Consideration Of Government Of Canada’s Proposal To Remove 30% Rule For Pension Funds

Canada’s 2024 federal budget announced a working group to explore how to influence greater domestic investment opportunities for Canadian pension funds, including the removal of the 30% rule for domestic investments. The modification of the 30% rule, which limits the investment of Canadian pension funds in companies, has been considered by prior provincial and federal governments without any changes implemented. This article briefly explores how the context has changed both for Canadian pension funds, as global investment leaders seeking to maximize returns for their members, and the Canadian government, seeking to increase domestic investment to boost its economy. Time will tell if the reconsideration by the government of the appropriateness of the 30% rule will lead to an alternate conclusion and the consequences of such reconsideration.

Budget announcement

In its 2024 Budget, Canada’s federal government announced measures to increase domestic investment by some of its largest asset holders, including public pension funds. The government believes escalated investment by Canada’s largest public pension funds in Canadian businesses will unlock new opportunities for those businesses, contribute to the growth of Canada’s economy, and increase the pension funds’ investment returns.

This announcement builds on the 2023 Fall Economic Statement, where the government committed to working collaboratively with Canadian pension funds to create an environment that encourages and identifies more domestic investment opportunities for pension funds and other institutional investors.

This announcement also reopens earlier government consultations. In 2015, Ontario announced in its Economic Outlook and Fiscal Review that it intended to eliminate the 30% rule from Ontario pension legislation to open up new investment opportunities and tap the capacity of the pension sector to contribute more to economic growth. Then, after the release of its 2016 Budget, the federal government opened consultations to assess the value of the 30% rule in the prudent management of pension investments. The consultations also sought views on the tax policy issues associated with the growth of active investments by pension plans. Neither of those consultations resulted in changes to the 30% rule.

Budget 2024 announced that the government, working with pension plans, will create a working group, led by Stephen Poloz (former Governor of the Bank of Canada), and supported by the Deputy Prime Minister and Minister of Finance, to explore how to influence greater domestic investment opportunities for Canadian pension funds. This working group will identify priority investment opportunities that benefit both pension funds and Canadian citizens, with the goal of meeting Canadian pension plans' fiduciary and actuarial responsibility, spurring innovation, and driving economic growth. Its efforts will focus on several specific investment areas, including the removal of the 30% rule for domestic investments. This article reviews some of the considerations in removing the 30% rule for Canadian pension funds.

What is the 30% rule?

The 30% rule prohibits pension plan administrators from directly or indirectly investing plan assets in securities of a company to which are attached more than 30% of the votes that elect the company's directors. The 30% rule applies regardless of whether the investment is being made in Canada or elsewhere globally. The federal pension investment rules currently have exemptions from the 30% rule for certain corporations – real estate, resource, and investment corporations – if the prescribed disclosure and undertakings are provided to the pension regulator.

The 30% rule is currently included in the federal pension investment rules and has been incorporated into Canada's federal pension legislation and the pension legislation of almost every Canadian province. The intention of the 30% rule, as stated since its implementation, is to limit pension plans to more passive roles in companies they invest in, rather than managing the day-to-day operations. This was originally thought to reduce the risk of exposure to the business failure of any particular investment. The 30% rule is unique to Canada, as ownership concentration limits or similar restrictive legislation do not exist on investments of other international pension funds. Any changes to the 30% rule would impact almost all pension plans registered in Canada, regardless of the jurisdiction of registration.

Notably, while the 30% rule exists under Quebec legislation, in June 2015, the Government of Quebec enacted legislation to exempt one of Canada's largest pension funds, Caisse de depot et placement du Quebec (CDPQ), from the 30% rule in respect of investments in infrastructure corporations. Further, the CDPQ has a dual mandate established by legislation to (i) seek optimal returns, while (ii) contributing to the Province of Quebec's economic development, which have equal importance. As a result, CDPQ has made substantial investment into Quebec's infrastructure, such as public transportation. No other pension fund has a similar mandate to contribute to Canada's economic development.

In fact, another intention of the 30% rule was to prevent pension funds from acting as commercial businesses that control large portions of the Canadian economy. The legislators who implemented the restrictions on pension funds, including the 30% rule, raised concerns that a rise of pension fund-managed businesses might stifle entrepreneurialism in favour of stable cash-flow maximization. The 2024 Budget announcement acknowledges and encourages pension funds to influence the Canadian economy. This follows the changes to the CDPQ mandate, which is – in part – to contribute to the Province of Quebec's economic development.

Pension fund and institutional investment trends

This change in position explains why the government is considering the removal or relaxation of the 30% rule on Canadian pension funds. Canadian pension funds hold over $2 trillion in assets, which grow through member and employer contributions, and which are continually invested both in Canada and globally to provide secure retirement income for plan members and retirees. However, investment by Canadian pension funds in Canadian public and private companies, real estate and infrastructure has decreased over time.

The proposal in Budget 2024 for the removal of the 30% rule is only in respect of domestic investments in an effort to increase such pension fund investment in Canada. Indeed, global investment trends have shown increased nationalism in the world, with industries moving back or near to their home countries, as seen with Japan and the U.S.

Based on previous submissions, pension plan administrators and investment advisors would prefer the 30% rule eliminated for all assets, not just Canadian domestic assets. Canadian pension plans have been recognized as global investment leaders and no longer act as passive investors to obtain an appropriate return on investment. To meet increasing liabilities to pay pension benefits, pension funds have diversified their investments across the world in return-seeking ventures. Additionally, it will be difficult to define what amounts to an investment in Canada if the investment has a global exposure which includes Canada.

In 2005, Canada eliminated the foreign property rule that restricted pension fund investments in foreign assets. From the Canadian government’s perspective, it is attempting to attract Canadian pension investment dollars back to Canada following the elimination of the restriction on foreign investment. From the perspective of the pension fund, the equal treatment of all assets will provide benefits from investment diversification across both domestic and foreign assets.

Based on investment history and policies, pension funds prefer long term, stable investments in specific sectors, such as infrastructure, airports, roads and utilities. Many companies in Canada operating in those specific sectors are currently owned by the government in Canada, so Canadian pension funds have expanded investment in global projects. To attract domestic investment, the Canadian government may need to privatize these types of projects, similar to Quebec’s change to incentivize infrastructure investment from CDPQ.

The 2024 Budget states that the new working group will identify priority investments, such as physical and digital infrastructure, airport facilities and venture capital investment. Any changes made to loosen the pension investment restrictions in these areas will likely increase pension fund investment. Recognizing this, the Minister of Transport will release a policy statement in summer 2024 that highlights existing flexibilities under the governance model for Canada’s National Airport System airports to attract capital, including from pension funds.

Increased transparency has been an ongoing theme of regulators in their oversight of pension plans, which extends to plan investments. In the 2023 Fall Economic Statement and the 2024 Budget, the government committed to improving transparency around pension funds’ investments. Seemingly in connection with the encouraged expansion of investment in Canada, the government proposes to require the federal pension regulator to release certain investment information of pension funds, including the distribution of their investments by jurisdiction and by asset class within each jurisdiction. The government will also engage with provinces and territories to discuss similar disclosures by Canada’s largest pension plans in a simple and uniform format.

Effects of removing the 30% rule

Over the years, pension funds have developed complex investment structures to acquire greater than 30% of the equity of a company in a 30% rule-compliant manner. However, these structures increase transaction costs and complexity without any corresponding benefit to the pension fund or the plan beneficiaries. The structures allow the pension fund to own more than 30% of the equity of a company without controlling more than 30% of the votes.

The separation of equity from control has the potential to create corporate governance problems by misaligning management interests with shareholder interests. By eliminating the 30% rule, the interests of those with equity and with control in a company are combined to enhance oversight, accountability and effective risk management for pension fund investments. Any such change must be accompanied by proper oversight through a formal governance structure and adherence to the prudent person standard in pension investments. As well, the removal of the 30% rule will allow pension plans to reallocate savings on costs to other areas, such as plan administration.

Tax considerations

To enable employees to accumulate greater wealth for retirement purposes, pension plans do not pay tax on investment returns. In past consultations with respect to eliminating or relaxing the 30% rule, the government has asked if it should adopt any new tax rules to preserve the Canadian corporate tax base in the face of elevated levels of pension fund investment, similar to tax rules in the United States or elsewhere. For example, the U.S. Internal Revenue Code contains earnings stripping rules that limit the deductibility of interest payments made to pension plans and to certain other investors in specific circumstances. It also imposes an unrelated business income tax on pension plans and other tax-exempt entities that derive certain types of income directly or indirectly through a flow-through entity. To a certain extent, these concerns have been alleviated by the recent proposal for Canadian earnings stripping limitations in the form of the excessive interest and financing expenses limitation (EIFEL) rules. Once enacted, the EIFEL rules will generally apply to corporations and trusts with taxation years beginning on or after October 1, 2023.

Looking forward

From a Canadian perspective, investments in Canada have a considerable impact on the country’s economy by creating jobs, growing businesses and increasing incomes for Canadians. Canadian pension funds benefit from government sponsorship and tax favourable treatment of assets and investment income. Balancing the two is challenging and any change to the system should be met with careful consideration. However, the original rationale of the 30% rule – to prevent pension funds from acting as commercial businesses and to limit pension plans to more passive roles in companies they invest in – is no longer pertinent in today’s market economy. Reconsideration by the government of the appropriateness of this pension fund investment restriction is warranted.

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