Upcoming Pension Investment Changes To Ontario-Regulated Pension Plans: A Primer

On March 25, 2015, the federal government published amendments to the *Pension Benefits Standards Regulations, 1985*(Canada) (PBSR) that were first proposed in draft form on September 19, 2014. While these amendments will obviously affect federally regulated pension plans, one large element of these changes – relating to the pension investment rules – will be relevant to many pension plans across the country, including Ontario-regulated plans. This is because several jurisdictions have incorporated by reference the PBSR limitations on pension investments, Quebec being a notable exception. This article focuses on those investment-related changes (Investment Changes).

Administrators of Ontario-regulated plans will recall that certain sections of the federal investment regulations (FIR) under the PBSR are incorporated by reference into Ontario pension standards laws.[1] For greater clarity, in this article, "FIR" refers only to those portions of the PBSR that have been incorporated by reference in Ontario. For Ontario-regulated plans, this will be a relevant distinction; however, it should not be relevant for federally regulated plans.

Timing

Most of the Investment Changes will become effective on July 1, 2016, although a few portions, including housekeeping amendments, will become effective earlier, on April 1, 2015.

Practical Tip for Ontario-Regulated Plans

Given that administrators of most Ontario-regulated pension plans will be reviewing their statements of investment policies and procedures (SIPPs) sometime during 2015 – in order to be ready for Ontario's requirement to amend SIPPs to address how, if at all, environmental, social and governance factors are considered in investment decisions and to prepare SIPPs to be filed with the Superintendent of Financial Services by March 1, 2016[2] – it may make sense to also address the Investment Changes as described below in conjunction with this review so as to avoid the need to amend the SIPP and file it a second time, later in 2016.

Investment Changes

With the considerations above in mind, one can look at the Investment Changes as falling into two broad categories: (i) those that will affect "member choice" defined contribution plans (or components of plans), under which members direct investment of their accounts (MCPs), and (ii) those that will affect all other plans.

New Approach to MCPs Effective April 1, 2015

Effective April 1, 2015, a SIPP is no longer required for MCPs (or MCP components of larger plans). (See amended section 7.1 of the FIR.) Administrators of MCPs will instead be obliged to provide a new form of annual statement on the plan's investment options that provides details of each of the available funds, including the nature of its investment objectives, its risk profile, its 10 largest holdings, its performance history, its benchmark, its fees and its target allocation. (See new section 7.3 of the PBSR.) Much of this information is typically available in the form of fact sheets provided by the fund managers, and so it is unclear precisely what the new statement will look like.

The application of this requirement to Ontario-regulated plans will be particularly interesting. Because Ontario incorporated the FIR as "amended from time to time," the federal elimination of the SIPP requirement for MCPs effective April 1, 2015, would automatically become effective for Ontario-regulated plans as of that date unless Ontario amends the OPBR to avoid this result. Moreover, since new section 7.3 of the PBSR (prescribing the contents of the annual statement on investment options under MCPs) is not incorporated by reference into the OPBR, the additional disclosure elements for MCPs would not automatically apply in Ontario. In the absence of amendments to the OPBR, one would hope that the Financial Services Commission of Ontario or the Ontario Ministry of Finance would at least provide early public guidance on this gap.

Other Investment Changes Effective April 1, 2015

Some housekeeping amendments will modernize the FIR's terminology. These include the addition of a new, more broadly defined term, "investment fund," to replace the former term "mutual or pooled fund"; a new defined term, "marketplace,"[3] to replace the outdated defined term "public exchange" (which still refers to defunct stock exchanges across the United States and which omits global powerhouses like the Tokyo and Hong Kong stock exchanges and the Deutsche Börse); and of course a defined term for "member choice account."

Investment Changes Effective July 1, 2016

The balance of the Investment Changes will be effective July 1, 2016. The reason for the postponed effective date is likely that this tranche of Investment Changes, discussed below, is more substantive. There appears to be recognition that, depending on investment styles, administrators will need additional time to assess how these changes will affect their plans in order to develop thoughtful and appropriate strategies. These changes include the following:

- **10% Rule for Non-MCPs –** The core diversification rule, the 10% Rule, is undergoing its first change since its introduction in 1994, with a shift from testing on a book value basis to testing on a market value basis. Generally, the requirement is that no more than 10% of the assets of a plan may be invested in or loaned to any single person, affiliated corporations or associated persons. In a nutshell:
    - Administrators will not be required to make any changes to their approach to the current 10% Rule in advance of the July 1, 2016, effective date, although, as is explained below, in some circumstances it may make sense to terminate automatic dividend reinvestment programs (DRIPs).
    - On and after July 1, 2016, it will be necessary to ensure that if *new* loans are made or securities acquired, the total holdings following the investment will satisfy the limitation. That is, the test is undertaken only when new investments (including further investments in existing "entities") are made. As a result, there is no need for transitional rules and there is no risk that a drop in the value of some holdings will raise the relative value of other assets and necessitate re balancing to maintain compliance with the 10% Rule. This is a welcome clarification from the government's September 19, 2014, proposals.
    - Although not dealt with expressly, a takeover of one entity by another or other similar event that has the effect of causing previously unrelated entities to become affiliated corporations or associated persons does not appear to give rise to a violation of the 10% Rule, since that event is not a new investment undertaken by or on behalf of the pension fund.
    - The historical exceptions to the 10% Rule – for investments guaranteed by the Canada Deposit Investment Corporation or the Canadian Life & Health Insurance Compensation Corporation (the reference to which will be updated to "Assuris"), investment corporations, investment funds that themselves comply with the limitations in the FIR, assets held in the general fund of a life insurance company, securities issued by a government in Canada or guaranteed by it, and index funds – are continued, and a new exception for derivatives where the reference asset is an index fund has been added. In addition, it should be noted that the relieving provisions of section 18 of the FIR (which apply to certain reorganizations, amalgamations and similar events, and investments acquired following realization of a plan's security interests) remain unchanged and may also provide relief in those specific circumstances.
    - **Possible Action Items for Administrators –** While some administrators and/or their service providers already track both book and market values, those who don't currently track market value should work with custodians, managers and others to confirm that the methodologies used to compute these amounts are sensible and uniform. For administrators using DRIPs, because the acquisition of the additional shares of a corporation or other entity under that program is likely to constitute a new investment for purposes of the market value test, where a holding

is close to or over the 10% market value level, it will be necessary to consider whether the DRIP should be “turned off” to avoid a potential violation of the limit.

- **10% Rule for MCPs –** There has been some disagreement on how the 10% Rule should apply to MCPs: whether on a plan-wide basis or on a stand-alone basis to each member account. The Investment Changes clarify that the 10% Rule is to be applied at the member account level. However, the typical exceptions will apply, and one additional exception has been added: an investment fund that complies with the 30% Rule (which limits a plan from holding more than 30% of voting securities in most corporations). It is not clear why compliance with the 30% Rule is the basis for relief in this case.
- **Relieving Rule for Special Purpose Corporations –** A small but useful change relevant to those pension plans that hold investments through investment corporations, real estate corporations and/or resource corporations (each as defined in the FIR) is that it is no longer necessary for the required form of undertaking to be obtained before or coincident with the plan acquiring in excess of 30% of the voting securities of those corporations. After July 1, 2016, the requirement will simply be to obtain the requisite undertaking, without a specific time frame.
- **Major Changes to Related Party Investments/Transactions –** For many pension plans, the biggest change will be the requirement to cease holding shares or making loans to persons and entities that constitute a “related party” to the plan, within the meaning of the FIR (with the main related party being an employer contributing to the plan and its affiliates and similar entities). There is a five-year transitional feature (discussed below) that avoids the need for immediate action, but this change does mean that, in contrast to the open time frame of the 10% Rule, there is a clear sunset on some holdings. Specifics of the changes are as follows:
    - *General structure unchanged* – The construction of the provision remains as it always has been, with a general prohibition on investments in or loans to a related party or entry into a “transaction” (as defined in the FIR) with a related party.
    - *Nominal or immaterial* – As good news for administrators, the current exemption for related party transactions where the “value of the transaction is nominal or the transaction is immaterial to the plan” has been retained. (The September 19, 2014, proposals would have deleted it.)
    - *Elimination of “acquired at a public exchange” exception* – Historically, and consistent with the related party rules in section 8514 of the *Income Tax Regulations* (ITR), an investment in employer (and other related party) securities was permitted if the securities were acquired at (“traded on” is the phrase in the ITR) a listed public stock exchange. Effective July 1, 2016, this exception will no longer be available. However, indirect holdings of such securities in an index fund or other collective investment fund will be permitted on the theory that the employer cannot direct the investment strategies of such a fund. Additional exemptions to investments in related party securities have been added that mirror the exceptions under the 10% Rule. If none of the exemptions apply (including the nominal/immaterial exemption discussed above), existing holdings of employer or other related party securities will need to be divested by July 1, 2021.
    - *Relaxation of restrictions on non-investment related party transactions*

–Historically, arrangements involving a pension plan and related parties serving as service providers, lessors and the like had to fit within an exception requiring that the transaction be “required” for plan administration and on “market terms and conditions” or better. The September 19, 2014, proposals contained more restrictive provisions that would have prevented leasing arrangements between an employer (for instance) and a pension plan but would have allowed service provider agreements, but the final revisions have been altered in a way that allows sensible transactions. Essentially all non-investment transactions with related parties will continue to be permitted, provided that they are on market terms and conditions.

Conclusion

Most of the revisions are clear and an improvement on the September 19, 2014, proposals. In general, we do not expect that the Investment Changes will demand wholesale changes in a plan’s investments or strategies. However, for those plans holding employer (or other related party) securities directly, it will be necessary to develop an orderly divestment strategy so that these holdings are eliminated by July 1, 2021. More immediate action will be required in 2015 or early 2016 to update each plan’s SIPP.

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