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INVESTMENT RULES FOR PENSION PLANS

(Prescribed under the *Pension Benefits Standards Act, 1985* (PBSA) and the *Pension Benefits Standards Regulations, 1985* (PBSR))

Issues Related to the Application of the 10 per cent Concentration Rule

A Consultation Paper prepared by the
Canadian Association of Pension Supervisory Authorities (CAPSA)

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The Canadian Association of Pension Supervisory Authorities (CAPSA) welcomes the comments, suggestions and ideas of pension stakeholders regarding the issues addressed in this paper. The paper can be found on CAPSA's website at www.capsa-acor.org. Written submissions or questions should be forwarded to:

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We look forward to receiving your submissions by June 30, 2003. Electronic copies of submissions would be preferred. As it is the intention of CAPSA to publicly release the submissions received in this consultation process, please indicate if you do not wish your submission to be made public.

Please note that the proposed directions in this paper should not be construed as the official position of any provincial or federal government or agency.

Issues Related to the Application of the 10 per cent Concentration Rule

The 10 per cent rule provides that no more than 10 per cent of the total book value of a plan's assets may be lent to or invested, directly or indirectly, in any one person, two or more associated persons, or two or more affiliated corporations *[Schedule III, ss. 9(1)]*. Certain kinds of investments are exempt from the 10 per cent rule *[Schedule III, ss. 9(2) and (3)]*.

ISSUE 1 Whether the 10 per cent rule should be based on book value or market value and how frequently investments should be monitored for compliance

Proposed Direction

The 10 per cent rule should be based on market value. Compliance with the rule should be ensured by the plan administrator for each new investment and all investments in the portfolio should be monitored at least quarterly (every three months).

Rationale

Stakeholders suggest that use of book value is not practical, especially for indirect investments. For member-directed defined contribution plans, use of book value is especially difficult in determining acquisition costs, monitoring and keeping records. In addition, because book value does not reflect an asset's current value, it may not provide an accurate measure of a plan's current risk.

Market value provides a more accurate measure of concentration risk at any given time. Reporting on a market value basis is the norm for financial statement purposes, and doing so would be consistent with the way concentration is measured for mutual funds and individual variable insurance contracts.

Recognizing that market value may not be readily available for investments other than publicly traded securities, some stakeholders suggest these investments should be valued in accordance with CICA standards as per the CICA handbook.

Finally, market valuation should also replace book valuation for the 5/15/25 per cent rules which limit concentration of a plan's investments in real properties or Canadian resource properties *[Schedule III, s. 10]*.

Implementation Considerations

1. If market value is adopted, how much time should plans have to convert to the new standard? What transitional issues should be addressed to prevent a major disruption for plans?
2. If a plan's investments exceed the 10 per cent limit under market value, how should they be handled?
3. Are there some instances in which "pure" market value would not be appropriate, such as real estate and private placements? Would a combination of book and market be more appropriate for these instances?

ISSUE 2 The 10 per cent rule and indirect investments

Indirect investments must be taken into account in the application of the 10 per cent rule *[Schedule III, s. 2]*. The "look through" provision requires plan administrators, in measuring the exposure to a single entity, to take into account investments made through pooled-like funds (mutual funds, segregated funds and index funds) in addition to direct investments the pension fund makes.

Proposed Direction

Status quo - the 10 per cent rule should continue to apply to indirect investments through pooled-like funds unless the investment is already exempted under the rules.

Rationale

Some stakeholders object to the 10 per cent rule being applied to indirect investments made through pooled-like funds. They are of the view that it is impractical and inefficient to require, for example, a mutual fund selected as a pension investment vehicle to comply with two regulatory regimes (pension and securities), particularly since the two regimes are quite similar. They also suggest that with respect to index funds, market capitalization is the most efficient diversification method. Further, they maintain that applying the 10 per cent rule to indirect investments adds to the cost and complexity of monitoring investments and may result in pension funds forgoing better returns for the sole reason of satisfying the quantitative limit.

However, applying the 10 per cent rule to indirect investments is consistent with the objective of ensuring that a pension plan does not invest too much of its assets in any one enterprise and thus increase its risk exposure. It prevents a plan from exceeding the 10 per cent limit by investing in pooled-like funds and discourages a two-level system, one for direct/active management and another for users of pooled-like funds.

Applying the 10 per cent rule to all investments helps prevent what is referred to as the "contagion effect" whereby various investments are adversely affected by poor results in one part of the portfolio. Investors must be aware of their total exposure, and should be encouraged to implement proper monitoring mechanisms to ensure adequate transparency of their investments. Fund managers must know their client and be fully aware of the regulatory environment.

Some stakeholders have noted that investment managers usually invest 10 per cent or less of the plan's assets in one entity as a matter of prudence and there is no need for a specific limit, especially for indirect investments. However, an investment that may be prudent for one plan may be imprudent for another. Removing the 10 per cent limit on indirect investments may encourage greater risk to the plan through increased concentration.

ISSUE 3 The 10 per cent rule and conglomerates

The 10 per cent rule currently applies to the aggregate of investments made by a pension plan in each entity of a "conglomerate". Therefore, if the pension plan invests 10 per cent of its assets in any one entity, it will not be able to invest at all in another entity that is part of the conglomerate.

Proposed Direction

The holdings in each entity of a conglomerate would not have to be aggregated in determining compliance with the 10 per cent rule. Rather, the 10 per cent rule would be applied to each entity of the conglomerate, subject to the prudent investment standard.

Rationale

Some stakeholders want the rule changed so that investments made in a conglomerate would not have to be aggregated for the purpose of complying with the 10 per cent rule. Rather, the 10 per cent rule would apply to each entity of the conglomerate. Their arguments for this approach are:

- Application of the 10 per cent rule to the aggregate of investments in a conglomerate restricts the pension plan from investing in any other related entity, even though that entity may be carrying on a totally different business. An investment in that entity might achieve greater diversification but would not comply with the 10 per cent rule.
- The Canadian stock markets are continually being exposed to higher levels of investment concentration because of domestic and foreign take-overs. This is tending to restrict the number of eligible quality investment opportunities in Canada.
- The foreign content annual limit to which pension funds are subject also restricts investment opportunities.

- Conglomerate structures are frequently complex and difficult to monitor, with various forms of investment that must be aggregated, including publicly traded equity shares and bonds, private placements, private equity, etc. There is no centralized source of data that summarizes and updates conglomerate structures and holdings, which creates difficulties in monitoring compliance.
- Conglomerates, especially large ones, tend to be better diversified than single product/service companies and tend to have characteristics similar to closed-end, incorporated mutual funds.

Exempting investment holdings in various entities within a conglomerate from being aggregated may, where the entities are in different businesses, allow for greater diversification. The prudent standard, which applies to all investments made by a pension fund, would discourage over-exposure in different entities within a conglomerate where the risks are similar or are inter-related. This approach would recognize the practical difficulties inherent in applying the 10 per cent rule to conglomerates and provide greater flexibility to invest in entities that are corporately-linked but are otherwise unrelated.

However, it is acknowledged that completely exempting these holdings from being aggregated would mean that the 10 per cent limit would not apply on an aggregate basis to entities within less diversified conglomerates. Further, by permitting greater concentration of investments in one corporate structure, the proposed exemption could increase a plan's exposure to risks that affect the entire conglomerate structure, arising, for example, from financial linkages between entities in a conglomerate.

Implementation Considerations

1. How should "conglomerates" be defined? Should a distinction be made between corporate groups that are well diversified and others that are concentrated in one or a few sectors? Because the general literature does not describe conglomerates in precise terms, stakeholders should provide a definition of "conglomerates" to assist regulators in being able to identify the type of corporation that would be eligible for the proposed exemption
2. If a plan wants to invest in different entities of a conglomerate, how much detail should go into the Statement of Investment Policies and Procedures?

3. Are there other ways to address this issue for conglomerates, such as increasing the limit on the aggregate value of investments in a particular conglomerate to, for example, 20 per cent of a plan's assets, subject to compliance with the prudent investment standard?

ISSUE 4 The 10 per cent rule and debt/equity

Some stakeholders have suggested that the rules are not clear as to whether the 10 per cent limit applies to the total of debt and equity or to each separately *[Schedule III, sections 1 and 9]*.

Proposed Direction

Clarify that the 10 per cent rule applies to the aggregate of debt and equity.

Rationale

Clarifying this would limit the exposure to a single entity and avoid investments of up to 20 per cent in a single entity. It also achieves better diversification of company-specific risk.

ISSUE 5 At what level should the 10 per cent rule apply to "member-directed DC plans"

The federal investment regulations do not specify at what level the 10 per cent rule applies to such plans and how they must be monitored. An interpretation that the rule applies at the member level is the best way to ensure that all plan members with individual accounts are subject to the same requirements. However, it is recognized that there are practical difficulties in applying the rules at the member level for member-directed DC plans.

Proposed Direction

Revise the rules to provide that all the federal investment rules, including the 10 per cent rule, apply at the member level but compliance can be achieved by only offering investment funds that in themselves are fully compliant.

Rationale

In practice, this would mean that plans could choose to offer to members only investment options that comply with the rules. This would be significantly easier and less costly than requiring monitoring at the individual member level.

One problem with requiring compliance at the plan level is that new members may be restricted in their options to keep the overall plan limit under 10 per cent. This would be avoided by ensuring that each fund in which members can invest complies with the 10 per cent rule, as all members would be offered the same options, all of which are compliant.