner that optimizes investment returns within a desired time frame.

With respect to private companies, PSPIB does not seek to run the business when it has a significant equity stake in the company. We rely on the company's management team to manage day-to-day affairs. In addition, with respect to these kinds of investments, PSPIB will most often team up with a partner that has management and operational expertise in the particular industry. This partner will generally be the party that focuses on management, strategies, operations and compensation. Moreover, PSPIB seeks to ensure that the private company has a Board of Directors (with an appropriate number of independent directors) and a management team that is subject to incentive plans that will motivate it to execute effectively on its business plan. PSPIB's expertise lies in evaluating and selecting investment opportunities, monitoring its investments and disposing of the investments once the business plan is completed. It recognizes that its skill sets are not those of an operator and so it is generally not looking to be a manager/operator. As noted by our President and CEO in a recent speech, PSPIB is in the business of capturing value created by others.[7]

"Prudent Person" Standard

One of the questions raised in the federal consultation is whether the philosophy that plan administrators should act as passive investors continues to be valid. We answer the question in the negative, and submit that, as explained above, the rationales for the implementation of the 30% rule are outdated. Large Pension Funds and pension investment managers, such as PSPIB, have sophisticated governance and risk management systems in place to ensure that the risk management concerns at the root of the 30% rule are, in fact, well addressed, which obviates the need for a prescriptive rule such as the 30% rule. The "prudent person" standard is a more appropriate regulatory standard than the quantitative limits in Schedule III.

We are of the view that the "prudent person" standard ensures an appropriate level of regulatory oversight. The "prudent person" standard outlined in section 32 of the PSPIB Act[8] would provide a more tailored regulatory standard, one focused more on good governance of the investment process, including risk management and diversification, as opposed to prescriptive rules. We have recently seen a move away from prescriptive investment rules toward a "prudent person" standard in other regimes, such as the *Trustee Act* (Ontario).[9]

Furthermore, it is important to note that the pension standards legislation itself, both at the federal and provincial level, contains prudency safeguards. At the federal level, the PBSA sets out the "prudent person" standard as a general standard for investment decisions in subsections

[7] http://www.investpsp.com/pdf/andre-bourbonnais-cercle-canadien-montreal.pdf

[8] Section 32 of the PSPIB Act provides that: "subject to the regulations, the board of directors shall establish, and the Board and its subsidiaries shall adhere to, investment policies, standards and procedures that a person of ordinary prudence would exercise in dealing with the property of others."

[9] The *Trustee Act* (Ontario) was amended in 1998 to incorporate the "prudent person" standard, with no quantitative investment restrictions. Specifically, subsection 27(1) provides that in investing trust property, a trustee must exercise the care, skill, diligence and judgment that a prudent investor would exercise in making investments.

8(4) through (5). Specifically, subsection 8(4.1) requires the administrator of a pension plan to "invest the assets of a pension fund in accordance with the regulations and in a manner that a reasonable and prudent person would apply in respect of a portfolio of investments of a pension fund." This requirement serves as a guiding principle for all investment-related decisions of a pension fund.

At the provincial level, the *Pension Benefits Act* (Ontario) (the "**PBA**") imposes in subsection 22(1) the prudent person rule, which requires pension plan administrators to exercise the care, diligence and skill that a person of ordinary prudence would exercise in dealing with the property of another person in the investment of plan assets.

Effectively, the "prudent person" standard provisions require that Pension Funds invest plan assets prudently, in a manner that manages risk through diversification of the investment portfolio. This is an approach to investment that emphasizes the overall prudence of the portfolio for the purpose of satisfying the funding objectives of the pension plans. When considering the risk management goals imposed by the "prudent person" regulatory requirements in comparison to the bright-line restriction in the 30% rule, it is important to note that the 30% rule does not limit the overall equity position that a Pension Fund may take in an investment, so it is difficult to justify the rule's existence as a diversification or risk-spreading tool.

PSPIB therefore supports the prudent person standard as the more appropriate and effective guiding principle for minimizing risk in the investment of pension plan assets.

International Experience

To provide additional context for consideration of the "prudent person" approach to regulation recommended above, we turn our attention to what other countries are doing as it relates to quantitative rules governing pension fund investments. We note that the 30% rule does not exist in any other OECD jurisdictions with which the Canadian pension and investment regulatory regime is often compared, specifically the United States, the United Kingdom and Australia. We note that all the jurisdictions reviewed here have moved to regulatory oversight based on a "prudent person" approach to pension asset management.

In the United States, the *Employee Retirement Income Security Act* (US) ("**ERISA**"), imposes a "prudent man" standard of care and diversification requirements, but no ownership concentration limits.[10] Section 404 of ERISA sets forth the general standards of fiduciary conduct requiring, among others, that plan trustees and other fiduciaries to the pension plan discharge their duties "with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character with like aims".[11]

The United Kingdom has adopted a similar "prudent person" rule method of regulation in the *Pensions Act* (UK). In carrying out their powers and obligations, pension trustees in the United

[10] Organization for Economic Co-operation and Development ("**OECD**"), "Annual Survey of Investment Regulation of Pension Funds" (2015), at Table 3.b.

[11] OECD, "Prudent Person Rule Standard For The Investment of Pension Fund Assets", p. 11.

Kingdom are bound to exercise reasonable care and "to show the prudence and diligence that an ordinary man of business would in the exercise of his own affairs."[12] The United Kingdom regulatory regime limits the use of quantitative requirements to situations such as related party investments.

Similarly to the United States and United Kingdom, Australia employs an "ordinary prudent person" standard and a risk-based approach to the regulatory oversight of pension asset management. Australia imposes diversification principles, but there are no ownership concentration limits.[13]

On a global playing field, given the more modern framework in place in other jurisdictions, the Canadian regulatory compliance requirements create competitive disadvantages for Canadian pension funds, including when investing in Canadian assets, relative to foreign investors, which are not encumbered by similar rules. We therefore support switching to a principles-based regulatory framework modelled after the "prudent person" standard in order to level the playing field for Canadian pension funds.

PART B – INCOME TAX CONSIDERATIONS

The Consultation Paper[14] poses a series of tax questions and raises concerns using specific examples. These relate to questions of horizontal equity (fairness among market participants) and tax leakage. In preparing this submission, we evaluated these specific questions, but based on our understanding that you would find a response aimed at the broader policy considerations at stake to be useful, we are providing input addressing the general concepts found in the Consultation Paper, considering them within the basic tax and regulatory framework that currently exists.[15] Because we have approached the issues in this way, we have not focused on the details of any possible amendments to the ITA, nor have we focused on whether a particular question is more or less relevant to our own investment philosophy.

The current Consultation Paper is only the beginning of any process that may develop, and we look forward to providing more concrete input at a later stage in the process (when the Department has moved from a policy analysis to considering particular tax legislation initiatives).

(i) Significant international capital pool chasing limited opportunities means intense competition

As a preliminary observation, the relationship of Pension Funds to the ITA is significantly different than that of most other system participants. Ensuring to the extent possible that Canadians have an adequate income in retirement is a key government policy objective, and

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[12] OECD, *supra* note 10, pp. 9-10.

[13] OECD, *supra* note 9, at Table 3.b.

[14] "Pension Plan Investment in Canada: The 30 Percent Rule"; https://www.fin.gc.ca/activty/consult/ppic-prpc-eng.asp

[15] Except for the 30% Rule itself, of course.

pension plans play a central role in achieving that objective in respect of many Canadians. In other circumstances the government seeks to advance its revenue raising goals while not having an unduly impeding effect on economic activity. Initiatives are developed having regard to concepts of neutrality and tax optimization but nonetheless with the intent of extracting tax revenues from economic activity. Because the government has no policy interest in taxing Pension Funds, the interaction of pension policy and tax revenue collection involves a very different sort of balance. In this context, the issues discussed in the Consultation Paper are questions about the extent of the tax support to be provided to the retirement savings objective, or where the boundaries should be between the Pension Funds' tax-exempt investing activities and the economy's taxable activities, taking various policy considerations into account. Pension funds' exempt status does not exclude them from tax policies considerations; but the balancing of considerations is very different than when dealing with taxable entities. Pension funds represent very different capital pools. These are not "1%" investors; they are an aggregation of ordinary Canadian citizen and taxpayers.

The scope and nature of the investment opportunities available in assets of all types have expanded substantially since the current provisions of the ITA governing Pension Funds were developed. Investment opportunities and sources of capital are increasingly internationalized. Worldwide there has been a great expansion of capital pools, whether retirement savings pools, sovereign wealth funds, charitable endowments, private wealth or otherwise. The use of private investing as a key component of an investment portfolio has moved from the edges of the investment community to a central position. These pools have adopted differing approaches to private investing, some choosing to use outside expertise in making investment decisions, such as third-party private equity funds, and others choosing to develop their own expertise in-house.

Pension Funds now regularly find themselves in direct competition for investments with these large international pools of capital. It is important that in a highly internationalized capital marketplace Canada's tax policies ensure that Canadian capital pools can compete on a favourable basis with these other capital pools, which frequently are tax-favoured in their home jurisdiction (or exist in jurisdictions that are inherently tax-favourable). Smaller Pension Funds may not find themselves participating in this marketplace to the same degree, or may find themselves participating only indirectly through third-party managed funds. To the extent this places these plans at a disadvantage relative to larger Canadian funds, the solution must *not* be to apply restrictive rules to larger plans that will have the effect of disadvantaging them in international competition. This approach would provide no benefit to the smaller plans, and would disadvantage the larger plans, their sponsors and their members for no purpose. Any disadvantage the smaller plans face is not tax-based but a result of their limited capital pools, resources and regulatory governance framework. This can be, and has been, addressed through non-tax policies such as provincial pooling vehicles. Indeed, PSP itself is a pooling vehicle for federal pension plans. Tax policy should seek to establish the optimum tax regime for Canadian tax exempt investors assuming they have the sophistication to take advantage of that regime. A more restrictive regime will cede investment opportunities to foreign investors long before it benefits smaller Canadian plans.

Recommendation: Tax (and other) rules governing investments by Pension Funds should not seek to establish artificial parity among those funds; they should provide all funds with the most favourable structural framework that is consistent with broader policy considerations so that each fund is able to invest for optimal returns.

(ii) Why should Pension Funds subsidize foreign investors of Canadian corporations through tax deductible equity? Distinction between investing in tax-motivated lending and true commercial lending

The Consultation Paper also identifies tax strategies that Pension Funds may employ to reduce tax at investee enterprises. The Consultation Paper identifies two responses to this: thin capitalization rules and anti-flow through investing rules based on the SIFT rules in the ITA.

These considerations should be considered in a broader framework. As noted, the ITA has long favoured capital real estate investment for Pension Funds. This policy approach, along with the development of the REIT as a business vehicle, has led to the dominance of these investors in the Canadian market for large office and commercial properties. The advantages of non-taxable investment gave the Pension Funds and REITs a competitive advantage that the taxable corporations could not match, despite the general belief that taxable real estate corporations did not pay tax themselves.

These policy decisions arose from a combination of factors: Pension Funds requiring safe investments; the need for additional sources of return to fund growing pension obligations; real estate as a logical investment category for "patient money"; and, perhaps, a sense that taxable investors were "not paying their share" in any case. In the 1981 budget a new category of assets was carved out for Pension Funds: resource assets. The government of the day was clear that one of the reasons for doing this was to access these pools of capital to support development that was considered beneficial for Canada.[16] This strongly implies that any concerns about crowding out of taxable investors were secondary to the more fundamental desire to bring capital to the

[16] A statement by a government official from that period is most informative about a variety of the issues under discussion here:

> "On average, pension fund liabilities have a long term to maturity. On the assumption...that assets with a long term to maturity will generally yield a better return (after adjustment for inflation) than assets with a short term to maturity, and that equities will produce the highest yields of all, the question is whether a high proportion of pension funds should be investing in new ventures (stocks and bonds) which ultimately yield better than average returns. In particular, what I have in mind are the needs for very large accumulations of capital over the next few decades for major resource projects especially those related to energy needs. Financial requirements are likely to be very great. Large concentrations of capital will be needed. Clearly pension funds cannot supply all of it. But there is no reason to think that they may not be able to provide many billions over the next decade or so...[T]here is an interesting similarity between the nature of the liabilities of pension funds and the types of financial requirements needed for Canadian energy and resource developments in the decades ahead. This raises the question as to whether new institutional arrangements should not be developed – possibly involving groups of pension funds – in an effort to channel a growing proportion of pension fund money towards these needs. In this way it may be possible to increase the rate of investment and return earned by pension funds to the benefit of the pension plan's sponsors and members and to the economy in general." 1985 CTF Conference Report Article by Stephen Heller, quoting a Mr Harvey Lazar, coordinator of the Department of Finance's retirement income policy review in a presentation to PIAC on October 12, 1979.

sector and foster development in a way that provided Pension Funds with a favourable return. It could be argued that a similar situation exists with respect to infrastructure investment today.

A policy of using tax incentives to shift investment priorities can be questioned, and tax policy presumably should not seek to encourage Pension Funds to make investments that, absent tax benefits, would not be considered appropriate. However, tax preference for "investment" activity as a category as distinct from "business" activity as a category does not raise this issue, to the same degree.[17] Instead, the question becomes one of identifying the line between investment and business Canadian resource properties, like traditional real estate, can be expected to be long-term investments.

There is no reason to think that the existing categories of investment assets are exhaustive. Funding of infrastructure investing in Canada has been acknowledged as a significant concern for the Government for some time. And the possibility of Pension Fund capital as a source of this funding has been mooted quite publicly. Infrastructure investment has many similarities to real estate and resource investing. It is a capital intensive, long term investment category. Similarly the concept of "Canadian resource properties" for these purposes could be expended to similar types of natural resources assets including timber, agricultural commodities and mining activities not currently permitted. Not coincidentally, the three categories of assets that PSP classifies as real return assets are real estate, infrastructure and resource. Given the focus that Pension Funds generally have on generating sufficient real returns rather than absolute returns, this asset class is of critical importance. It would be consistent with past policy and practice to give serious consideration to tax-preferred status for pension infrastructure and investments in a broader class of natural resources as classes.

Recognizing that there are sectors that are or perhaps should be entitled to preferential treatment implicitly recognizes that other sectors should not. The Consultation Paper asserts that a regime that provides inappropriate superior returns to Pension Funds simply because of their status as such can have distortive effects, divorcing assets from their best managers. There is some merit to this. However, there is no reason to assume that active pension plan investors are any less able investment managers than any other financial purchasers, and financial purchasers make up a very large component of today's investment landscape. But while pension plans can acquire market-sector expertise and become highly skilled investment managers, it still is true that their tax advantage may position them ahead of others with equivalent expertise but lacking this tax benefit.

However, if it is asserted that Pension Funds have an unfair advantage, an underlying question is, an unfair advantage as compared to what benchmark? The ITA is replete with preferences and advantages of various types that distinguish between categories of investors. For example, Canada's interest deduction rules can generate large pools of tax shelter in Canada for businesses with foreign operations. This has been a long-standing, deliberate policy choice.[18] This can shelter domestic reinvestment of earnings on an equivalent-to-tax-exempt basis to the extent of

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[17] And to the extent it does raise the issue, the broader policy considerations of prudence, effective retirement planning and a leveler playing field in commercial environments can be weighed against it.

[18] The abortive introduction of section 18.2 and the more recent "foreign affiliate dumping" rules are acknowledged in this regard.

the shelter available. The dividend tax credit regime provides an incentive for Canadian individuals to invest in domestic corporations by reducing the after-tax cost of those investments. While the origin of this treatment is a form of credit for underlying tax, it is not extended to foreign investors in Canadian corporations, or Canadian investors in foreign corporations (other than foreign affiliates). The thin capitalization rules present a degree of subsidization for non-resident investors into Canadian corporations, in that their focus on related-party (loosely) debt allows the provisions to be used to establish a layer of "tax deductible equity" after all desired third-party financing has been obtained. Combine this with the ability for the foreign purchaser to earn that income in a tax-efficient jurisdiction and it presents a financing advantage that domestic taxable purchasers cannot compensate for. More generally, the interest deductibility rules in paragraph 20(1)(c) provide a tax advantage to a taxable acquiror of a business over a long-term owner through the higher level of re-leveraging that is possible on the acquisition.

And Canadian capital pools are presented with tax-favoured investment opportunities by tax regimes operative in other jurisdictions. While BEPS may be on the way to eliminating or reducing some of the disfavoured tax-savings opportunities, it is clear that others will remain and indeed that many jurisdictions remain committed to tax-competition as an economic policy.

So, in this context it is not appropriate to look to a single comparator in determining what is an inappropriate tax advantage. Various considerations need to be taken into account. These relate to the nature of competitive advantages between various capital providers and the effect of different tax regimes globally on investment decisions.

The Consultation Paper identifies shareholder loans to taxable operating entities as an area of concern. Adoption of thin-capitalization rules is put forward as a potential solution. In the context of Pension Fund investors, this needs to be approached carefully. A Pension Fund's debt desk may choose to provide what otherwise would be arm's length financing to an investee corporation of the fund's equity desk, because the market debt terms offered by third-party lenders represent an attractive investment. This decision may be made in conjunction with the equity investment decision, having regard to the blended risk/return of combined debt and equity ownership.[19] Where the Pension Fund is participating alongside other lenders, it is not clear that this debt should be considered tax-motivated, or objectionable in any way. Similarly, the Pension Fund may find an investee corporation's senior debt an attractive investment opportunity. Where the Pension Fund acquires senior debt of an investee corporation and arm's length financial institutions provide *bona fide* junior debt bearing the first risk of loss, is there any reason to treat the Pension Fund's loan as subject to thin capitalization rules? It clearly is in substitution for what otherwise would be third party debt, and has been undertaken for an investment purpose. And, depending on the nature of the investee corporation, the natural level of leverage for the business may be well in excess of thin-capitalization limits in section 18 of the ITA. These are not abstract theoretical matters; they are real-world considerations.

Further, as noted above, the existing thin capitalization rules address the benefit to a non-resident investor of substituting subordinated shareholder debt for equity investment from a tax

[19] This is an investment consideration that does not typically apply to a commercial equity investor, whose objective most commonly is to obtain an appropriate level of debt from third parties to safely minimize its investment in the business, freeing capital for investment in other business ventures, consumption, etc.

perspective, meaning that they frequently are dealing with debt that would not exist but for tax considerations. In this environment, they establish a maximum level of substitution. There is no reason to treat Pension Funds less favourably than non-resident investors given the obvious collateral benefits Canada derives from its Pension Funds. So it would be appropriate to allow Pension Funds the same leeway with respect to thin capitalization. But doing this will really only occur where circumstances such as those described above are excluded from the mix. This suggests that this question is significantly more complex than a "simple" thin-capitalization comparison, and at a minimum that any approach should have multiple safe harbours.

These considerations may lead one to ask whether a general restriction on the deductibility of all corporate interest expense would be appropriate instead, as it avoids questions of this nature. While this would level the playing field in one respect, it presents a range of other problems. First, it would seem that it would be exceptionally difficult to establish a set of rules that is responsive to the range of possible commercial environments discussed above. Second, it would be difficult to undertake in a tax system that does not adopt consolidation concepts. Third, it would represent a change to the entire Canadian tax landscape of a fundamental nature to address what is a much narrower concern.

Recommendation: Any move to restrict interest expense for debt issued to Pension Funds which are material shareholders should be careful to distinguish between tax-motivated lending, which may be subject to the rules, and commercially-motivated lending, which should not be taken into account. A thin capitalization rule with appropriate safe harbours for loans that are part of, or substitutes for, arm's length financings would be a reasonable policy approach.

(iii) Diversification through investing in public and private flow-throughs

The Consultation Paper also identifies flow-through investing as an area of concern. The SIFT rules are offered as a possible response. In considering this issue it is readily apparent that there are multiple possible ways to address these concerns.

The first observation is that historically the ITA has allowed tax-exempt investment in flow-through structures. Prior to the repeal of the foreign property rules these investments were treated as part of the foreign property basket. This pairing of very different investment categories can be explained on the basis that neither investment directly generates corporate level tax in Canada, so that the tax revenue cost of each dollar of foregone tax on the Pension Fund investment is greater than where such investment is in a taxable Canadian entity and leads to increased earnings by that entity.[20]

The abolition of the foreign property regime in 2005 signaled the end of any association between tax assistance to the pension fund and investment in tax-generating activities. It also lifted the limit on tax-exempt flow-through investing. It was noted at the time that this consequence would occur and that it raised policy considerations.[21] However, before this step the foreign property

[20] Or, similarly, the benefit of the fund acting as a purchaser of government debt.

[21] 2005 Budget Supplementary Information.

limit had been increased to 30% of a Pension Fund's assets, allowing substantial flow-through investing in any case.

Public flow-through investing of course has been restricted by the SIFT Rules, with an exception to allow REITs to continue to operate. We do not propose to review the history of the REIT rules and the proposals put forward before they were adopted. Rather we note that the ITA generally distinguishes between public and private corporations, affording a much more flexible and dynamic set of rules to private corporations, and implicitly permitting a greater degree of double taxation of investments in public corporations. The approach in the SIFT rules of deeming the entity to be non-transparent for many purposes and thus largely equivalent to a public corporation can be seen as consistent with this, given that income trusts were publicly traded and were largely indistinguishable from many public corporate entities apart from the tax benefits afforded by their structure (and the need for substantial annual distributions).

While entity-level taxation may be an appropriate response to publicly traded flow-through entities it is not clear that it is an appropriate response to private flow-through investing, which involves a range of different motivations and considerations. It is not the only available response to the issue, nor the most targeted. Under the foreign property regime the cost was a tax on the Pension Fund based on the cost of its foreign property in excess of permissible limits. This was effectively a penal tax given the rate (1% of cost per month). But this approach equally could be a form of minimum tax rather than a penal tax, simply by adjusting the rate or measurement base.

Part XII.2 tax represents another response to a similar issue, one that imposes an entity level tax but subject to credit for those investors who are not the object of the rules (which are aimed at non-resident and, in certain circumstances, tax exempt investors).

Since the repeal of the foreign property rules private flow-through investing by Pension Funds has been generally permitted under the ITA. Changes to the "bump" rules in section 88 and the anti-avoidance rules in section 100 of the ITA have curtailed transactions that could deliver tax benefits to taxable investors as a result of the tax-exempt status of the Pension Funds.

Anecdotally we are aware that flow-through investing structures are used for investment in commercial businesses by Pension Funds, or collective investment vehicles that have tax exempt investors as partners. We have no issue with an initiative to tax flow-through investing by Pension Funds in commercial activity, provided it is properly legislated. Of principal concern is that any rules not adversely affect existing permitted real estate and similar investing, and that they not create a burden disproportionate with the issue. We are not aware whether the relaxation of the foreign property rules has led to a material increase in this flow-through investing. We also are not aware of the absolute value of such investing. It seems clear that despite the eleven years the current regime has been in effect and general knowledge of its operation, there has not been the sort of snow-ball effect that became so problematic with income trusts.

Recommendation: Taxation of Pension Fund investment in commercial activity on a flow-through basis is a reasonable policy objective. But any initiative should be clearly focussed so as to not adversely affect permitted flow-through investing or interfere with effective structuring of investment vehicles. And the need for such initiatives should first be validated with empirical evidence.

(iv) Foreign tax policy proposals

Canada has long taken significantly different approaches to domestic and off-shore investments by taxable Canadians. The Canadian foreign affiliate system adopts what has essentially become an exemption system for most foreign-source business income, and does not attempt to police the ability of Canadian enterprises to structure their offshore investing in a tax-efficient manner.

As Pension Funds have grown in scope and sophistication they are engaging in foreign direct investing to a greater and greater extent. This reflects their ability to pursue the best investment opportunities available, and a recognition that geographical diversity is a hedge against risk and thus prudent.

A consideration of Canada's foreign tax policy with respect to taxable investors clearly indicates that Canada should similarly take a hands-off approach to Pension Fund investing abroad, as it has done. The Consultation Paper does not discuss international investment by Pension Funds, and the tax concerns it raises are in the domestic context. This focus is appropriate in the broader scope of the ITA, and if or when steps are taken in connection with issues raised by the Consultation Paper this should be kept in mind.

Indeed, in the international context, the government is encouraged to pursue foreign tax relief for Pension Funds where possible. A policy of seeking to reduce withholding taxes on Pension Fund investments on a reciprocal basis in the context of tax treaty negotiations would be consistent with general tax policy regarding Pension Funds and would serve an obvious purpose in improving returns to Pension Funds from their foreign investments, on a basis consistent with the domestic tax relief provided to Pension Funds.

Recommendation: Any changes to tighten the tax rules applicable to Pension Fund investing should be closely focused on domestic investing. Enhanced withholding tax relief for foreign investments should be considered as a policy objective in tax treaty negotiations.

CONCLUSIONS

In conclusion, from a prudential angle, we submit that the most appropriate way to reform the regulatory framework governing pension investments is to replace the 30% rule with a principles-based approach to regulation that is aligned with the "prudent person" standard that governs the investment of pension funds pursuant to the provisions of federal and Ontario pension standards legislation.

From a tax perspective, we have set out in bold and italics above our recommendations. We thank you for the opportunity to provide input with respect to deliberations regarding the treatment of pension plans going forward. We view this as a critical matter, not only for the direct stakeholders but for the country generally. We have limited our comments here for space and topicality to the Consultation Paper, but would welcome the opportunity to discuss both these and other issues relating to the tax and regulatory regime under which Pension Funds operate.

Appendix "A"

PSPIB Governance and Risk Management Framework

(i) Governance

PSPIB is a Crown corporation that is arm's length from the federal government. PSPIB's operations are overseen by a Board of Directors composed of 11 members. The Board of Directors manages and supervises the management of the business and affairs of the Board. The Board is responsible, *inter alia*, for the selection, appointment, performance evaluation and compensation of PSPIB's President and CEO, who reports to the Board.

Directors are appointed by the Governor in Council on the recommendation of the President of the Treasury Board. The recommendation of the President of the Treasury Board must be made from the list of qualified candidates proposed by the nominating committee. Candidates for the Board of Directors are selected from a list of highly qualified person who are proposed by an external nominating committee, which operates separately from the Board of Directors and the Treasury Board Secretariat. The nominating committee consists of 8 members appointed in accordance with the PSPIB Act. Candidates for the Board of Directors are selected based on their relevant experience and expertise.

PSPIB also has significant accountability and reporting requirements. PSPIB is required to undergo a yearly external audit and a special examination at least once every 10 years. Further, there are quarterly and annual reporting requirements with which PSPIB must comply. PSPIB's annual report must be made available to contributors to the pension plans managed by PSPIB and is tabled in each House of Parliament by the President of the Treasury Board.

PSPIB communicates on a regular basis with various officials involved in the execution of its statutory mandate, including the Chief Actuary of Canada and Treasury Board officials. Further, PSPIB is required to hold a public meeting each year.

(ii) Risk Management

PSPIB's Board of Directors (**"Board"**) is responsible for approving the guiding principles that govern the overall approach with respect to PSPIB's risk management and relevant risk limits.

The timely identification of material risks to PSPIB's business is overseen by the Board through the implementation of appropriate systems and processes to identify, monitor and manage material financial and non-financial risks. To assist the Board in discharging its risk oversight responsibilities, regular reporting on risk related matters is received from management. This information allows the Board to understand how risks are being evaluated, how they impact PSPIB and how management is addressing them.

PSPIB employs a specialized department dedicated to risk management to assist PSPIB to fulfill its mandate of investing the pension assets with a view to acting in the best interests of the plan beneficiaries, and for maximizing investment returns without undue risk of loss. The Risk Management department's raison d'être is to ensure the independent oversight of investment and non-investment risks within the boundaries of PSPIB's risk appetite. Further, the Risk Management department supports enterprise-wide activities by establishing effective risk

management practices, procedures and processes. Its mandate is derived directly from the Enterprise Risk Management Policy (**"ERM Policy"**) established by the PSPIB's Board, discussed in more detail below. The Risk Management department is headed by the Chief Risk Officer who reports directly to the President and CEO of PSPIB.

The Risk Management department ensures that key metrics are regularly monitored and findings reported to senior management and the Board. Complementary metrics, including stress tests, are also tracked on an ongoing basis for investments. Findings are shared with senior management and the Board.

As part of the Risk Management department, two specialized teams oversee risk management activities: the Private Markets Risk team and the Public Markets Risk team.

The Private Markets Risk team is responsible for performing fundamental analysis for all private markets' investments, and assigns internal ratings to these investments. In addition, the Private Markets Risk team maintains a timely awareness of changing market conditions and emerging risks with the aim of proactively responding to the needs of PSPIB's Board and senior management.

The Public Markets Risk team monitors and reports on all aspects of investment risk for publicly traded securities. Essentially, the team is responsible for market, credit and counterparty risk. Market risk activities include measuring the value-at-risk related to the total portfolio and active management, and performing portfolio stress tests, sensitivity analyses and monitoring risk metrics relevant to specific portfolios. The Credit and Liquidity groups perform formal fundamental credit analysis and the team also monitors and reports on liquidity and ensures that investments held meet high standards in terms of liquidity and credit profiles within limits and guidelines established by PSPIB.

In addition to a dedicated Risk Management department, PSPIB has an Investment Committee which is responsible for overseeing PSPIB's investment management function. The Investment Committee's duties are assigned to it by the Board, or are specifically provided for in the PSPIB Act, and include:

- Approving all investment proposals and related borrowings above thresholds delegated by the Board to management for approval;

- Making annual and other recommendations to the Board of Directors on the statement of investment policies and procedures for each pension plan account;

- Overseeing PSPIB's investment risks and ensuring that an appropriate control environment is in place to govern the management of investment risks; and

- Approving the engagement of external investment managers having discretionary authority to invest PSPIB's assets under management.

Moreover, PSPIB has established key policies and procedures which outline the guiding principles of PSPIB's overall philosophy, values, culture and approach with respect to risk management in the following risk-specific policies and procedures: the Risk Appetite Statement (**"RAS"**), the Statement of Investment Policies, Standards and Procedures, the ERM Policy, the

Investment Risk Management Policy (the "**IRM Policy**") and the Operational Risk Management Policy.

The RAS formalizes and combines the key elements of risk management at PSPIB and clearly defines the federal Government's assumed appetite for risk. The RAS outlines the Board and management's attitude and tolerance to risk. With regard to risk management, it also distinguishes the role of the Board in relation to that of management and defines PSPIB's overall risk governance structure. The RAS sets basic goals, benchmarks, parameters and limits for the key risks assumed, and provides boundaries to PSPIB's ongoing activities. For each risk area, the RAS framework also assigns clear metrics and related controls to specific departments.

The ERM Policy provides a framework for identifying, evaluating, managing, mitigating, monitoring and reporting several categories of investment and non-investment risks to which PSPIB is exposed. The categories of investment risks considered and continually assessed are: market risk, liquidity risk, credit and counterparty risk, leverage risk and concentration risk. The non-investment categories of risk which are monitored include: governance risk, strategic risk, operational risk, stakeholder risk, legal and regulatory risk, and reputational risk. With the continuing evolution of risk management strategies and processes, and of the business environment in which it operates, PSPIB strives to ensure that the framework remains effective.

As part of its overall ERM Policy, PSPIB's IRM Policy supports the management of risk inherent to its investment decision making process. The IRM Policy outlines a framework that is designed to ensure that investment activities respect PSPIB's risk philosophy, and align with the tolerance and limits of its risk appetite.