Ontario Considers Elimination Of 30% Corporate Control Limit

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Most pension plans in Canada are limited to holding no more than 30 percent of the voting shares of a corporation – elimination of the rule by the Government of Ontario will provide new opportunities for investment managers of Ontario-registered pension plan assets by providing access to a larger universe of potential investment opportunities – the 30 percent limit applies regardless of whether the investment is being made in Canada or elsewhere.

The Ontario government has recently announced that it intends to eliminate the 30 percent corporate control restriction contained in Ontario pension legislation. The unanticipated statement was contained in the government's 2015 Ontario Economic Outlook and Fiscal Review and reflects the government's desire to "open up new investment opportunities and tap the capacity of the pension sector to contribute more to economic growth."1 The Ontario government had already been considering an exemption to the limit for investments in public infrastructure having identified this as an opportunity in 2013; and also follows on from the previous Federal government's proposal to undertake public consultation on the usefulness of the limit in federal law.

Description and Rationale for the Rule

Schedule III to the Pension Benefits Standards Regulations, 1985 (Canada) ("Schedule III"), which has been incorporated into the local pension legislation of most provinces of Canada including Ontario, prohibits the administrator of a pension plan from directly or indirectly investing the moneys of the pension fund in 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.2 Investments in "investment corporations", "real estate corporations" or "resource corporations" are not subject to this limit3 provided the corporation deposits the required undertaking with the regulator.4

The rule has a number of underlying rationales including the view, possibly now outdated, that investments of pension plans should be of a passive nature. At the time Schedule III was enacted, the separation of financial and commercial spheres of economic activity was seen as desirable and pension plans should not be viewed as commercial businesses that controlled commercial enterprises in the Canadian economy. Underlying these views was the concern that an increase in pension-

managed commercial enterprises would stifle innovation and entrepreneurship in favour of an emphasis on more stable cash flow.

Time for Change

The Ontario government intends to publish the proposed change for public consultation sometime in early 2016. Scant detail exists at the moment except for a reference contained in the announcement that pension plan administrators "would continue to be required to exercise a fiduciary standard of care, diligence and skill in the administration and investment of the pension fund."5

Some commentators have argued that the limit should be removed because it:

- has been applied and enforced inconsistently;
- puts Canadian pension plans at a competitive disadvantage; and
- separates equity ownership from control which inevitably leads to governance issues.

Over the years pension plan administrators in Canada together with their advisors and investment managers have developed complex investment structures in order to obtain 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. Such technical compliance was achieved through the use of convertible debt or restricted voting shares among other tools. These structures were approved by regulators with the result that transaction costs increased, which costs were ultimately borne by plan beneficiaries.

Similarly, Canadian pension plans have argued that they are at a disadvantage when competing with foreign plans for high quality investment alternatives. In the current low yield environment this disadvantage has been exacerbated resulting in a mismatch as between plan liabilities and investment returns in the medium to long term.

Finally, governance experts argue that the 30 percent rule disaggregates ownership from control and removes a critical mechanism – the ability of a pension plan to elect or remove directors in circumstances where the plan has greater than a 30 percent equity stake in the corporation. Permitting a plan to fully vote the equity that it owns can only enhance accountability and oversight of its investments.

A Way Forward

It is not clear whether the 30 percent rule will be eliminated completely or whether it could be eliminated only for certain plans. For example, the Ontario government could eliminate the restriction for plans of a certain size or for plans that have the necessary resources and expertise in place, including policies and procedures, to effectively monitor and oversee an active and controlling investment.

A way forward might also be for renewed emphasis on principles-based regulation and specifically guidance around prudence by the administrator to achieve reasonable return in light of risk across the entire portfolio of investments as opposed to reliance on a prescriptive limit that is in large measure outdated in today's investment environment.

1 Building Ontario Up, Progress for Prosperity. Ontario Economic Outlook and Fiscal Review, 2015 Background Papers, p.65.

2 Schedule III, s.11(1)

3 Schedule III, s.11(2)

4 The undertaking that is filed with the Superintendent (OSFI), or FSCO in the case of Ontario plans (or applicable regulator for other provinces), requires, among other things, restrictions on the activities of the corporation and that certain prescribed financial information including audited financial statements, lists of the corporation's assets, its officers and directors be delivered to the Superintendent, and authorisation to the Superintendent to attend at the corporation's offices and examine its books and records.

5 Ontario Economic Outlook and Fiscal Review, 2015 Background Papers, p. 65

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