FTR Now

Proposed Investment Rule Changes for Registered Pension Plans

Date: September 26, 2014

On September 19, 2014, the Department of Finance Canada released proposed amendments to the federal Pension Benefits Standards Regulations, 1985 ("PBSR"). The proposed amendments would modernize the pension investment rules applicable to pension plans registered in many Canadian jurisdictions. Specifically, these changes will, if adopted as drafted, impact the investments that are permitted to be held by federally regulated pension plans and by pension plans regulated by provincial pension legislation in Ontario, Alberta, British Columbia, Manitoba, Newfoundland and Labrador, or Saskatchewan ("Specified Jurisdictions"), all of which have adopted Schedule III of the PBSR, as amended from time to time (the "Federal Investment Rules").

The Federal Investment Rules supplement the general requirement under pension legislation that pension plan investments be prudent. This *FTR Now* reviews the proposed changes to the Federal Investment Rules and their implications for administrators of pension plans that are registered in the Specified Jurisdictions.

The PBSR amendments released on September 19, 2014 include other changes that affect only federally regulated pension plans, which will be reviewed in a separate *FTR Now*, to be released shortly.[1] These other proposals aim to improve the regulatory framework for defined contribution plans and to enhance member disclosure for all types of federally regulated pension plans.

THE 10% LIMIT

The current Federal Investment Rules generally prohibit plan administrators from investing more than 10% of plan assets in an entity or any associated or affiliated entities, subject to certain exceptions. The purpose of the 10% limit is to ensure diversification of a pension fund's investments. The current 10% limit is based on the "book value" of the plan's investments. The proposed amendments change the rule by measuring the 10% limit based on the "market value" of the plan's assets, which reflects the change in the value of investments over time. The amendments also clarify that the 10% limit applies to the total of debt and equity.

Existing exceptions to the 10% limit will continue to apply to:

- moneys of a plan held by a bank, trust company or other financial institution to the extent that the investments are insured by the Canada Deposit Insurance Corporation, Assuris or

other similar provincial body; and
- investments in:
    - investment funds or segregated funds that themselves comply with the Federal Investment Rules;[2]
    - an investment corporation, real estate corporation or resource corporation;
    - the general fund of a Canadian life insurance business;
    - Government of Canada or provincial government or agency-issued or guaranteed debt; and
    - a fund composed of mortgage-backed securities that are fully guaranteed by the Government of Canada, a provincial government, or agency thereof.

The current exception to the 10% limit for funds that replicate the composition of certain listed stock exchange indices is expanded by the proposed amendments. The exception is broadened so that the 10% limit will not apply to investments designed to track the performance of a wider variety of market indices. Specifically, this exception will apply to investments that involve the purchase of a contract or agreement in respect of which the return is based on the performance of a widely recognized index of a broad class of securities traded at any marketplace.[3]

MEMBER CHOICE ACCOUNTS

The proposed amendments also create new rules that apply to “member choice accounts” which include defined contribution and other accounts such as flexible pension accounts within a defined benefit plan that permit member-directed investments. Previously, member choice accounts within pension plans were not individually subject to investment restrictions. Rather, the restrictions applied to the pension fund as a whole.

If the PBSR is amended as proposed, member choice accounts will become subject to the 10% market value limitation and most of the exceptions noted above. One notable difference is that instead of the investment fund and segregated fund exception described above, there will be an exception for “member choice accounts” which exceed the 10% concentration limit for holdings in investment funds or segregated funds provided those funds do not hold shares (or other interests) to which are attached more than 30% of the votes to elect the directors to any single corporation. Most fund offerings under defined contribution plans are well diversified and are expected to comply with this restriction.

TRANSITION

No transition rules have been specified for the changes to the 10% limit.

RELATED PARTY INVESTMENT RULES

Another significant change in the proposed amendments relates to the related party investment

rules. The changes are intended to tighten the prohibitions against investing in related parties to enhance diversification between employment-related risks and pension investment-related risks and ensure that pensions are invested in a safe and responsible manner.

Related parties include the plan administrator, a person responsible for holding or investing the assets of the plan, any employer who participates in the plan, any entity that holds a substantial investment in the employer, affiliate corporations, and corporations that are directly or indirectly controlled by a person who otherwise falls within the definition of related party, in addition to other listed persons.

MANNER OF ACQUIRING RELATED PARTY SECURITIES

Currently, plan administrators may invest pension plan assets in the securities of a related party if those securities are acquired at certain listed public exchanges. This provision is removed in the proposed amendments and the manner of acquiring related party securities is no longer relevant. The provisions are now more restrictive than the prohibited investment rules applicable to registered pension plans under the Income Tax Regulations.

NOMINAL OR IMMATERIAL RELATED PARTY TRANSACTIONS

The current Federal Investment Rules also contain an exemption that permits the administrator to enter into a transaction with a related party if the value of the transaction is nominal or immaterial. The PBSR does not define a threshold for a nominal or immaterial transaction and plan administrators have been required to define the scope of these terms within their Statements of Investment Policies & Procedures (“SIPPs”). The proposed changes remove the nominal or immaterial exemption entirely and prohibit related party investments except as specified.[4]

A key exception to the ability of a pension fund to hold related party investments applies where the investment is made through an investment fund or segregated fund that is available to investors other than the plan administrator and its affiliates, and (i) the fund itself complies with all of the Federal Investment Rules, or (ii) for investments applicable to a member choice account, the fund does not hold shares (or other interests) to which are attached more than 30% of the votes to elect the directors to any single corporation.

Another important exception applies if the related party investment involves the purchase of a contract or agreement under which the return is based on the performance of a widely recognized index of a broad class of securities traded at a marketplace (for example, an investment that tracks the S&P 500).

Exceptions also apply to any related party investment in:

- the general fund of a Canadian life insurance business;

- Government of Canada or provincial government or agency-issued or guaranteed debt; and
- a fund composed of mortgage-backed securities that are fully guaranteed by the Government of Canada, a provincial government, or agency thereof.

PLAN OPERATION AND ADMINISTRATION SERVICES BY A RELATED PARTY

The proposed amendments clarify that an administrator may engage the services of a related party for the operation or administration of the plan provided the transaction is on market terms and conditions. Previously, the requirement was that the transaction must also have been required for the operation or administration of the pension plan.

TRANSITION

Pension plan administrators will have five (5) years from the date the changes come into force to divest of related party investments in order to comply with these new provisions. If, on a go-forward basis, the administrator runs afoul of the related party rules as a result of a transaction by the employer, the administrator would have five (5) years within which to bring the plan investments into compliance with these requirements.

IMPLICATIONS

If the proposed amendments to the PBSR are passed, the changes to the Federal Investment Rules will have implications for the administrators of pension plans registered in the Specified Jurisdictions. It will be necessary for administrators of these pension plans to review investment manager agreements, investment fund documentation, compliance processes and the fund's SIPP, and make changes as appropriate.

The proposed amendments to the PBSR are intended to come into force on the same day as the *Pension Benefits Standards Act, 1985* amendments in Bill C-47, Sustaining Canada's Economic Recovery Act. A target implementation date has not yet been announced. A 30-day comment period commences on the official publication date of the proposed PBSR amendments in the *Canada Gazette*, September 27, 2014.

If you have any questions regarding the proposed changes to the Federal Investment Rules, or wish to submit comments to the Federal Department of Finance, please contact a member of Hicks Morley's Pension, Benefits and Executive Compensation Group.

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[1] Federally regulated pension plans include plans for employees employed in shipping, railway, air transportation, radio broadcasting, banks and other businesses within the legislative authority of the Parliament of Canada.

[2] A new definition of “investment fund” will replace the definitions of “mutual fund” and “pooled fund.” As defined, an investment fund includes pooled funds and mutual funds whether created as corporations, trusts, or limited partnerships and, in general terms, provides for the pooling of investments with unitholders holding a proportionate interest in the assets of the fund.

[3] A new definition for “marketplace” includes all investment platforms in recognition that pension plan investments may be bought/sold not only on public exchanges, but also on quotation and trade-reporting systems and other platforms.

[4] There are, however, no proposed amendments to section 7.1(h) of the PBSR, which requires that a SIPP set out the criteria used to establish whether a transaction is nominal or immaterial to the plan. It is not clear whether this was intentional, but this requirement for SIPPs is arguably unnecessary if the nominal and material exception to related party transactions is eliminated.