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Department of Finance Canada

Via email: fin.pensions-pensions.fin@canada.ca

Dear Mesdames/Sirs:

Consultation on Federally Regulated Pension Plans and the 30 percent rule

We are writing further to your invitation in the June 3, 2016 consultation paper for submissions pertaining to the ongoing usefulness of the so called "30 percent rule".

British Columbia Investment Management Corporation (bcIMC) is a provincial crown agent with over 300 employees and was formed in 1999 pursuant to the *British Columbia Public Sector Pension Plans Act* (British Columbia). bcIMC currently invests over $120 billion for the benefit of its clients. As the fourth largest fund manager in Canada, bcIMC invests funds deposited with it by British Columbia public sector pension plans, insurance and benefit funds, government bodies, publicly administered trust funds and government operating funds.

As an investor of pension plan monies, bcIMC manages its investments in compliance with the 30% rule along with other requirements imposed under applicable pension benefits standards legislation, its constating legislation and Canadian and international tax laws. bcIMC investments are primarily managed by bcIMC, with some investments managed by third party investment managers. bcIMC invests in various asset classes including public equities, commercial mortgages, fixed income, infrastructure, renewable resources, private equity and real estate.

We believe that in the current investment climate it is prudent for large Canadian public sector pension plans to hold significant investments in private equity, infrastructure and renewable resource assets, including economic interests in excess of 30 percent. The 30 percent rule contained in the federal *Pension Benefits Standards Act, 1985* (PBSA) restricts the ownership by a single pension plan of voting securities of a corporation – it does not restrict the holding of economic interests in excess of 30 percent by a pension plan.

Prudent investment management dictates oversight and governance control rights commensurate with the level of investment, while the 30 percent rule artificially disjoins investment and governance. As a result, the application of the rule artificially requires pension plans to limit their governance rights to 30 percent where prudent investment policy often favours the holding of a greater than 30 percent economic interest. Given this disconnect, in our submission the 30 percent rule should be eliminated.

We also submit that the 30 percent rule is, at its core, a prudential matter, not a tax matter.

Consequentially, there is no plausible nexus between tax policy and the elimination of the 30 percent rule. The 30 percent rule restricts the holding of voting securities by a pension plan in a corporation. It has no impact on the taxation or tax status of the underlying corporation. The imposition of what

would necessarily be a complex and administratively burdensome tax scheme on corporations and/or pension plans linked to ownership by a pension plan in excess of 30 percent of voting stock of a corporation is not justified.

Prudential Considerations

The 30% rule and the rationale for large investments

The federal PBSA contemplates and permits pension plans to hold in excess of 30% of the voting securities of corporations qualified as real estate or investment corporations. Although bcIMC does not invest funds on behalf of federally regulated pension plans, as with many other provinces, the investment restrictions contained in the PBSA have been incorporated by reference by applicable British Columbia legislation to apply to the British Columbia public sector pension plans. bcIMC, consistent with the practice of many pension plans in Canada, utilizes both real estate and investment corporations to hold real estate and other qualified investment assets. Notably, both real estate and investment corporations are restrictive in the types of assets that may be held in corporate form by pension plans in compliance with the 30% rule.

The consultation document correctly notes that many pension plans, fund managers and investment advisors representing pension plan monies have, in recent years, increased investment allocations to infrastructure, renewable resource and private equity assets with the objective of securing "strong and steady" returns over the medium and long term. This is in part a reaction to volatile public markets and the low interest rate environment of recent years. It is also because, similar to real estate, infrastructure and renewable resource investments provide consistent yields over the long term - an investment and return profile attractive and necessary to the British Columbia public sector pension plans, each of whom is required to manage their assets to meet long term liabilities for pensioners.

Coupled with the increasing focus on infrastructure, renewable resource and private equity investment has been a trend by pension plans to hold larger positions in such assets. Such larger positions have become available to pension plans partly as a consequence of the inherent advantage pension plans have as holders of "patient capital" given their long term focus relative to public companies and hedge funds. Historically, both Canadian and international pension funds have invested in these types of assets primarily through third party private equity and infrastructure fund managers and funds. Although this remains an ongoing investment strategy, more recently larger pension plans, including bcIMC, have increasingly favoured larger direct investments in these types of assets. The benefits of direct investment include: management fee cost savings; direct influence over corporate governance and independence from funds and other investor interests in determining, among other things, timing of sale. Notably, pension plan monies most often have a significantly longer term investment horizon than many other investors. As a consequence, independence in investment decisions is increasingly important in regards to prudent investment management by pension plans.

Other factors that favour larger investments include:

- More prudent and efficient allocation of pursuit costs and internal resources;

- The scarcity of sizable investments in Canada in infrastructure, renewable resources and private equity – an acute concern for large public sector pension plans required to deploy significant investment dollars annually to diversify investment returns and risk;
- A preference among many sellers to find buyers of larger stakes; and
- A need for more robust oversight of such investments, often through representation or access to the board of directors given that private investments do not have the same disclosure and governance obligations as publicly traded companies.

Investment Management Concerns

As explained in the consultation document, the principle underpinning the 30 per cent rule is that an investor holding such a percentage of shares is an active investor and pension plans should be passive investors rather than managing the day-to-day operations of businesses in which they invest. The rule was also intended to reduce pension plans' exposure to risk should a controlled business fail (e.g., incentives to retain investments in a failing business in the hope that its operations will turn around). These concerns, although potentially valid when the 30 per cent rule was introduced decades ago, are no longer valid with the evolution of modern investment management of pension plan monies by organizations like bcIMC and its peers.

Underpinning the aversion to pension plans being involved in day-to-day operations is a concern that pension plans and their staff are not equipped, in both resources and expertise, to provide day-to-day operational management. However, in our experience, there is no direct correlation between the holding of voting securities and involvement in day- to-day management. The role of pension plans and their investment managers is not to run the businesses; it is to oversee the investments. This is generally limited to exercising influence at the level of the board of directors, receiving reports on activities and making decisions on material business changes - rights that are typically granted to large shareholders whether pension funds, third party fund managers or other investors. For organizations like bcIMC, this oversight role is carried out by internal professional investment management teams, or in the case of investments made indirectly through funds, by qualified third party managers. Although in some cases this may include considerable participation in strategic decisions it is still consistent with the role typically played by a board of directors.

In our view, the concern of reducing pension plans' exposure to risk should a controlled business fail is also adequately managed in the modern investment climate through professional investment management teams and the overall obligation of pension plans to manage investments on a prudent basis.

In short, given the sophistication and experience of modern investment managers overseeing pension investment and the prudential obligations imposed on pension plan trustees under the PBSA, historic reasons for maintaining the 30 per cent rule are outweighed by the overall benefit to pension plans in holding significant positions in private equity, renewable resource and infrastructure assets.

Responses to the 30% rule consultation questions

Does the philosophy that plan administrators should act as passive investors continue to be valid. If not, why?

We believe that this question misses the mark. As explained, the holding of an investment position in a corporation in excess of 30 per cent does not equate with ceasing to act as a passive investor. The holding of a significant stake most often provides a pension plan with the ability to appoint a board member. Exercising such typical shareholder rights with governance involvement in investee companies is part of prudent investment practice and should be welcomed, not discouraged.
What are the benefits and risks of pension plans taking on a dual role of providing benefits to members and taking an active role in the operations of a business?

As explained above, in the modern investment climate, the holding of a significant investment position does not in and of itself result in pension plans taking on an active role in the operations of a business – quite the contrary, in our experience it will result in a board level oversight role with professional management experts in the relevant business taking on day to day management. The benefits to members of holding significant investment positions in assets are, as explained above, an ability to achieve higher investment returns and diversify investment risk over the long term.

Are the prudent person and other PBSA standards sufficient to offset potential risks involved in pension plans acquiring a controlling stake in a corporation?

In our view and experience, yes. As explained in the consultation document, the prudent person standard requires the administrator of a pension plan to invest the assets of the pension plan in a manner that a reasonable and prudent person would apply in respect of a portfolio of investments of a pension plan. In practice, this standard has and does impose on pension plans an obligation to utilize professional and competent investment managers, either internally or externally, to exercise governance rights associated with significant investment positions in corporations to oversee such investments and to allocate investments in a manner that ensures a properly diversified portfolio and prudent risk management.

If a pension plan's investment exceeds a certain threshold, should the plan be subject to additional requirements? If so, what should those requirements consist of and what would be the appropriate threshold?

In our view, the imposition of prudent person investment standards on pension plan trustees and managers provide sufficient protection. Imposing additional requirements, limitations or restrictions on such investments may unduly restrict otherwise prudent investment opportunities for the benefit of members. As such, we do not believe that imposing additional requirements such as reporting or investment conditions are merited.

Investment Performance

Consultation Questions

In response to the specific consultation questions relating to investment performance, we submit:

Does the 30 per cent rule impede pension administrators from obtaining appropriate investment returns. If so, why?

Prudent management of pension plan monies requires diversification of investment. In Canada and, increasingly in the global investment climate, access to high quality infrastructure, renewable resource and private equity investments requires the commitment of a significant investment stake, often times in excess of 30 per cent. Denying pension plans the opportunity to compete for attractive investments through the imposition of an artificial 30 per cent voting restriction would result in loss by Canadian pension plans of such opportunities to hedge funds, private interests, sovereign wealth funds and foreign pension plans.

What are the costs, if any, that the 30 per cent rule imposes for pension plans seeking active investments?

The costs include administrative and legal compliance costs. Application of the 30 per cent rule may also result in an overall weighting of pension plan investment through third party investment funds with the resulting imposition of asset management fees, including profit participation. Direct investment often times results in overall lower fees and costs thereby enhancing investment returns while providing more direct governance oversight over investment assets. The costs, accordingly, include not only lower returns but increased risk.

Does the 30 per cent rule create inequities between large and small pension plans? Conversely, could its removal do so. If so, why?

In our view, the removal of the 30 per cent rule should not create inequities between large and small pension plans. bcIMC is a large pension plan investor within Canada, but on a global scale is one of many similar sized investors participating worldwide in search of high quality diversified investment assets. The inequities that arise as a result of the 30 per cent rule already exist on the global investment stage. Small pension plans will continue to have access to infrastructure, renewable resource and private equity investments through pooled investment platforms such as investment funds. A lack of ability to take large direct shares in such assets is not a function of the applicability or inapplicability of the 30 per cent rule, but simply a matter of available investment capital.

Tax Policy Considerations

The link between the 30 per cent rule and Canadian income tax

The consultation paper suggests a link between the 30 per cent rule and the tax implications for Canadian businesses owned by Canadian pension plans. In our view, the elimination of the 30 per cent rule will have no material impact on the federal or provincial income tax base in Canada. Certainly not one that would merit introduction of a new scheme within the *Income Tax Act* for the taxation of pension plans or Canadian investments held by pension plans. Further, we understand that the impetus for the 30 per cent rule is prudential, not tax policy.

As the consultation document notes, Canadian pension plans already own more than 30 per cent of the economic interest of many Canadian and foreign corporations, individually, together in co-investments or through managed funds, while continuing to comply with the 30 per cent rule. Eliminating this rule simply reduces complexity of such investment structures and provides more governance oversight rights to pension plans. It will not drive investment decisions, since those decisions have been made and

will continue to be made based on diversification and investment return criteria whether or not the 30 per cent rule applies.

Notably, decisions as to the appropriate percentage ownership interest (and resulting voting rights) in a given company are driven by considerations beyond tax, including the quality of the investment, availability of a given stake in a company, internal asset allocation and available capital for investment. Investment decisions regarding the level of ownership of Canadian businesses made by pension plans and managers of private equity and infrastructure funds investing both domestic and foreign pension plan monies are driven by these non-tax considerations more than anything else.

Concerns that the elimination of the 30 per cent rule will result in significantly higher tax exempt investment by pension plans in Canadian businesses are unfounded. As mentioned, those decisions are being made currently for non-tax reasons and further, due to diversification concerns, Canadian pension plans have limited allocations of investment capital to private equity and infrastructure assets, and in most cases an even more limited allocation to such assets in Canada. Furthermore, many smaller investments in Canadian businesses are already made by both large and small pension plans through third party managed funds.

Ownership of large and attractive Canadian businesses is not static – ownership will vary between private and public ownership, a mix of domestic and foreign ownership along with a mix of taxable and tax exempt capital. As such, concerns regarding tax planning opportunities arising from ownership by domestic Canadian pension plans are transient, as a business partly owned by Canadian pension plans today may tomorrow be a public company. Such concerns are further diluted since, in practice, large Canadian businesses are typically not owned solely by single pension plans but more often than not by a mix of investors, including foreign, domestic, exempt and taxable.

Finally we note that although pension plans themselves may be exempt from tax, their members are not. As a result, returns realized by plans from investment in Canadian businesses are ultimately taxed.

Level playing field

We understand that the primary concern with respect to ensuring a "level playing field" as expressed in the consultation document is that businesses owned by tax exempt Canadian pension plans have a competitive advantage over other Canadian businesses.

As an initial observation, we note that it is uncommon in the current investment climate for a Canadian pension plan to wholly own and control a Canadian private corporation carrying on an active business. Investment by pension plans in most large privately controlled assets that generate significant Canadian tax dollars is typically jointly owned with other investors, be they other Canadian or foreign pension plans, private equity funds, non-resident hedge funds or sovereign interests. As such, in practice, the ability of a Canadian pension plan to dictate tax planning of a private business in which it holds more than 30 per cent is diluted by other investor interests and non-tax commercial considerations.

In our experience, there are no material inequities in the playing field among businesses owned by Canadian pension funds, private equity funds and taxable investors or combinations of the three. The concerns regarding a level playing field presuppose that tax efficiencies potentially available to large ownership of Canadian businesses by tax exempt Canadian pension plans will drive such pension plans

to pay more than other potential owners for Canadian businesses. This assumption is not supported based on our experience over the past decades. Investment and acquisitions decisions and the pricing of mature Canadian companies are driven primarily by considerations other than tax. Those considerations include, among others, strategic accretive acquisitions by public and private businesses, diversification of investment strategies by foreign sovereign interests and foreign pension plans and investment strategies of private equity funds. Furthermore, valuations of private businesses are often primarily driven off of metrics based on pre-tax earnings rather than tax planning strategies for ongoing investment income. As an example, in most private equity investments, non-residents will not be subject to Canadian income tax on gains realized on disposition of stock of non-real estate based businesses. As such, valuations based on multiples of earnings are not impacted when Canadian pension plans compete for investment opportunities with foreign interests.

Notably, in some instances pension plans may have an inherent higher cost of capital than other non-pension investors due to their own pension liabilities, making them less likely to pay a higher purchase price (and accept a lower return) than competing investment interests.

The consultation document also suggests that permitting pension plans to hold a greater than 30 per cent voting stake in Canadian corporations and businesses could influence businesses to incur more debt than would be prudent, with the intent of utilizing interest expense to lower income subject to taxation. In our experience, the use of leverage to increase overall returns is a commonplace strategy employed for tax and non-tax reasons by tax exempt and taxable investors alike. Notably, investors acquiring Canadian businesses will often utilize debt financing from non-resident, third party lenders not subject to Canadian thin capitalization restrictions. Furthermore, where taxable investors and third party fund managers inject their own debt into businesses they acquire, those loans are generally not subject to thin-capitalization.

The ability of pension plans and other tax exempt investors to insert debt into existing investments is a function of many factors, both tax related and non-tax related. The use and amount of such debt is also contingent on other commercial considerations (such as the security package, market interest rates, the lending environment in the case of external debt, the need to conform to the arm's length standard for internal debt, etc.), as well as the concerns of other co-investors and third party lenders.

All of the above is not to suggest that tax considerations play no part in investment decisions of Canadian pension plans but rather that tax is not, by far, the predominate consideration. We suggest it is only one of many factors that must be considered by Finance with respect to discerning any potential advantage relative to other Canadian and international investors.

Response to the tax policy consultation questions

In our view, a discussion of specific legislative changes to the *Income Tax Act* is unnecessary at this stage given our perspective that the underlying tax policy concerns expressed in the consultation paper are not material enough to justify imposition of taxation on pension investment. Notably, however, we observe that if Finance were to consider extending the SIFT (specified investment flow through) rules as currently drafted to pension plan investments, such rules would be overly broad and inconsistent in terms of how they might apply to direct pension plan investment and indirect investment through private equity and infrastructure funds. We would also suggest that given that existing pension investments were made based on the current taxation scheme, any changes to the taxation of pension

plans or their investments ought to apply to prospective and not existing investments. This is particularly the case given that investment decisions were predicated on meeting pension liability obligations to pension members based on current tax law.

Closing Remarks

The primary tax policy concern expressed by Finance associated with the elimination of the 30 per cent rule is whether the removal of the rule will result in an inappropriate advantage to businesses owned by Canadian pension plans as compared to those businesses owned by non-pension investors. In our view, the 30 per cent rule or its lack of application has no impact on this consideration. Other tax exempt domestic and foreign investors acquire and hold Canadian businesses without application of the 30 per cent rule to their investments. In practice, we have not seen evidence of inequities arising from the tax status of investors acquiring Canadian business interests, nor has Finance provided any such evidence in the consultation document.

The current Canadian pension plan investment and taxation scheme is important to millions of Canadian pensioners and their pension returns. Introducing significant changes to the *Income Tax Act* to effectively tax Canadian pension monies invested in Canadian business through an extension of the SIFT and/or thin capitalization rules to pension plan investment would be a major policy and technical change to the Canadian tax system that would impact Canadian pension plans. Given these considerations, we believe that it is incumbent on Finance to provide empirical evidence of the magnitude of the potential cost to Canadians that would justify making such changes.

More specifically, we suggest that key issues are not fully addressed in the consultation document, including:

1) What public policy considerations should be considered before making a material change in the approach in the taxation of pension plans?

2) What empirical evidence is there that the existing tax system results in an unlevel playing field between pension plan owned businesses and those owned by taxable persons?

3) Does this evidence show that pension plan owned businesses are gaining market share or that pension plans are winning auctions largely or solely for tax reasons?

4) To what extent would any changes in tax policy impact recent federal and provincial government policy initiatives to promote assets classes such as infrastructure, clean energy and venture capital?

As mentioned above, providing comment on proposed legislative changes to the *Income Tax Act* is, at this time, premature. If further consultation and disclosures by Finance regarding the policy and economic considerations that Finance believes would justify any such proposed changes are put forward, we would be pleased to provide input at that time based on a better understanding of Finances' concerns.

In closing, we appreciate the initiative of Finance in engaging stakeholders such as bcIMC in this important discussion regarding prudent management of Canadian pension plan assets. We look forward to this ongoing open dialogue taking into account interests of all Canadians, including the members of the plans whose investments bcIMC manages.

Sincerely,

Gordon J. Fyfe, *Chief Executive Officer, Chief Investment Officer*