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COMMENTARY

THE PENSION PAPERS

A Matter of Voice:

The Case for Abolishing the 30 percent Rule for Pension Fund Investments

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In this issue...

Pension fund managers have devised ways to effectively skirt the rule that limits them to acquiring no more than 30 percent of the shares eligible to vote for the directors of a corporation. It's time for regulators to enforce the rule or eliminate it entirely, thereby giving pension funds a voice commensurate with their equity stake.

The Author of This Issue

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The Study in Brief

The security of pension plan assets is of crucial importance to Canadians in the private and public sectors. Regulations designed to ensure the stability of these plans through diversification currently take two forms: general "prudent person" standards that managers must comply with, and a series of more specific quantitative rules that restrict the activities of pension managers. This *Commentary* addresses a particular rule, the 30 percent rule, which is an impediment to the investment decisions of Canadian pension plan managers. The paper argues that the rule should be eliminated in favour of greater reliance on a principles-based approach.

The 30 percent rule restricts pension plans from holding more than 30 percent of the votes to elect the board of directors of a Canadian corporation. The original motivation was to encourage passive investment by financial institutions and prevent the concentration of ownership of commercial business by Canadian financial institutions. In practice, the rules do not restrict managers from taking large stakes in corporations, but do require them to construct elaborate transactions in order to satisfy regulators.

Pensions plans face three principle challenges due to the 30 percent rule: i) the rule is only subject to superficial compliance, as regulators have allowed companies to work around the rule, resulting in unnecessary complexity and increased transaction costs; ii) since no other OECD jurisdiction has a similar rule, Canadian plans are at a disadvantage relative to foreign competitors when competing for a given investment; and iii) there are governance problems that result from disaggregating ownership from control.

A better method than quantitative restrictions is to rely on prudent person standards. This method allows managers to use their expertise and discretion in constructing their portfolios. The author explains the case for adopting prudent person standards combined with appropriate guidance and direction to pension fund managers in place of quantitative restrictions. An evaluation of potential reforms leads to the conclusion that the 30 percent rule should be eliminated.

Pension funds play a critical role in the Canadian economy, both as guardians of the retirement dreams of a large segment of the workforce, and as major investors in enterprise. The legal and regulatory framework that pension funds must operate within has a direct affect on their viability, and so merits careful consideration.

In particular, one investment rule that pension funds must comply with should be reconsidered – the 30 percent rule, which limits pension funds to voting no more than 30 percent of the shares entitled to elect the board of directors of a corporation. This paper argues that this rule should be eliminated in favor of a regulatory framework that advances a more principles-based approach.

The regulatory framework for investments made by pension funds in Canada uses both principles and rules. On one hand, the "prudent person" standard, a general principle, requires the pension plan administrator to invest the pension funds using the care, diligence and skill of a person of ordinary prudence. On the other hand, the framework imposes detailed quantitative rules and limits on asset classes, specific investments and control.

The 30 percent rule is a specific quantitative restriction that provides that the administrator of a pension plan shall not, directly or indirectly, invest the monies of the plan in the securities of a corporation to which are attached more than 30 percent of the votes that may be cast to elect the directors of the corporation. (Defined resource corporations, real estate corporations and investment corporations are exempted from the rule, although other rules apply as outlined in Table 1.) This rule was intended to encourage passive investment by financial institutions and prevent the concentration of ownership of commercial businesses by Canadian financial institutions.

This *Commentary* will begin by briefly summarizing the types of quantitative rules in Canada, and the arguments for the elimination of the 30 percent rule. It will then discuss the general debate on rules-based versus principles-based regulation and some of the challenges in implementing a principles-based regulatory framework. Next, it will discuss the rationales for the 30 percent rule in detail and evaluate three negative effects on the Canadian economy and pension plans that throw the existing rule into question. Turning to potential reforms, the paper will discuss 10 factors to consider in assessing them. Finally, the options for reform of the rule will be presented and evaluated. Although there are reforms that fall short of eliminating the rule entirely, a careful assessment leads to the conclusion that elimination is the best potential option.

Background

In Canada, pension plans are regulated federally or provincially, depending on whether the employer is regulated by the federal or provincial/territorial government. Pension plans of employers that fall under federal jurisdiction, such as banks, airlines, and railways, are regulated by the federal *Pension Benefits Standards Act,* 1985, whereas pension plans of employers that fall under provincial/ territorial jurisdiction, such as public schools, are regulated by provincial pension standards legislation. Schedule III of the regulations of the federal *Pension Benefits Standards Act,* 1985, set out a series of quantitative restrictions on investments that can be made by pension funds. Many provinces, including Alberta, British Columbia, Manitoba, Nova Scotia and Ontario have adopted federal Schedule III, even though they each have their own pension benefits legislation. Therefore, the quantitative restrictions in Schedule III apply to the vast majority of private pension funds in Canada. Table 1 below sets out some of the key quantitative rules under Schedule III.

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Table 1: Quantitative Rules for Private Pension Funds in Canada

Portfolio Diversification - The 10 percent Rule for a Single Entity

- Restricts pension plans to holding no more than 10 percent of the book value of the pension fund in any one entity.
- Debt of the federal government, provincial/territorial governments and agencies thereof is exempt from the 10 percent rule.

Industry Concentration - The 5 percent, 15 percent and 25 percent Rules for Real Estate

- Restricts pension plans to holding 5 percent of the book value of the fund's total assets in any single parcel of real estate or Canadian resource property;
- Restricts pension plans to holding 15 percent of the book value of the fund's total assets in all Canadian resource properties; and
- Restricts pension plans to holding 25 percent of the book value of the fund's total assets in the aggregate of real estate and Canadian resource properties.

Passive Investment - The 30 percent Rule on Control

- Restricts pension plans to holding no more than 30 percent of the shares eligible to elect the Board of a corporation.
- Defined resource corporations, real estate corporations and investment corporations are exempt from the 30 percent rule subject to undertakings and specific requirements.

Short Summary of Reasons for Abolishing the 30 percent Rule

The 30 percent rule has not been consistently enforced by pension fund regulators. Technical, superficial compliance by pension funds has been considered acceptable, most recently in the proposed acquisition of Bell Canada Enterprises (BCE) where the Ontario Teachers' Pension Fund (Teachers') was able to gain enough votes to control the company by having a portion of its acquired shares nominally held by another individual (as explained below), clearly undermining the rationales upon which the rule is based.

The rule therefore needlessly increases transaction costs and complexity by interfering with optimal investment management techniques. The rule requires pension funds to construct elaborate financial, legal and organizational structures, which allow them to own more than 30 percent of the equity of a company without controlling more than 30 percent of the votes required to elect the board of directors, so as to be in compliance with the rule.

The rule also puts Canadian pension funds at a competitive disadvantage vis-à-vis foreign pension funds. Canada is the only OECD country that imposes such a rule on pension fund investments, which is a concern when Canadian pension funds are competing with foreign funds on a global basis for investments.

While the transaction costs analysis and the competitive disadvantage arguments are compelling, another persuasive public rationale for abolishing the rule is that it creates a serious corporate governance problem by separating equity ownership from control. The ability of a shareholder – in this context, a pension fund – to vote to elect (or remove) the directors is a critical corporate governance mechanism that acts to ensure that directors and the professional managers whom they oversee fulfill their duties and responsibilities in good faith and with a view to the best interests of the corporation, and in particular, to shareholders. The 30 percent rule currently prevents this convergence of interests between directors, managers and shareholders, in the context of all equity investments in public and private companies, but particularly in the context of private equity investments by Canadian pension funds.

Eliminating the 30 percent rule would enhance the oversight, accountability and transparency of public and private companies and allow for more effective risk management by Canadian pension funds, ultimately benefiting plan members, employers and retirees in Canada.[1]

The Debate on Rules versus Principles

Both investment rules and principles of prudence attempt to achieve portfolio diversification, and thus asset and pension benefit security, albeit through different means. While rules, such as the 30 percent rule, provide specific quantitative restrictions on investments, a principles-based approach focuses more on high-level, general standards and recognizes the expertise and experience of pension fund administrators.

A rules-based approach that provides specific quantitative restrictions on investments has certain benefits for both regulators and regulated pension funds since rules create bright lines regarding what is and what is not permitted. Compared to principles, rules allow for greater certainty and predictability for pension fund managers as to their compliance with the law. They also allow for regulators to monitor compliance with the law with greater ease relative to principles.

However, a rules-based approach is based on a "one size fits all mentality" for the entire spectrum of pension funds in Canada, which vary in size, types of investments, resources, expertise and governance. Well-governed pension funds in Canada have the resources and expertise to implement more sophisticated risk management systems and processes to evaluate and oversee investments. Some pension funds may also have a greater appetite for private equity investments, which makes the 30 percent rule particularly grating in this context because it takes away an important mechanism – electing directors to the board – that would allow them to exert influence or exercise control over their investments in private companies.[2]

A rules-based approach to investment regulation can also encourage a loophole mentality on the part of pension fund managers. They may become more interested in checking off the boxes than they are with ensuring full and complete compliance with the rationales underlying the rules. A pension fund can achieve technical compliance with a rule but avoid it in substance.

A rules-based approach to investment regulation also constrains the good judgment, expertise, and decision-making authority of a pension fund manager to determine whether an investment is prudent in light of the portfolio of investments held by the fund.

Some commentators have also argued that the quantitative restrictions imposed on pension fund investments are a way for governments to have a steady demand for their own debt securities, as well as being captive sources of financing for government budgets or social investments.[3]

In contrast to the rules-based approach, the principles-based approach focuses more on high-level, general standards. This approach recognizes that regulators and pension funds are "partners in a shared mission" to ensure portfolio diversification and security of pension benefits. Under a principles-based regime, a regulator is "more pragmatic, more willing to devolve responsibility to industry, and perhaps humbler about how well-informed and well-equipped it is relative to industry itself."[4] Under the prudent person standard for pension fund investments, responsibility falls squarely on the pension fund's senior management for implementation of

1 A reasonable argument can be made that all quantitative rules restricting investments by pension funds should be abolished; this paper focuses only on the 30 percent rule, which is regarded as one of the most onerous restrictions that larger public sector pension funds must comply with.

2 Only 32 of the top 100 pension funds in Canada have an allocation for private equity. Teachers' owns more than 10 percent of all of the private equity and mezzanine debt in Canada. The returns on private equity are significantly higher than the overall portfolio returns. See Puri (2007, p. 5).

3 Vittas (1999, p. 22); Davis (1995, p. 368); Davis (1997, pp.93-96); Queisser (1998, p.45).

4 Ford (2008).

decision-making processes and risk control systems to ensure that the principle is being met. The prudent person standard recognizes that not all funds are alike and it therefore provides flexibility to the fund manager to determine which investments and what asset mix are most appropriate for the portfolio. Under this approach, the pension fund manager would develop a coherent and explicit statement of objectives and principles as well as procedures to be followed in making investment decisions.

Challenges to Principles-Based Regulation

Despite these significant benefits, a principles-based approach can lead to challenges. While principles provide flexibility, they may also encourage "herding behavior" by pension fund managers, whereby they are effectively paralyzed by their choices and end up following the lead of others in the industry.[5] Such behavior can diminish systematic diversification benefits and lead to excessive pro-cyclicality in the market.

A principles-based approach to regulating fund investments can create a lack of certainty and predictability for pension funds about regulators' expectations. The same principle may also be interpreted differently by pension funds of different sizes, capacity and expertise. Given that a principle may be interpreted differently by regulators and the different members of the pension fund community, there needs to be mechanisms put in place for ensuring a shared understanding of principles. However, a pure principles-based system can be refined without incorporating specific quantitative limits; for example, the *Quebec Supplemental Pension Plans Act* makes diversification a specific requirement and provides additional guidance with respect to investment policy, without quantitative constraints on how to achieve that diversification.[6]

A principles-based approach also creates challenges for both regulators and pension funds in respect of compliance and enforcement. How is compliance with the prudent person standard assessed both internally within a pension fund and then ultimately by regulators? Is it based on having appropriate decision-making processes and systems in place to ensure that investments and portfolios meet the test of prudence? Or, is it based on substantive outcomes and performance results of particular investments, asset classes and/or the entire portfolio? In hindsight, an investment may not be prudent because it did not ultimately perform well, but clearly prudence needs to be assessed based on the information that was available and the diligence that was conducted at the time that the investment was made. Compliance and enforcement are nuanced and more subtle processes under a prudent person standard, as they are based on the evaluation of behavourial processes, not necessarily actual outcomes.

A useful line of enquiry in the debate on rules versus principles in pension fund investment regulation is to examine the performance by pension funds under both regimes. Studies show that pension funds governed under jurisdictions that have prudent person standards achieve better performance results than those governed under a rules-based approach. One study examined returns in OECD countries from 1967 to 1990 and found that the average returns for countries with prudent person standards were 3.4 percent compared with 2.9 percent in countries with asset restrictions.[7] Another study found that between 1984 and 1993, the average real rates of return were 9.5 percent for "prudent person" countries versus 6.9 percent for countries with asset restrictions.[8] One should exercise caution in relying too heavily on these findings, as there may very well be other factors which complement, interact with or override the effect of portfolio restrictions for pension funds.[9]

5 Vittas (1999).

6 See s. 170 of Quebec's *Supplemental Pension Plans Act,* R.S.Q. chapter R-15.1.

7 Davis (1999).

8 De Ryck (1997).

9 Galer (1999); see also Queisser (1998).

Given the level of uncertainty caused by the recent credit crisis, there may be a general push towards more prescriptive, rules-based regulation of pension funds and other financial institutions. However, principles-based regulation remains a superior alternative for the very reason that it allows individual pension funds the flexibility to respond to the credit crisis in ways that are most aligned with their particular needs and concerns. A blanket rules-based approach may have the effect of stifling the ability of pension fund administrators to devise investment strategies that best respond to, and reflect their position within current market conditions.

While a detailed examination of all of the quantitative restrictions imposed on pension funds is beyond the scope of this paper, it should be noted that, as a general matter, quantitative restrictions may be safely supplanted by a prudent person standard that is combined with appropriate guidance and direction to pension funds without specifying quantitative limits.

Rationales for the 30 percent Rule

Turning back now specifically to the 30 percent rule, it is useful to consider the public policy goals it is trying to advance. The rule has two main rationales. The first is that pension funds and other financial institutions should be passive investors. A 1985 Department of Finance background document on the regulation of Canadian financial institutions states that the investments of pension plans and other financial institutions should be of a passive rather than an active nature.[10] The view at the time was that "patient" investments do not represent an ideal match for most of the liabilities carried by such financial institutions. This view has changed over time such that real estate and infrastructure projects, for example, are now viewed as appropriate matches for the long-term liabilities that pension funds must meet. The second rationale for the rule was a desire to maintain a general separation between the financial and commercial spheres of economic activity.[11] Pension funds, which are responsible for pensioners' benefits, are not viewed as commercial businesses and the view was that they should not control commercial enterprises in the Canadian economy. There was concern that public sector pension plans, in particular, should not control large chunks of the Canadian economy.

A concern related to both these rationales was that a rise of pension fund-managed business will stifle entreprenurialism in favor of stable cash-flow maximization. While pension funds have short-term liabilities that need to be matched with liquid and stable cash-flows, they also have long-term liabilities that need to be matched with longer-term investment which may involve significant growth and active oversight.[12]

There is a complex socio-political and economic context surrounding the division between financial and commercial spheres in Canada, the US and the UK – in contrast to other industrialized economies such as Germany and Japan, where there is a much closer affiliation between the two sectors. The separation of the financial and commercial spheres, in the context of banks in the Anglo-American model, was originally intended as a check on banks to prevent them from exercising undue influence over the commercial sectors of the economy.[13] There was a fear that allowing the merger of finance and commerce would generate significant negative economic externalities for third parties. While some large corporations that combine financial and commercial activities may

10 When federal Schedule III was enacted in 1993, the Office of the Superintendent of Financial Institutions (OSFI) published a Regulatory Impact Analysis Statement that referred to a 1985 document entitled "The Regulation of Canadian Financial Institutions: Proposals for Discussion" and a related technical supplement as well as a 1986 document entitled "New Directions for the Financial Sector." The technical supplement contains some analysis of the rationales of the 30 percent rule. See Department of Finance (1985, Technical Supplement p. 51 and 1986).

11 *Ibid.*

12 The increasing attention given to socially responsible investment practices on the part of pension funds also indicates that, from a broad policy perspective, we are now encouraging pension funds to be active rather than passive. See Sturm and Badde (2000).

13 Cantillo (1995).

improve operational efficiency, the concern was that significant costs would be passed along to the economy as a whole in terms of (i) the misallocation of credit by banks inappropriately favouring credit to their affiliates over other unrelated commercial businesses, (ii) anti-competitive effects, (iii) exposure of the federal deposit insurance funds and taxpayers to greater risks, and (iv) additional supervisory burdens borne by federal banking or anti-trust regulators who would have to oversee the investments made by the bank.[14] Whether these concerns are justified or not depends on how competitive the markets are in the first place. For example, a bank could charge above-market rates to creditworthy competitors of its commercial affiliate, but only if there were no other lenders to step in and offer the market rate. Likewise, a bank could charge below-market rates to its own affiliate (or its affiliate's suppliers or customers), but would only do so if the affiliate could recoup this loss by producing above-market returns in its own market. Moreover, there is growing recognition that maintaining a separation between finance and commerce is anachronistic to the post-war/depression era in North America and that in other industrialized countries such as Germany and Japan, the financial sector has elaborate affiliations with the commercial sector.[15]

There are several reasons why the rationale for separating commercial and financial activity holds less force than in the past. First, combining commercial and financial activities could reduce information costs between sectors. For example, one of the basic functions of a bank is to take deposits and provide finance to firms and other people in the economy. It is natural for banks to perform this service because they can gather information about borrowers more efficiently than can individual depositors. Thus, it is plausible that banks would want to hold significant blocks of equity in firms in order to enhance their position as intermediaries. By holding a large block of equity, a bank could provide a source of discipline to management that would reassure less-informed investors.

Another information-related reason for financial institutions to hold equity in commercial entities is to reduce their exposure to moral hazards. If it is difficult for a lender to monitor a borrower's risks, limited liability borrowers will have incentives to increase the risk of their operations. Financial institutions that anticipate this risk-shifting will either charge a higher price for the loan or demand more collateral. One way a firm can overcome this problem is to offer the financial institution an equity claim.

In the context of pension funds, the rationale for merging commercial and financial activity is analogous. The same benefits of reduced information costs and reduced exposure to moral hazard accrue to pension funds that are able to hold significant blocks of equity in commercial enterprises. These benefits are related to the broader governance concerns that result from disaggregating ownership of equity and active oversight, which is perpetuated by the 30 percent rule. To the extent that pension fund regulators do not have adequate authority or sufficient capabilities to monitor pension funds and their controlling investments appropriately, they should be provided with the resources to develop the needed capabilities, rather than preventing these investments.

While these policy rationales suggest elimination of the 30 percent rule, the 1985 government background document actually suggested that the investment-control threshold limit of 30 percent be lowered to 10 percent, to make it more onerous, on the basis that more intricate methods of exercising control had been devised and a 30 percent limit may no longer be appropriate. It also suggested that a change to 10 percent would limit exposure of the pension fund to undue risk. The government recognized, as stated in the technical supplement/background document that pension funds have become major investors in the capital markets and that these restrictions could be a

14 Brown (1991).

15 Shull (1999).

significant impediment to the future functioning of these markets. However, it concluded that quantitative limits serve as an important safeguard by imposing minimum risk-spreading rules on the fund manager. It is important to note that the rule does not limit the overall equity position in an investment, just voting rights, so it is difficult to justify its existence as a diversification or risk-spreading tool.

Challenge 1: Superficial Compliance, Unnecessary Complexity and Increased Transaction Costs

Both pension fund regulators and pension funds seem to be satisfied with technical, superficial compliance with the 30 percent rule, even though the underlying rationales of the rule are not advanced. However, technical compliance with the rule creates unnecessary complexity and can increase transaction costs in the process of investing for pension funds. Regulators generally accept substantive non-compliance with the rule; it may be that these regulators recognize that the rule needs to be repealed but have decided that permitting technical compliance is less onerous than organized efforts at regulatory reform.

The 30 percent rule does not prevent the pension fund from acquiring a stake greater than 30 percent in the equity of a corporation. It simply says that the pension fund cannot acquire more than 30 percent of the shares that *elect* the directors of the corporation. When a pension fund manager decides that it is prudent to acquire a stake greater than 30 percent in any one corporation, the pension fund and its advisors have to construct elaborate financial, legal and organizational structures to bring their investments into compliance with the rule.

There are several methods that have been used. Convertible debt has been issued in lieu of voting shares to achieve technical compliance with the 30 percent rule. For example Teachers' invested $35 million in Railpower Technologies Corp. in 2007 by way of a private placement of unsecured convertible debentures.[16] The debentures are convertible into common voting shares (with full voting rights to elect the board) and/or restricted voting shares with no voting rights in respect of electing the Board of Directors. If Teachers' were to convert all the debentures into common voting shares, it would hold 56.6 percent of the common shares, and thus be able to control and elect the board of directors. However, since Teachers' cannot control more than 30 percent of the voting shares, it would have to convert the debentures into a combination of voting and non-voting shares to ensure compliance with the 30 percent rule.

In other transactions, a combination of voting shares and convertible non-voting shares have been issued that collectively exceed the 30 percent ownership, but do not technically exceed the 30 percent control threshold created by the rule. For example, as at 2007, Teachers' had an ownership stake in Maple Leaf Foods Inc. whereby it owned just over 20 million (19.7 percent) voting common shares and an additional 22 million non-voting common shares, together holding 33.6 percent of the shares of the corporation. The non-voting shares are convertible into voting shares on a one-to-one basis at any time at the option of the holder, and automatically convert to voting shares upon transfer by Teachers' to any other person.[17]

Most starkly, the 30 percent rule was an issue in the proposed deal to privatize BCE, where one of the purchasers was also Teachers'. The proposed transaction was structured so that Teachers' would not own more than 30 percent of the shares eligible to vote to elect the directors. In fact, Teachers' would have owned no voting shares in the corporation at all. A former executive of Teachers' would have held 66.7 percent of the Class A shares of BCE Holdco. He and Teachers' had an agreement that granted Teachers' full voting and transfer rights over the shares. The former executive could only have voted the shares in the manner instructed by Teachers' and he could not in any way have voted them

16 See Railpower Technologies Corp., Notice of Meeting (November 15, 2007) and Information Circular for a Special Meeting of Shareholders to be held on December 18, 2007.

17 See Maple Leaf Foods Management Information Circular 2007.

independent of Teachers' instructions.

The Canadian Radio-television and Telecommunications Commission (CRTC), which had to approve the deal, was concerned with the structure and whether there was compliance with the 30 percent rule. The Financial Services Commission of Ontario (FSCO), which is the provincial regulator responsible for administering the *Ontario Pension Benefits Act,* issued a letter that stated that the proposed structure complied with the 30 percent restriction to which Teachers' is subject.[18] FSCO reasoned that Teachers did not "invest" in the voting shares because the former executive acquired the Class A voting shares with his own money (albeit a purely nominal sum). FSCO also thought it was important that the former executive did not receive any remuneration from Teachers' for the share voting agreement. The CRTC only accepted and approved this structure/arrangement after being provided with this assurance letter from FSCO.[19]

The structure in the proposed BCE transaction is perhaps the starkest example of technical compliance with the 30 percent rule that obtained express regulatory blessing. Given that this transaction involved the privatization of Canada's largest communications company by Teachers' and its partners, it is difficult to see how the rationales of passive investment and maintaining a separation between financial institutions and the commercial sphere that underlie the rule would have been furthered.

If the government and pension regulators are serious about the rationales underlying this rule, then they need to ensure compliance with it by enforcing it with vigor. If they are no longer serious about the rule, then why waste resources to force pension funds to devise structures that make it appear as if they are complying with it?

Challenge 2: Competitive Disadvantage with Foreign Pension Plans

No other OECD jurisdiction has a similar rule relating to control over a corporation's board of directors.[20] As such, Canadian pension plans are at a disadvantage vis-à-vis foreign pension funds when competing for investments.

Challenge 3: Governance Problems that Result from Disaggregating Ownership from Control

Another persuasive public concern about the rule is that it creates a corporate governance problem by separating equity ownership from control. The ability of a shareholder – in this context, a pension fund – to elect (or remove) the directors is a critical corporate governance mechanism that acts to ensure that directors and the professional managers whom they oversee fulfill their duties and responsibilities in good faith and with a view to the best interests of the corporation, including shareholders. The 30 percent rule currently prevents this convergence of interests between directors, managers and shareholders.

In addition, the Canadian capital markets have a high proportion of family-controlled public corporations.[21] The rule allows for a greater possibility of abuse of the minority by the majority shareholders and a further imbalance of power between professional managers and controlling shareholders, on the one hand, and retail and institutional shareholders on the other.

If a shareholder has, for example, a 60 percent equity stake in a corporation, why should the law prevent it voting all of its shares? Where a shareholder owns more than 30 percent equity but can only vote 30 percent of the equity, there are greater possibilities for misconduct by (or at minimum a misalignment of interests with) other larger or controlling shareholders and professional managers.

18 See letter from FSCO at: http://www.crtc.gc.ca/public/broad/applications/2007/FSCO%20letter.PDF.

19 See CRTC approval at http://www.crtc.gc.ca/archive/ENG/Decisions/2008/db2008-69.htm.

20 OECD (2007, Appendix 1, Table 3).

21 Gray (2005).

The ability to elect the board of directors is a particularly important governance mechanism in the context of equity investments in private corporations, where the market is generally less liquid and hence the possibility of sale – as a corporate governance mechanism – is less realistic. Only 32 of the top 100 private pension funds in Canada have allocations for private equity; from a systemic perspective, the 30 percent rule may contribute to the underdeveloped venture and private equity market in Canada.[22]

Allowing a pension fund to fully vote the equity that it owns would enhance the oversight, accountability and transparency of public and private companies in the Canadian capital markets.

Factors to Consider in Reforming the Rule

The following factors should be considered when assessing options for reform of the 30 percent rule:

1. Protecting the assets in the pension plan and retirees' benefits.
2. Ensuring a reasonable risk-return tradeoff in individual investments and the entire portfolio.
3. Ensuring appropriate diversification in a pension fund portfolio.
4. Ensuring appropriate risk management systems for making decisions in respect of investments.
5. Impact on pension funds of different sizes, sophistication, expertise and resources.
6. The expertise and resources available to the regulator to oversee and monitor investments and investment decisions.
7. Policy rationales for passive investment.
8. Policy rationales for separating financial businesses from commercial businesses.
9. Impact on Canadian capital markets and ensuring good corporate governance mechanisms for public and private companies in the Canadian markets.
10. Governance in the pension fund including its ability to take an active role in investments.

None of these factors is determinative, but each plays a role in assessing the costs, benefits and risks of various options for reform.

Factors 1-3 focus on the ultimate goal of ensuring that retirees' benefits are secure by specifying that each investment and the entire portfolio of investments achieves a reasonable return in light of its risk, and that the portfolio is well diversified such that the fund can achieve reasonably consistent returns under a wide range of economic conditions. It is important that any change to the 30 percent rule not undermine these goals in any way; that said, since the rule does not limit equity ownership, but only voting control, abandoning it would not have a negative impact on diversification.

Factors 4 and 5 are extremely important considerations in any assessment of options for reform. The 30 percent rule and other quantitative restrictions are based on an underlying assumption that the regulator is in the best position to determine what an investment portfolio should look like; this rule also assumes that all pension funds are alike. The reality is that pension funds vary in size, sophistication and resources. Some pension funds have the resources and expertise to have sophisticated procedures and systems in place in respect of investment decisions; along the same line, they also have the internal procedures and practices in place to ensure that they can effectively monitor and oversee active and controlling investments in commercial enterprises. This is not true for all pension funds, and abolishing the rule may need to be pursued in conjunction with a requirement that pension funds ensure they have the necessary and appropriate systems in place to make and monitor such investments.

Factor 6 highlights the importance of the role of the regulator in overseeing the investment activities of pension funds. Currently, the 30 percent rule is easily monitored and enforced by the regulator. Any change to the rule (such as exemptions or repeal) needs to take into account the impact on the regulator with respect to its

22 Cumming et al. (2004).

resources and expertise. Under a prudent person standard without a 30 percent rule, the regulator may need to provide additional guidance on its expectations for meeting the standard, without reference to specific quantitative restrictions on control.

Factors 7 and 8 focus on the original rationales for the rule, and as discussed above, there is a long-rooted Anglo-American tradition of separating the financial sphere from the commercial sphere. The issue is how much weight these considerations should be given in the modern Canadian economy. The concerns that arise from allowing financial institutions to control commercial enterprises have to be weighed against the benefits of such a merger, which include reducing information costs between sectors, reducing moral hazard and reducing the governance gap, as discussed earlier.

Factors 9 and 10 focus on the impact of the rule and its reform to public and private companies in Canada. As it currently stands, the legal framework disaggregates ownership from control by prohibiting pension funds from exercising their voting rights beyond 30 percent of the votes entitled to elect the directors. Allowing for exemptions or, alternatively, eliminating the rule would allow for this governance gap to be reduced, thereby strengthening the oversight of public and private companies in Canada.

These 10 factors need to be considered and balanced when assessing the various options for reform to the 30 percent rule.

Options for Reform to the Rule

There are several options for reform to the 30 percent rule, including the following:

- Maintain the rule, combined with ensuring compliance and vigorous enforcement;
- increase the threshold to a percentage greater than 30;
- grant exemptions on a transaction-by-transaction basis;
- grant exemptions based on governance structures of pension fund; or
- eliminate the rule.

MAINTAIN THE RULE: If the passive investments and separation of financial and commercial enterprise rationales underlying the 30 percent rule remain important public policy concerns for the government and stakeholders in today's economic reality, then regulators needs to get serious about enforcing the rule. When regulators do not enforce legal rules, turn a blind eye to non-compliance, or expressly endorse avoidance structures, both regulators and the regulatory framework lose credibility in the eyes of stakeholders.

If the rule is to be preserved, then pension fund regulators should provide clear guidance about compliance with the rule. They should clearly set out a list of anti-avoidance provisions – techniques and maneuvers – that will be considered to be a violation of the rule. This may include owning, or exercising control or direction over voting shares, non-voting shares that are convertible into voting shares, or debt that is convertible into voting shares. Under this scenario, Transactions such as the proposed BCE deal, whereby Teachers' would have controlled 67 percent of BCE, would also have been prohibited, both on the basis of the specific 30 percent rule but also on the larger principle that pension funds must be passive investors.

INCREASE THE THRESHOLD TO A PERCENTAGE GREATER THAN 30: Increasing the 30 percent threshold to a higher number, such as 40 percent, would be an arbitrary move. It would still result in pension funds maneuvering to avoid the rule and would also continue to impose corporate governance challenges because the pension fund as shareholder would be limited from exercising its right to elect board members so long as the number is less than 50 percent.

DISCRETIONARY RELIEF ON A TRANSACTION-BY-TRANSACTION BASIS: Another reform option would allow discretionary relief from the 30 percent rule. A pension fund could apply to regulators to have a particular transaction exempted from the rule. The challenge is to determine the basis on which the regulator would grant an exemption. Would regulators' review involve a substantive assessment of the expected outcome of the investment? Or would regulators' review examine the pension fund's decision-making process for the investment? It is difficult to think of a situation where regulators could do something other than examine the method in which the decision or judgment is made, given that every investment decision is a judgment call on an unknown future. Before pursuing this option as a reform possibility, one would need to ensure that regulators have the infrastructure, capacity, expertise and resources to engage in such reviews. This option may also be impractical because regulators may want to give notice to the plan membership, which may give rise to members challenging the investment decision. There may also be confidentiality concerns about the proposed investment that is under review.

EXEMPTIONS BASED ON GOVERNANCE STRUCTURES OF THE PENSION FUND: Rather than allowing transaction-by-transaction relief, one could exempt funds that have appropriate governance structures in place to ensure effective decision-making about investments, as well as appropriate governance structures and processes to allow for active oversight of investments.[23] To access this exemption, the CEO or the board of directors of the fund could be required to make a signed statement that they believe the fund has adequate risk assessment structures in place to properly evaluate the various risks involved in deciding whether to make an equity investment greater than 30 percent. They should also have to certify that the fund has the governance systems in place to actively manage the investment. This reform could be coupled with refining the prudence and fiduciary standards expected of fund managers.[24] While this option would not repeal the rule, it would nonetheless require regulatory reform.

ELIMINATE THE RULE: The best approach in the context of the 30 percent rule is to eliminate it entirely. It is clear that regulators have not enforced this rule and have given their express and explicit blessing for transaction structures that clearly violate its underlying rationales. While passivity and separation of financial and commercial spheres were the original rationales for this rule, as stated over 20 years ago, the reality is that pension funds are no longer passive investors and are actively involved as owners of commercial enterprise.

By eliminating this quantitative limit on investment, regulators could make investments subject to a more principles-based "prudent expert" standard. In relation to having appropriate mechanisms in a fund's governance structure to oversee and ensure compliance with legislative requirements, having a more principles-based legislative scheme will allow regulators the discretion and resources to enforce the principles effectively. A principles-based approach to the regulation of pension funds will allow regulators more discretion to approve a variety of plan arrangements and issue guidelines specific to new plan arrangements. Regulators should also have the power to review and require changes to the fund's governance and the power to impose administrative penalties and other sanctions for failure to provide important information to the regulator to allow it to exercise its oversight role.

A number of principles-based regulatory instruments can be developed to address the governance concerns of pension funds.[25] For example, the pension statutes could clarify that fiduciaries, in making investment decisions, must make those decisions in the best financial interest of the plan members and can take nonfinancial matters such as environmental, social and governance factors into account only insofar as they affect the potential risk and return of the

23 Report of the Expert Commission on Pensions (2008).

24 *Ibid*; see also, Report of the Joint Expert Panel on Pensions Standards (2008).

25 See Report of the Joint Expert Panel on Pensions Standards (2008) from the Alberta/British Columbia Pensions Standards Review for their recommendations in this regard.

investment. Moreover, training programs at post-secondary institutions could be made mandatory for plan fiduciaries to give them more guidance and context on how to fulfill their roles. Statutory defenses could also be set up to provide pension fund fiduciaries with a defense if they can demonstrate that they have adhered to governance guidelines and have acted in good faith, on an informed basis, in the interests of the beneficiaries and in the absence of conflicts of interest.

Abolishing the rule would also mean that pension funds no longer have to engage in legal maneuvering to be in technical compliance with the rule at face value. Equally as important, it would reduce the governance gap by allowing and encouraging pension funds to be strong and active shareholders, exercising their ability to elect the board of directors. This is particularly important in the context of private equity investments where other governance mechanisms are not easily available.

The time has come to repeal the 30 percent rule and focus more on a prudent person regulatory standard that better achieves the objectives of underlying pension fund investment regulation. Repealing the rule would enhance the oversight, accountability and transparency of both public and private companies and allow for more effective risk management by Canadian pension funds, ultimately benefiting plan members, employers, retirees and Canadian taxpayers.

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